FALSE PROFITS

HOW AUSTRALIA’S FINANCE SECTOR UNDERSALUES THE ENVIRONMENT
AND WHAT WE CAN DO ABOUT IT
ARE FINANCIAL markets a force for environmental sustainability, or are they an impediment?

This simple, challenging question was posed ten years ago by Stephen Schmidheiny and Federico Zorraquín, two leading businessmen writing in collaboration with the World Business Council for Sustainable Development.

Their response is complex and nuanced, but the short answer is this: it's up to us.

One of their important insights is that we can expect markets to support sustainable development only where we have created the necessary frameworks for markets to measure and value the environment and environmentally sound economic activities. They called for the development of new ways for the finance sector to understand and value the environment.

Their question and their call to action are, if anything, even more pressing today.

Australian environments are under tremendous pressure. The number of extinct, endangered or vulnerable Australian species rose by 40% from 1993 to 2003, and many endangered species are in continued decline.

Australia’s greenhouse emissions per capita remain among the highest in the world, while climate change threatens our ecosystems, agricultural productivity, great Australian icons such as the Great Barrier Reef, the Alps and Kakadu, and the communities and businesses that depend on them.

Increasing demands on our water and marine resources are adding to the damage to our rivers and oceans.

The economic activities that underpin these environmental stresses have the backing of the financial markets. However, unless these environmental problems are remedied, they will all have detrimental economic consequences, which will erode the finance sector’s vitality as well.

There are also significant economic opportunities in tackling our environmental challenges. Cutting waste is good for the environment and productivity. Healthy natural areas are the basis for one of Australia’s largest economic sectors – tourism. Healthy landscapes are the foundation for our primary industry. Renewable energy is the fastest growing energy sector worldwide, and part of the solution to climate change.

The challenge, then, is to ensure that frameworks for financial decision-making result in financial capital being put to good and productive uses that minimise the stress placed on the natural environment and maximise the economic and environmental benefits of business activity.

Fortunately, an increasing number of financial institutions are realising that financing environmentally damaging activities is not in anybody’s best interests. Some leading finance businesses are designing new and innovative ways to integrate long-term environmental issues into their core financial decision-making processes.

This report highlights some of these new initiatives, which demonstrate the practicality and effectiveness of environmental sustainability in finance. It also outlines public policy reforms that would inform and promote the development of financial markets that fully value the environment.

There is much progress still needed to put Australia’s finance sector on an environmentally sound footing. We hope this report contributes to that process.
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EXECUTIVE SUMMARY

This report is about the financial decision-making processes that lead to false profits, and how we can reform them. By drawing lessons from ten successful innovations in the finance sector, and supplementing them with a set of public policy reforms to address structural defects in the financial system, this report describes a possible pathway towards a sustainable finance sector in Australia.

By false profits, we mean financial returns earned by imposing unsustainable burdens on the natural environment. These narrow financial returns are illusory; they can be regarded as “profits” only if one disregards their collateral environmental and financial costs, and the long-term erosion of environmental health and the societies and economies that depend on it.

PART I
SHARPENING THE BUSINESS CASE FOR SUSTAINABILITY IN THE FINANCE SECTOR: REASONS FOR ACTION

Sustainability is important for the finance sector foremost because the long-term success of financial enterprises is inextricably linked to that of the overall economy and its ecological foundation. Investments that generate short-term financial returns while degrading the environment are, in the end, self-defeating for the finance sector, even from a narrow profit-maximising perspective.

Most large financial institutions and institutional investors approximate “universal investors”, or investors that are so diversified that they hold a roughly representative stake in an entire economy. Their prosperity depends on the prosperity of the nation as a whole, rather than the fortunes of any particular business or sector.

Such financers are exposed to the environmental externalities of the very activities they finance. For example, a bank that lends to a power plant is exposed not only to the risks and rewards of the power plant’s operations, but also to the damage pollution from the power plant could impose on other activities, in which the bank also has a stake.

The traditional analytical tools on which financing decisions are based are ill-suited to furthering the interests of a modern, highly diversified financial institution. Tools such as credit risk assessment and most mainstream equity valuation methods focus on the potential returns from a specific transaction, but are not concerned with environmental externalities that may affect other parts of the financer’s portfolio. The inadequacy of these traditional tools is a major reason for finance sector institutions to develop innovative new ways of ensuring their financing decisions are environmentally sustainable.

There are other, more widely recognised justifications for financial sector businesses to improve the sustainability of their core activities. For example, activities with heavy environmental impacts may be more risky from a financial perspective and, for a secured lender, environmental liabilities could impair the value of collateral. Further, financing of environmentally damaging activities may expose an institution to reputation damage, with consequent impacts on consumer loyalty, staff morale and recruitment ability.

PART II
TEN EFFECTIVE, DEMONSTRATED FINANCE SECTOR INNOVATIONS THAT ENHANCE THE ENVIRONMENT AND LONG-TERM PROFITABILITY

Having recognised the alignment of its long-term financial interests with environmental sustainability, the more daunting challenge for any institution is to design and implement core business reforms that enhance sustainability yet still make business sense, in competitive markets and regulatory systems that may discourage or even penalise far-sighted initiatives.

The following ten areas for reform take up this challenge. For each, a short description of the nature of the problem and the solution called for are given, along with a key example by a successful finance sector institution that demonstrates the practicality and effectiveness of the solution. These examples illustrate the feasibility of positive, meaningful reform under current market and regulatory conditions, as well as recognising the creativity and accomplishments of institutions showing genuine leadership.
1. MEASUREMENT, ANALYSIS AND DISCLOSURE OF AGGREGATE ENVIRONMENTAL CHARACTERISTICS OF INVESTMENT PORTFOLIOS

Few if any financial institutions measure, assess or disclose their indirect contribution to major environmental impacts, such as greenhouse pollution and water use. As a consequence, most are unable to assess how resilient their portfolios are to environmental and regulatory changes, and have little notion of how their portfolios compare to their competitors’. Measuring the indirect effects of investment activities on a whole-of-portfolio basis, rather than focusing on specific investments in isolation, allows an institution to get a clearer sense of the total potential effect of environmental issues on its business.

**KEY INITIATIVE:**
JP Morgan Chase has committed to disclosing the aggregate greenhouse gas emissions of its energy investments portfolio from 2006.

2. ENHANCED CLIENT AND TRANSACTION ASSESSMENT PROCEDURES

Traditional credit risk and other forms of financial analysis fail to address environmental externalities a particular business may impose on other constituents of an overall portfolio. Further, credit risk analysis has in the past tended to undervalue long-term environmental, regulatory, and reputation risks. Credit risk assessment should be strengthened by more rigorous and specific analysis of salient environmental issues, and should be supplanted by additional procedures to ensure environmental externalities are fully considered.

**KEY INITIATIVE:**
ABN AMRO’s risk assessment procedures are detailed and robust, with sector-specific policies requiring consideration of environmental concerns, and dedicated staff with sustainability expertise working in parallel with the credit risk assessment process.

3. IMPROVED FINANCIAL ANALYSIS OF ENVIRONMENTAL ISSUES

Demand for rigorous financial analysis of the impacts of longer-term environmental issues and trends is low, in part because of the chronic short-term focus of capital markets. The investment community does not generate sufficient information to assess the long-term investment implications of climate change and other important issues. Deliberate dedicating of resources to financial analysis of key environmental issues helps facilitate meaningful incorporation of environmental issues into investment decision-making.

**KEY INITIATIVE:**
The Enhanced Analytics Initiative is an effort to stimulate specific demand for improved analyses of long-term social, environmental and governance issues. Participating institutions agree to dedicate at least 5% of broker commissions to “extra-financial” analysis, including analysis of environmental issues.

4. INTEGRATION OF ENVIRONMENTAL PRICING AND INCENTIVES INTO FINANCIAL PRODUCT DESIGN

Most mainstream financial products do not encourage, and may discourage, consumers and businesses from pursuing sustainable practices. Conversely, niche financial products such as “green” mortgages include sustainability incentives, but have had only limited take-up. Environmental pricing and incentives can and should be built into mainstream financial products, rather than consigned to niche products.

**KEY INITIATIVE:**
The goGreen car loan offered by credit union mecu demonstrates the viability of building environmental impact criteria into a core consumer financial product. The product, which is mecu’s only vehicle loan rather than an ancillary product, gives a major incentive for sustainable consumer choices through a 5 percentage point interest rate spread between low-emissions and high-emissions vehicles.

5. STRUCTURES FOR COLLECTIVE FINANCE SECTOR ACTION ON SUSTAINABILITY

The incentives for an individual financial institution to undertake sustainable activities can be undermined by market failures arising out of collective action problems. For example, the costs for an individual shareholder of engaging with companies to improve environmental performance can outweigh the benefits for the shareholder, since the benefit of engagement accrues to all investors. To solve this problem, financial institutions – particularly in the investment field – can pool their resources to ensure effective and efficient engagement.

**KEY INITIATIVE:**
The BT Governance Advisory Service pools the resources of participating institutional investors for the purpose of engaging efficiently – and with greater weight and expertise – on environmental, social and governance issues that are material to long-term corporate success.
ARE THERE DIFFERENCES IN THE RELATIVE CONTRIBUTION OF AUSTRALIA’S MAJOR LENDERS TO MAJOR ENVIRONMENTAL IMPACTS?

Based on an analysis of major lending activities of banks active in Australia over a five-year period, there do appear to be major differences in relative contribution to environmental impacts.

ACF analysed the relative environmental intensity of the syndicated lending activities of 24 institutions in the Australian market from 2000-2004. For each lender’s syndicated loan activities, greenhouse emissions intensity and water use intensity values were calculated by averaging the environmental impact intensities of the industry sectors in which that institution’s borrowers were active. The values are weighted according to the dollar value of each lending transaction.

The results, for the top 10 lenders by total number of transactions, are shown in these two charts.

These results indicate that the activities financed by the worst performing lender in each case were around 2.5 times as intensive, in environmental terms, as the activities financed by the best performing lender. The substantial disparity in indirect environmental impacts could well translate into materially higher levels of environmental risk for those banks that are not adequately monitoring and reducing their indirect environmental impacts.

For complete results and a full discussion of this analysis, including methodology and key assumptions, see pages 21-23 and the Appendix, pages 84-89.
6. EFFECTIVE SUSTAINABLE INVESTMENT

Mainstream investment markets, in pursuit of short-term financial goals, are structured around investment selection and engagement methods that discount heavily the long-term interests of their constituents. Investment selection and engagement methods that have a more balanced approach to short-term and long-term goals, and that adequately consider environmental and social externalities, have achieved demonstrated success and should be widely adopted.

KEY INITIATIVE:
Superannuation fund VicSuper has dedicated 10% of its investments across major asset classes to investments with a particular focus on sustainability. Where a suitable sustainable investment vehicle did not exist, as in the Australian property sector, VicSuper drove the development of a suitable investment fund. More generally, the continuing financial success and growth of “deep” sustainability funds such as Australian Ethical Investment continues to build mainstream awareness of and confidence in sustainable investment techniques.

7. SUSTAINABLE COMPENSATION AND INCENTIVE STRUCTURES

Fund managers, corporate executives and others often have little personal incentive to pay attention to long-term environmental concerns, because their individual financial incentives are to maximise profits and/or increase assets over very short time frames. The behaviour of fund managers in particular is shaped by their quarterly and annual financial performance assessments. Personal and institutional compensation structures that utilise longer time horizons, smooth performance over assessment periods, and balance financial and non-financial performance criteria are more likely to drive sustainable outcomes.

KEY INITIATIVE:
In a modest move towards more long-term incentive systems, U.K. funds manager Generation Investment Management has implemented a compensation system through which its annual performance-based payments and are based on three-year rolling averages of performance, rather than the industry-standard quarterly or annual targets.

8. PUBLIC AND POLITICAL ADVOCACY ON KEY ENVIRONMENTAL ISSUES

With some notable exceptions, the Australian finance sector is largely absent from public and political debates about the environment. This disengagement means that Australian business is represented in such debates by more vocal sectors, particularly resource- and pollution-intensive industries such as mining and manufacturing. The result is public policy uninformed by the expertise of the finance sector and skewed towards environmentally unsustainable outcomes. The finance sector should invest more resources and expertise into contributing constructively to the development of sound public environmental policy.

KEY INITIATIVE:
As members of the Australian Business Roundtable on Climate Change, IAG, Swiss Re and Westpac have adopted a strong public policy stance on climate change, urging Australian governments to design a “long, loud and legal” framework to establish a carbon price signal, encourage innovation and investment in emerging and breakthrough technologies, and build national resilience to the impacts of climate change. The collective advocacy of these institutions is backed up by commissioned research, released publicly, on significant environmental and economic effects of taking such strong action on climate change.

9. EFFECTIVE, PRACTICAL SUSTAINABLE SUPPLY CHAIN MANAGEMENT

While some institutions have implemented extensive supply chain management programs, the expertise, capacity and interest of many other institutions in improving the sustainability of their supply chain is lacking. Individual finance sector businesses can develop effective supply chain management systems by focusing on key suppliers and issues related to core business activities.

KEY INITIATIVE:
IAG is a leader in practical engagement with suppliers (and customers) on environmental issues relevant to its core business. The insurer’s Risk Radar product is a practical, detailed and accessible online guide for improved environmental performance among IAG’s network of smash repairers. Another example is IAG’s Greensafe vehicle profiler, which enables consumers to assess the environmental performance of a wide range of vehicles.

10. INTERNAL ENVIRONMENTAL MANAGEMENT

Most sustainability programs at financial businesses overemphasise internal environmental management, given that the direct environmental impacts of finance sector operations are trivial compared to the impact of finance decision-
making. Moreover, even within the bounds of internal environmental management, most institutions lag far behind international best practice. Internal environmental management programs should complement, rather than supplant, more important reforms in the area of finance decision-making, and should pursue international best practice, such as full carbon-neutrality.

**KEY INITIATIVE:**
In 2005, HSBC became the first large financial institution to achieve full carbon neutrality – less than one year after it announced an intention to do so. HSBC has demonstrated the financial viability of carbon neutrality even for a large, multinational diversified operation. Carbon neutrality stimulates demand for clean energy, reduces environmental impacts and sends a powerful message to an institution’s clients and the public generally.

**PART III**
STRUCTURAL REFORM FOR A SUSTAINABLE FINANCE SECTOR: THE ROLE OF GOVERNMENT
The ten private sectors reforms outlined above can be achieved without any government intervention or support, as demonstrated by the key initiatives highlighted. Nevertheless, an improved regulatory structure would dramatically increase the pace, scope and effectiveness of such reforms.

Currently, the legislative and policy framework underlying the operation of the Australian finance sector often discourages sustainable policies and practices by private business. Changes are particularly desirable in the areas of directors and trustees’ duties, taxation and spending policies, and governance of managed funds. Further, governments can play an essential role in helping to overcome the problems of collective action by, for example, pricing environmental externalities and ensuring transparency of ownership and environmental and social performance in the corporate sector.

The following ten legislative and policy reforms would catalyse and amplify the private sector reforms outlined above. While these reforms of course must ultimately be adopted by governments, many of them are unlikely to occur without the concerted support of the private business sector.

1. **REFORM OF CORPORATE DIRECTORS’ DUTIES**
The usual understanding of directors’ duties, that corporate directors are obligated to pursue the maximisation of shareholder profits, may inhibit directors from considering broader interests. The Corporations Act should clarify that the duty of a director to act in the best interests of the corporation entails an obligation to consider all corporate constituencies, including the community’s interest in a healthy environment.

2. **REFORM OF INSTITUTIONAL INVESTORS’ DUTIES**
Under their statutory and common law duties as usually interpreted, superannuation trustees, life insurance companies, and responsible entities of managed investment schemes are required to maximise narrow portfolio financial returns, even if doing so prejudices broader financial or non-financial interests of their beneficiaries. These duties should be modified to require managers to act in the best interests of their members and beneficiaries in the broadest sense, including their financial and non-financial interests outside of the fund itself.
3. MEANINGFUL CORPORATE DISCLOSURE LAWS

Australian corporations are not required to report on their environmental performance in any meaningful, comprehensive and comparable way, and Australian practice lags far behind international leaders. Australian law should require annual disclosure of key environmental performance and risk indicators, based on a framework combining principles-based and specific reporting requirements, such as the Global Reporting Initiative.

4. DEMOCRATIC GOVERNANCE OF MANAGED FUNDS

The ultimate beneficiaries of superannuation and other pooled investment vehicles have little or no say over how their funds are invested and how the fund exercises shareholder rights on their behalf. Structural reform of managed fund governance to facilitate meaningful participation of individual members is necessary, including the introduction of mechanisms such as an annual meeting of fund members, the right of members to introduce and vote on issues of investment policy and practice, and improved transparency of fund holdings.

5. PRICING OF ENVIRONMENTAL EXTERNALITIES

Australian governments should facilitate the direction of financial capital to sustainable economic activities by ensuring that businesses are forced to internalise environmental costs. Whether through fees, taxes, market-based trading systems or other mechanisms, businesses should bear the full societal costs of their greenhouse emissions and other pollution, generation of waste, resource consumption, environmental degradation and other externalities.

6. ENVIRONMENTAL TAXATION REFORM

The Australian taxation system can distort investment and divert it away from sustainable uses. Perverse tax incentives, such as the fringe benefits tax provisions that reward overuse of company cars, should be repealed. More generally, the capital gains tax should be redesigned to encourage longer investment holding periods, while taxation overall should be progressively shifted from desirable activities, such as labour, to undesirable activities such as resource use and pollution. Reform should include a full public inquiry into environmental taxation reform, and the creation of a well-resourced environmental taxation policy unit drawing on the expertise of Treasury, the Department of Environment and Heritage, and other government and external experts.

7. LEVERAGING PRIVATE INVESTMENT

There is great potential, largely untapped, for Australian governments to mobilise private investment into environmentally and socially positive activities. Australian governments should introduce an ambitious programme of leveraging private investment into sustainable activities, through direct subsidies, tax incentives, government guarantees, business support and other mechanisms. Capital gains and dividends from investments in “deep green” ethical funds should be tax-advantaged.

8. SENSIBLE INDICATORS OF OUR SUCCESS AS A SOCIETY

Australian governments must begin to make decisions and measure outcomes based on more than growth in economic throughput, as measured by the GNP/GDP. Genuinely sustainable economic growth, and progress as a society, will not come about unless policy is guided by measurements and indicators that reflect the full social and environmental costs and benefits of our activities. To this end, a measure such as the Genuine Progress Indicator (GPI) should replace the GNP/GDP as the headline indicator in government reporting on economic progress, in modelling and assessment of proposed public policies, in the ABS “Key National Indicators” publication, and so forth.

9. INVESTMENT TRANSPARENCY

Many aspects of the investment system lack transparency, which inhibits the ability of civil society to identify and hold accountable those ultimately responsible for unsustainable corporate activities. Reforms that would increase transparency include (1) mandating disclosure of beneficial ownership of publicly listed companies; (2) amending banking secrecy laws to allow banks to disclose details of the aggregate environmental and social performance of their investment portfolios; and (3) requiring periodic disclosure by superannuation funds and other pooled investment funds of a list of investment holdings.

10. LEADING BY EXAMPLE

As substantial managers of financial assets and providers and consumers of financial services, Australian governments have substantial power to lead by example and to use their market power to drive positive changes. Where Australian governments invest in the private economy, such as through the Future Fund, investment mandates and policies should include furthering the public interest in environmental sustainability. Where external financial services providers are used, they should be required to utilise best international sustainability practices.
INTRODUCTION

THE RETURNS on environmentally damaging investments are false profits. They are false not only from the lofty vantage point of our society as a whole, but often even from the more grounded perspective of the financial bottom line of a particular business.

Consider: a bank lends $200 million to a brown coal-fired power plant at 7% interest for ten years. The loan is repaid with interest. We say that the bank has "profited" from its investment, but in what sense is this true?

The power generation industry is a heavy contributor to global warming, a phenomenon which marine scientists say could kill the Great Barrier Reef within 20 years if unchecked.¹ The Great Barrier Reef is an economic powerhouse, contributing at least $5.8 billion² annually to the Australian economy – a contribution exceeding the annual gross value of Australian wheat and comparable to the annual gross value of all Australian livestock products.³ If the reef was listed on the Australian Stock Exchange, its annual profits would dwarf those of all but a handful of Australia’s major corporations.

The bank’s returns from its power generation investments must therefore be seen in light of their possible contribution to damage to the health of the reef and its dependent industries and communities. If the bank has any stake in the reef’s multibillion-dollar contribution to the economy (including the tourism, hospitality, fisheries, bio-prospecting and pharmaceuticals sectors, among others), then the profits from its power plant loan may be offset, perhaps even eliminated, by consequent losses from its reef-dependent investments over time. It is true, of course, that climate change is a global problem, and each individual polluter’s contribution to it is small. Yet, if climate change does impose heavy economic costs, the portion of those costs notionally attributable to each individual polluter may be very high indeed.

This vignette about the power plant and the reef is one version of a story that is repeated, on scales miniscule to vast, across our entire economy. A notionally profitable but environmentally damaging business imposes costs on other investments; the financer sees the direct returns and thinks it has profited thereby, but fails to measure, or even comprehend, the corresponding lost opportunities and damage to the rest of its portfolio.

Traditionally, the finance sector has ignored these dynamics, blithely harvesting these false profits without accounting for the costs.

Slowly, this is changing. The past decade has been a period of tentative experimentation in other, more sustainable ways of doing business. Innovative initiatives by leading financial institutions are already demonstrating how to overcome the barriers that have inhibited environmentally sustainable financial decision-making.

This report is about the financial decision-making processes that lead to false profits, and how we can reform them. By drawing lessons from ten key successful sustainable finance initiatives, and supplementing them with a set of public policy reforms to address structural defects in the financial system, this report describes a possible pathway for a sustainable finance sector in Australia.

THE ROLE AND RESPONSIBILITY
OF THE FINANCE SECTOR

In an industrial, capitalist democracy like Australia, decisions about what major economic activities will be undertaken are expressed through two major decision-making authorities: governments and financial markets.

A major function of governments is to formulate and enforce decisions on which activities are deemed acceptable. Within those constraints, financial markets largely determine which commercial activities will actually be undertaken. Or more succinctly:

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1. Ian Gerard, “Reef to ‘die in 20 years’”, The Australian, 6 February 2006.
governments decide what may be done, financial markets then decide what will be done.

This is not to ignore the interrelationships among government and private markets. Governments can and frequently do steer investment not only by direct prohibitions and mandates, but also through subsidies, taxes and other incentives, as well as by softer measures such as education, research, and so forth. Conversely, financial markets affect government, not least through the lobbying activities of major financial institutions.

Nor is this to deny the importance of individual action, civil society groups, businesses, other nations, technology, and the physical environment to shape the decisions of both government and financial markets. All of those factors, and many others, inform both governments and markets and, to various degrees, influence or determine the outcomes. It remains true, however, that the financial markets are the forum in which all of this information is ultimately collected, sifted, weighed up, analysed, and translated to an ultimate decision on which economic activities will attract our focused resources as a society. For better or worse, the financial markets are the machinery through which we finalise decisions about allocation of capital.

For the finance sector to perform its role in our collective best interests, then, it is crucial that this machinery accurately and comprehensively account for the environmental consequences of economic activity. Where this does not occur, due to the myriad of ways in which markets can and do fail, financially poor and environmentally disastrous decisions can result.

There are five broad areas in which the activities of a financial institution may intersect with environmental considerations:

1. **Philanthropy**
   Financial institutions may support external environmental initiatives through the contribution of volunteer effort, financial support, expertise and advice, and so on.

2. **Direct operations**
   The conduct of finance sector operations entails the use of modest amounts of resources like energy and paper, and the generation of some waste. Like any other business, a financial business can seek to minimise these effects on both financial and environmental grounds.

3. **Supply chain**
   Financial institutions may affect the behaviour of their major suppliers, which may include suppliers of physical goods and services such as paper, equipment, energy and travel, as well as other financial and professional services entities.

4. **Finance policy and practice**
   The core business of a financial institution is the allocation of financial capital, through lending, investment, insurance and other means. Determinations of what activities obtain the necessary capital and under what conditions have major environmental consequences.

5. **Public policy**
   Financial institutions can strongly influence government policy, including environmental policy, through lobbying, political donations, public statements and other influence, both by individual institutions and through industry associations.

Of these five, many institutions have perceived environmental relevance primarily in their direct operations and philanthropic relationships, if at all. Many institutions’ public reporting, targets, and initiatives are limited to reducing the direct environmental consequences of their office-based operations.

However, the environmental implications of the finance decision-making and public policy activities far outweigh such environmental gains as there are to be had in reducing paper use and supporting another local clean-up program. This report therefore stresses the ways in which financial decision-making and policy advocacy can better reflect the economic and environmental goals of sustainability. Philanthropy, supply chain practices and internal environmental management are discussed only briefly.

**A NOTE ON TERMINOLOGY**

This report focuses on the effects of current and alternative finance sector practices on the natural environment and the ecological foundation of human societies.

In so doing, however, we freely acknowledge that the concept of sustainability extends to interrelated concerns about social equity, justice, human rights, cultural heritage, diversity and other issues, all of which relate to ecological concerns as well.

Our use of the term “sustainability” throughout is thus a term of convenience, used only because a more precise formulation such as “ecological sustainability” would be cumbersome and repetitive. Similar, the term “externality” is used throughout to refer to environmental externalities, though of course externalities in an economic sense are not so limited.

It is our hope that this examination of how the finance sector can improve its approach to environmental challenges will also improve our understanding of how to place our economy on a sustainable footing, in the broadest sense.
Sustainability is important for the finance sector foremost because the long-term success of financial enterprises is inextricably linked to that of the overall economy and its ecological foundation. However, the traditional analytical tools on which financial decisions are made are ill-suited to furthering those goals.

Prominent businessmen Stephen Schmidheiny and Federico Zorraquin traced as early as 1996 how “accounting and reporting systems do not adequately convey potential environmental risks or opportunities. Financial markets are compelled to make decisions based on biased information.”

In addition to the deficiencies in accounting and reporting frameworks, most financial analytical tools and methodologies are focused on specific transactions or business organisations. This can lead to systemic blindness to environmental issues that cannot easily be traced through to specific, quantifiable short-term liabilities for particular businesses, even though they may have major impacts on economies and financial portfolios as a whole.

Section 1 of this part outlines the business justification for developing processes to measure and address environmental externalities. Section 2 reviews some of the traditional arguments advanced in favour of sustainability in the finance sector. Section 3 addresses some commonly voiced objections to sustainable finance.

1. SYSTEMATIC UNDEREVALUATION OF ENVIRONMENTAL EXTERNALITIES IN FINANCIAL DECISION-MAKING

SYNOPSIS:
Most large financial institutions approximate “universal owners”. They are exposed to the environmental externalities of the activities they finance. However, the traditional analytical tools on which financing decisions are based are ill-suited to furthering the interests of such an institution. Tools such as credit risk assessment and most mainstream equity valuation methods focus on the potential returns from a specific transaction, but are not concerned with environmental externalities that may affect other parts of the financier’s portfolio. The inadequacy of these traditional tools is a major reason for finance sector institutions to develop innovative new ways of ensuring their financing decisions are environmentally sustainable.

DIVERSIFICATION AND UNIVERSAL OWNERSHIP
One of the most striking characteristics of modern financial institutions is their immense diversification. Consider the holdings of one of the larger Australian banks: through its corporate lending practice, it has a stake in mines, factories, services, retailers and a myriad of other enterprises large and small. Through mortgage and personal lending, it has interests across all of Australia in housing and in the financial success of millions of individual residents. As an investment manager and financial adviser, it directs money on others’ behalf to major corporations. As an investment banker, it constructs other vehicles for investing in commercial businesses and properties. And it invests heavily in other financial institutions, and is in turn itself owned in part by them. Such cross-investment occurs frequently and on a large scale, thus adding another dimension again to its diversification.

In fact, it is fair to say that most large Australian banks, insurers and fund managers hold a stake in nearly every aspect of the Australian economy. Their ultimate financial holdings, aggregated and stripped of all the various intermediary forms and vehicles, would more or less resemble a proportionate slice of the entire economy.

Of course, there are differences in weightings – one institution may be relatively more exposed to coal mining, another has a bit more property in Queensland, a third is underweight in telecommunications equities. But on the whole the similarities vastly outweigh the differences.

A financial institution that has so diversified its holdings that it effectively has a stake in an entire economy is called a “universal owner”.

The concept of universal ownership was explored by economists James Hawley and Andrew Williams in an important series of publications over the past decade. According to Hawley and Williams, “the fundamental characteristic of a universal owner is that it cares not only about the governance performance of the individual companies that compose its investment portfolio, but that it also cares about the performance of the economy as a whole.”

One of their main conclusions is that a prudent universal owner has to pay close attention to the externalities of the enterprises they finance, because the performance of the other assets and businesses that constitute their overall portfolio can be affected by such externalities.

The universal owner can be contrasted with the “one-off lender” – a lender that makes just one loan. (The same concept also applies to the investment and underwriting contexts.) The performance of the one-off lender’s portfolio is likely to diverge substantially from that of the economy as a whole. Furthermore, the one-off lender will not be overly concerned with the externalities of its transaction, unless they impact the risk or financial performance of the loan itself.

The universal owner and the one-off lender are idealised types, describing opposite poles of what in reality is a continuum. The following table summarises some key differences between these two poles.

(Again, the concepts are transferable to the investment or underwriting contexts as well.)

<table>
<thead>
<tr>
<th>ONE-OFF LENDER</th>
<th>UNIVERSAL OWNER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio profile unrelated to profile of underlying economy</td>
<td>Diversified portfolio profile mirrors the underlying economy</td>
</tr>
<tr>
<td>Success not directly related to performance of economy</td>
<td>Success closely correlated to performance of economy</td>
</tr>
<tr>
<td>Not exposed to externalities imposed by borrower on others</td>
<td>Fully exposed to externalities imposed by financed businesses on others</td>
</tr>
<tr>
<td>Amount at risk limited to amount of financing extended in the transaction</td>
<td>Amount at risk in any given transaction exceeds the amount of financing, since externalities of financed activities may impact other components of portfolio</td>
</tr>
<tr>
<td>Risk/return on transaction determined by borrower’s ability to repay</td>
<td>Risk/return on transactions depends on borrowers’ ability to repay as well as effect of positive and negative externalities on rest of portfolio</td>
</tr>
<tr>
<td>Credit risk analysis sufficient to maximise returns</td>
<td>Credit risk analysis must be supplemented by measures to minimise negative externalities and protect long-term performance of economy</td>
</tr>
</tbody>
</table>

### ONE-OFF LENDER (IDEAL)

<table>
<thead>
<tr>
<th>Sector-specialists (eg, vehicle finance firms; sector-specific listed investment trusts)</th>
</tr>
</thead>
</table>

### UNIVERSAL OWNER (IDEAL)

<table>
<thead>
<tr>
<th>Consumer finance lenders; property investment vehicles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit unions, building societies and small banks</td>
</tr>
<tr>
<td>Regional banks</td>
</tr>
<tr>
<td>Major insurers, mainstream superannuation funds</td>
</tr>
<tr>
<td>‘Big 4’ banks; major diversified financial services groups</td>
</tr>
</tbody>
</table>

In Australia, most medium to large financial institutions and most institutional investors, come much closer to the universal owners model than the one-off lender. While exposures will be weighted in various ways, such large institutions have a direct or indirect stake in the whole breadth of the Australian economy, from equity and debt investments and loans across the full range of industries through to property investments, consumer lending and so on.

### THE GAP IN ENVIRONMENTAL RISK ANALYSIS

The financial decision-making tools in common use today are designed to maximise the financial returns of the one-off lender, but are inadequate to protect the interests of the universal owner.

This is a key theme of this report, and a primary business justification for most of the recommendations that follow in Parts II and III.

To illustrate this point, consider a hypothetical proposed cotton farm to be located near a coral reef that is a major tourist attraction and fishing area. If established, pesticide runoff from the cotton farm, though within legal limits, could contribute to damaging the reef and thus causing tourism and fishing businesses in the area to decline.

The one-off lender, in deciding whether to finance the cotton farm, may focus its assessment on the creditworthiness of the borrower. That analysis could take into account the pesticide runoff, but only to the extent that it affects the borrower’s creditworthiness – for example by increasing exposure to environmental claims or more stringent future regulations that increase the cost of growing cotton. However, the one-off lender is unlikely to consider the downstream impacts of the runoff on other businesses as an independent interest, because it has no stake in those businesses. If the loan is not repaid, the single lender stands to lose, at most, the amount of the loan.

Should a universal owner consider the same proposal any differently? Yes, because its interests are much broader. For one, the universal owner (by definition) has a stake in the downstream tourism and fisheries.
businesses. If those businesses are harmed, their credit risk may increase, and the value of their stock may decline. This could occur whether the cotton farm is successful or not.

The universal owner is therefore exposed to some of the externalities of the cotton farm in a way that the one-off lender is not. If it extends financing, the universal owner is potentially placing more at risk that simply the value of the loan: in a worst-case scenario, the cotton farm could default on its loan and damage downstream businesses. But even if the cotton farm is a success and generates profits for the universal owner, the transaction could still be a net losing proposition for the universal owner, if those profits are offset by increased risk or decreased value of financing to the downstream businesses.

As Hawley and Williams explain:

“[N]egative externalities lower the cost to the firm generating the externality by imposing those costs on other firms and on citizens at large. Because of their ownership of the economy as a whole, universal owners end up bearing those costs … as owners of other firms. … Since the costs are generally larger than the benefits that accrue to the company causing the externality, universal owners experience an overall net loss. Consequently, a universal owner’s portfolio returns would be directly enhanced by a proper treatment of the externality in the first place.”

A prudent universal owner should therefore try to ascertain not only the commercial prospects of the cotton farm, but also how it fits into the broader economy and environment and the nature and magnitude of externalities (both positive and negative) it may impose on other economic participants.

The gap in financial environmental risk analysis is that it tends to focus solely on environmental issues that directly affect creditworthiness in the lending context, or direct stock price in the investment context.

In short, risk assessment procedures that focus exclusively on creditworthiness or stock price may work for one-off lenders, but the more an institution resembles a universal owner, the less satisfactory those procedures become.

The paradox of the Australian finance sector is that, while many institutions have the characteristics of universal owners, they frequently do not act as prudent universal owners should. Instead, they utilise analytical techniques better suited to the one-off lender.

**CURRENT APPROACHES TO ANALYSING EXTERNALITIES**

In the course of preparing this report, we explored with a wide range of financial institutions how they would analyse the following sorts of issues:

- If the project finance arm of a bank is considering a loan to finance a power plant with high greenhouse gas emissions, how are the effects of those emissions (such as climate change) on the bank’s property portfolios and agricultural loans considered?
- If an institutional investor is investing in a business that involves land clearing and loss of habitat and biodiversity, how are the lost business opportunities stemming from that lost biodiversity for the rest of the investor’s portfolio (e.g., in the pharmaceutical or tourism sectors) analysed?
- If a bank is financing a new facility that could decrease property values in a particular area, how are the impacts of that facility on the institution’s mortgage loan book considered?

Almost across the board, the response was that these sorts of cross-sector or cross-transactional externalities are not quantified or otherwise systematically assessed.

To the extent that environmental considerations are taken into account beyond their effect on creditworthiness, institutions tend to focus heavily on reputation risk to the institution itself and/or a generalised sense that environmentally sensitive projects were not a good “fit” for the institution. These are not bad reasons to scrutinise the environmental impacts of possible financings, but in the end they are incomplete and may be seen to lack rigour or persuasive force, not least with the senior management of the institution.

Much of the debate on integrating sustainability into financial decision-making has focused on improving credit risk analysis and stock valuation. A number of lenders, including Westpac, ANZ and NAB, have undertaken thorough revamps of their credit risk procedures, to try and ensure that all environmental factors that affect a borrower’s ability to repay are ascertained and taken into consideration. Similarly, some mainstream investors are starting to appreciate the effect of environmental issues on stock prices.

Of course, nobody can argue with improved credit risk or stock valuation processes. There have been real

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improvements in these areas, and it is reasonable to think that these have translated into at least some practical environmental benefit.

Nevertheless, universal owner theory suggests that, no matter how accurate credit risk and equity value assessment processes are, they will fail to generate financially or environmentally optimum results for the finance sector, because they systematically undervalue or ignore environmental externalities. This is not to say that credit risk analysis is unimportant or inadequate, but rather that it is incomplete as the basis for financial decision-making.

For a universal owner, the traditional analytical tools must be supplemented by additional processes or initiatives that minimise net negative externalities and foster the environmental health that is the basis for long-term sustainable macro-economic success. These additional tools may differ vastly in methodology, skills required, and the locus of activity within an institution. To give but one example, public policy advocacy to improve environmental standards is a viable and defensible business strategy for a bank, if by doing so the bank reduces externalities that harm its lending portfolios.

If environmental risk is understood not simply as a risk to individual assets, but as a risk to entire portfolios and the economies than underpin them, then the reforms outlined in this report are core business imperatives rather than optional “corporate responsibility” add-ons.

### 2. OTHER BUSINESS REASONS FOR SOUND ENVIRONMENTAL PRACTICES AND ENGAGEMENT ON SUSTAINABILITY ISSUES

#### SYNOPSIS:
Environmental sustainability initiatives can also be important for financial institutions to ensure accurate risk assessment, avoid site remediation and other direct risks, build market positioning in developing technologies and industries, build a positive business reputation, and increase employee motivation and retention.

There are many additional reasons for financial institutions to address environmental concerns in their core business operations. If this report gives these reasons summary treatment, it is not because they are unimportant, but because they are more widely understood already and have been more thoroughly explored elsewhere.

Marcel Jeucken gives a good account of these additional reasons in his book, Sustainability in Finance. Some of the most important can be summarised as follows:

#### A. ACCURATE ENVIRONMENTAL RISK ASSESSMENT

Although traditional valuation tools such as credit risk and stock price analysis are by themselves inadequate to advance the long-term interests of the finance sector, incorporating accurate environmental risk analysis into those processes is nevertheless vital.

For equity investors, environmental liabilities or increased costs may reduce the value of the investment. For lenders, these liabilities and costs may impair both the borrower’s ability to repay and the value of any collateral the lender may have. For insurers, increased environmental risks may result in both increased claims and decreased value of statutory assets held to back up policies. Conversely, environmental opportunities, such as reductions in energy and other resource use and positive market positioning in developing environmental markets, can reduce risks and improve the performance of underlying assets.

#### B. SITE REMEDIATION AND OTHER DIRECT LIABILITY RISKS

The most common direct environmental risk occurs when a financer (a bank, most often) takes possession of land over which it has a security interest. If the land is contaminated, its value is obviously impaired, and in some cases the bank may itself be liable for site remediation costs. These can exceed the value of the property.

In some circumstances, a financer’s involvement in particular transactions can trigger cleanup liabilities if the financer participates in certain ways in the management of the borrower’s enterprise, separate from any liabilities as an owner of contaminated land. An example of this is the 1990 U.S. v. Fleet Factors case, in which a U.S. court held that the
C. MARKET POSITIONING

Proactive engagement in particular industry sectors and new environmental markets can lead to a substantial competitive advantage as those sectors and markets grow. While government support in Australia for recycling, renewable energy and other clean technologies has been mixed, most of the finance sector participants interviewed for this report expressed a strong view that these sectors would continue to grow in the long term.

There is at least anecdotal evidence that some Australian institutions are already reaping some of the positioning benefits of early action. For example, a representative of one major bank related the story of a particular environmental technology business that approached them specifically because of the bank’s positive environmental reputation. In addition to approving of the bank’s environmental policies generally, the borrower felt that this bank was more likely to easily understand their business. From the bank’s perspective, the approach was a tangible manifestation of the competitive advantage that a focus on sustainability can generate.

D. REPUTATION RISK AND BENEFIT

Financial institutions may themselves be exposed to criticism for financing environmentally harmful activities, and conversely may enjoy benefits for developing a positive environmental reputation.

Impacts on reputation of association with unsustainable activities can be difficult to quantify, but this hardly lessens their importance. In the United States, for example, a concerted, highly public campaign from 2002-04 by the Rainforest Action Network (RAN) against Citigroup’s financing of unsustainable forestry operations was alarming enough that Citigroup implemented a comprehensive forestry policy broadly acceptable to RAN.

In Australia, environmental activists have mounted sustained campaigns publicly highlighting the role of the financers of destructive old-growth forestry in Tasmania and uranium mining at Jabiluka, among others. More recently, such activism has extended not only to banks, but also other institutional investors including superannuation funds that have not traditionally been subject to such scrutiny. It is perhaps only a matter of time before similar campaigns are mounted against, for instance, the financing of destructive resource extraction and logging in Southeast Asia and the Pacific, or the financing of climate pollution-intensive industries.

Environmental reputation has a flip side as well. A positive reputation for environmental performance and responsibility can be a significant advantage in attracting customers and motivated staff. In Australia, institutions with a strong focus on sustainability such as credit union mecu and superannuation fund VicSuper have reported strong resonance between their environmental programs and the values of their members. Westpac and Bendigo Bank are other institutions that have seen some of the benefits of a strong community reputation.

E. EMPLOYEE MOTIVATION AND RETENTION

A poor environmental reputation is a severe barrier to a business’ ability to attract and retain qualified and motivated employees and management. According to a recent survey by CPA Australia, 67% of the general public and 66% of Directors, CEOs and CFOs stated that they would be discouraged “a lot” from working for a company with an unfavourable environmental reputation.

Conversely, a surprising number of individuals stated that they would prefer to work for a company with an excellent social and environmental reputation, even if that entailed a lower wage or salary. A full 57% of the public, and 40% of Directors, CEOs and CFOs, said that they would accept lower pay at such a responsible business, with a further 18% and 16% respectively saying that it would depend on the job.

Thus, poor environmental performers would appear to be seriously disadvantaged in accessing the labour market and the small pool of corporate directors and senior managers. The competitive disadvantage of poor environmental reputation and performance is plain.

7. ACF has been active in some of these efforts, identifying and publicly highlighting the role of superannuation and other pooled investment funds in financing Tasmanian forestry company Gunns Limited following that company’s lodgement of legal proceedings against 20 individual and NGO environmental activists for broad-ranging allegations of “conspiracy”.

3. COMMON MISCONCEPTIONS AND BARRIERS TO EFFECTIVE ACTION

**SYNOPSIS:**
Common objections to sustainable finance initiatives are largely misplaced, and have not prevented innovators from improving sustainability in financial services.

Before proceeding, it is convenient to address together five overarching objections that appear frequently in discourse about sustainable finance, and indeed that were often articulated in interviews for this report.

There are real barriers to sustainable finance, but the following supposed hindrances are not among them. The objections tend to be most strident when suggestions are made that could alter how institutions conduct their core business activities. While some of these may have some superficial appeal, in truth, none of them have prevented strong leadership by businesses with a genuine desire to align their business activities to sustainability. Fundamentally the objections are most often deployed as a thin smokescreen for inaction, when a bit of acumen, creativity and commitment can find solutions.

**OBJECTION #1:**
“ENVIRONMENTAL REGULATION IS A MATTER FOR GOVERNMENTS, NOT THE PRIVATE FINANCE SECTOR.”

**RESPONSE:**
Ideally, governments are indeed best situated to minimise environmental externalities of business activity through regulation. Unfortunately, governments frequently get it wrong. The legacy of orphaned contaminated sites in Australia, the ongoing failure to rein in damaging greenhouse pollution, and the tragic record of species extinction in Australia (sometimes as a result of deliberate government policy, as with the extermination of the Thylacine) are all concrete evidence of governments getting it very wrong in the past. Despite improvement in environmental awareness, there is little reason to think that governments will not continue to get aspects of environmental policy wrong, to the ultimate detriment of the finance sector.

A bank would not dream of allowing government to protect the environment? In the long-term, the environment is at least as important, so it is difficult to see why the finance sector should defer to governments and assume they will protect the interests of the finance sector.

Furthermore, governments react to pressure from their constituencies, particularly corporate interests. If environmental issues are understood as a serious concern for the sector, financial institutions that claim it’s all for governments to handle should be advocating vigorously for improved regulation, rather than leaving it to others to determine policy.

**OBJECTION #2:**
“IF WE DON’T FINANCE THIS COMPANY, UNSUSTAINABLE THOUGH IT IS, SOMEBODY ELSE WILL.”

**RESPONSE:**
It is perhaps surprising to hear this objection so frequently raised. After all, we would never accept this sort of argument in our personal lives. The strong likelihood that an unlocked bicycle will eventually be stolen by someone is not generally accepted as a justification for me to steal it.

But buried in this objection is another, somewhat more serious one. The existence of others who may finance unsustainable activity can undermine the ability of individual institutions or even collective groups to enforce the standards they desire. This does not justify unsustainable financings, but it does suggest limits on how far an institution can go in demanding high environmental standards before it begins to erode its customer base.

Viewed in this light, the objection is a variation of the classic prisoner’s dilemma problem: an institution that voluntarily adopts higher standards will be disadvantaged if its competitors do not follow suit. Clients may flee to the more permissive institutions. A race to the bottom results, and the lowest standard prevails – even though all would be better off with higher standards.
The concern is not always empirically justifiable. One business head at a major Australian bank recounted the case of a particular business that approached the bank no fewer than four times through different offices and business lines, seeking financing of an environmentally dubious project. Declined by the bank each time on environmental grounds, the proponent was apparently unable to obtain finance elsewhere.

Further, evidence from the performance of some products seems to contradict the view that institutions can not act unilaterally to improve environmental standards among their customers. Bendigo Bank’s green mortgage product and mecu’s goGreen car loan are both predicated on an interest rate benefit for responsible environmental consumer choices, yet the products have not driven off customers to other lenders.

Nevertheless, competitive pressure that may drive down standards can be a serious impediment to sustainable finance. Inaction is not the solution; collective action and policy reform are. Joint finance sector initiatives such as the Carbon Disclosure Project, BT’s Governance Advisory Service, and the Equator Principles are examples of moderately successful collective sustainability initiatives.

**Objection #3:**

“WE WOULD LIKE TO DO MORE, BUT ARE BOUND BY THE SHORT-TERM VISION, DEMANDS AND MANDATES OF OUR SHAREHOLDERS / CLIENTS / MEMBERS / ANALYSTS / INVESTORS.”

**Response:**

This is frequently heard from fund managers: their clients give them a mandate to generate short-term returns, and their performance is scrutinised on a quarterly or even monthly basis. If they fail to maximise short-term returns, clients will abandon them and asset consultants will not longer recommend them to institutional investors.

The asset consultants, in turn, claim that they are merely carrying out the wishes of the superannuation trustees and other investors that consult them. The trustees, in turn, point to their legal duties and the purported desires of their members (possibly expressed, but often assumed) to maximise profits at any cost.

While these structural hindrances certainly exist, they are far less severe than is usually said to be the case.
not have to take investment mandates as a given, but in fact have some power to shape how those mandates are structured and even what the long-term performance measures are.

A similar finger-pointing exercise can occur with consumer financial products. Institutions express genuine frustration at the lack of demand for green mortgages and other specialised green products. Conversely, consumers may be unfamiliar with such products -- or may act on the advice of their financial adviser who may be unlikely to raise environmental issues unprompted. Financial advisers in turn may claim that consumers do not ask.

Financial product issuers (including large banks) claim that the market determines their suite of product offerings, but they often understate their own role in shaping consumer demand through advertising. One solution to this particular conundrum is not to create separate “green” products at all, but rather to embed environmental incentives in mainstream consumer products. Mecu’s goGreen car loan is a successful working demonstration of this model.

**OBJECTION #4:**

“IT’S ALL TOO HARD. WE DON’T HAVE THE RESOURCES OR TOOLS TO ACCOMPLISH THIS TASK OF ANALYSING EXTERNALITIES OF THE BUSINESSES WE FINANCE, AND THEN FIGURING OUT WHAT TO DO ABOUT IT ALL.”

**RESPONSE:**

Environmental externalities and the impact they have on portfolios do not disappear merely because they are difficult to measure and address. So, while it may be unrealistic to expect a detailed externality analysis for every small transaction an institution enters into, analytical difficulties do not justify inaction.

A practical balance must be struck. While all externalities might not be identified and quantified, it is well within the resources of large institutions and industry groups to get a handle on the key environmental issues affecting the economy, and to take practical and efficient steps to deal with those issues. Some progress has already been made on climate change, for example, through the actions of BT’s Governance Advisory Service, initiatives like the Carbon Disclosure Project and the Investor Group on Climate Change, and the initiatives of individual institutions. More is needed on this issue, but also on other environmental concerns such as loss of biodiversity, water scarcity and drought, and land clearing and unsustainable forestry practices.

**OBJECTION #5:**

“WE ARE BOUND BY OUR FIDUCIARY DUTIES.”

**RESPONSE:**

Corporate directors are under a duty to act in the best interests of the corporation, and trustees and other managers have statutory and common law duties to act in the best interests of their beneficiaries or members.

The duties are not inconsistent with rigorous environmental assessments and proactive policy advocacy and institutional engagement on environmental issues. Quite the contrary: if externalities are serious enough that they may have an impact on the economy and thus on investment portfolios, a failure to consider those issues could constitute a breach of fiduciary duty. For example, a recent report by the Investor Group on Climate Change concluded that, in light of the materiality of climate change to impact a fund’s returns over the long term, it is consistent with a fund trustee’s fiduciary duty to ensure that climate change risk is addressed.9

This is not to say that the current statutory expressions of directors’ and trustees’ duties are optimal. The wording of both should more clearly incorporate broader interests, as discussed in Part III.

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PART I OF THIS REPORT OUTLINES some of the important reasons for proactive engagement of financial institutions on sustainability issues. This Part takes up the question of what that engagement should look like.

Having recognised the alignment of its long-term financial interests with environmental sustainability, the more daunting challenge for any institution is to design and implement core business reforms that enhance sustainability yet still make business sense, in competitive markets and regulatory systems that may discourage or even penalise far-sighted initiatives.

The following ten areas for reform take up this challenge. In each section, a description of the nature of the problem and the solution called for are given, along with a key example by a successful finance sector institution that demonstrates the practicality and effectiveness of the solution. These examples illustrate the feasibility of positive, meaningful reform under current market and regulatory conditions, as well as recognising the creativity and accomplishments of institutions showing genuine leadership.

Some of these sections also include a comparison of the current practice of financial institutions active in Australia. Of particular interest to finance sector analysts may be the comparative analysis of the greenhouse emissions and water use intensities of the syndicated lending activities of 24 institutions active in the Australian market (see pages 21-23 and the Appendix).

PART II

TEN EFFECTIVE, DEMONSTRATED FINANCE SECTOR INNOVATIONS THAT ENHANCE THE ENVIRONMENT AND LONG-TERM PROFITABILITY
1. MEASUREMENT, ANALYSIS AND DISCLOSURE OF AGGREGATE ENVIRONMENTAL CHARACTERISTICS OF INVESTMENT PORTFOLIOS

SYNOPSIS:
Few if any financial institutions measure, assess or disclose their indirect contribution to major environmental impacts, such as greenhouse pollution and water use. As a consequence, most are unable to assess how resilient their portfolios are to environmental and regulatory changes, and have little notion of how their portfolios compare to their competitors'. Measuring the indirect effects of investment activities on a whole-of-portfolio basis, rather than focusing on specific investments in isolation, allows an institution to get a clearer sense of the total potential effect of environmental issues on its business.

BARRIER: LIMITED UNDERSTANDING OF ENVIRONMENTAL CHARACTERISTICS OF INVESTMENT PORTFOLIOS
Financial institutions typically do not measure the environmental externalities of the activities they finance. Further, environmental risks are usually measured only in the context of specific high-risk transactions, rather than viewed as systemic issues that may affect entire portfolios.
Our review of Australian practice revealed only one effort to aggregate these risks across an entire investment portfolio – a project by one institution to attempt to ascertain its overall indirect institutional lending exposure to climate change.
It may come as a surprise that, with that one exception, financial institutions do not endeavour to measure the aggregate environmental characteristics embedded in their investment portfolios. After all, such information could reveal valuable, financially relevant trends and exposures to future environmental and regulatory changes.
The failure to monitor the environmental aspects of portfolios means that financial institutions are typically not in a position to quantify their aggregate exposure to changes in environmental regulation, resource pricing, environmental events such as droughts, bushfires and storms, or other environmental issues.
For example, most banks grant loans to a broad range of sectors, including industries that have high greenhouse emissions (such as fossil fuel electricity generators and metal manufacturing industries), as well as to less polluting sectors, such as property investments and professional services.
A bank may be aware of the possible effect of increased regulation of greenhouse emissions on specific high-impact activities – a coal-fired power plant, for example. However, transactions are not placed in context by assessing the relative greenhouse emissions efficiency of an entire portfolio of investments, or benchmarking against competitor's portfolios. This hinders an institution's ability to understand key environmental risk exposures and to take appropriate action to reduce them.
Insurers are something of an exception: measuring portfolio-wide exposure to risks (including environmentally-driven events such as storms and bushfires) is a core activity. However, based on our discussions it does not seem that insurers apply their expertise in measuring and aggregating environmental risk to their investment portfolios, as opposed to their underwriting exposures.
In short, finance portfolios may be weighted in environmentally and financially significant ways that portfolio managers do not measure or understand.

SOLUTION: SHIFT FROM A TRANSACTIONAL TO A PORTFOLIO APPROACH TO ENVIRONMENTAL RISK AND IMPACT MEASUREMENT
A portfolio approach to environmental risk and impact measurement offers a more comprehensive and useful insight into the overall environmental performance and positioning of a financial institution.
An example of this approach is the commitment by JP Morgan Chase to measure and report on the aggregate impacts of at least one aspect of its institutional lending portfolio. The bank announced that it would "annually report the aggregate greenhouse gas emissions from our power sector projects beginning in 2006." If this disclosure includes all of its power sector financings (and not just new projects in that year), JP Morgan Chase will take a modest but conceptually revolutionary step towards portfolio-level analysis and disclosure.10
Citigroup has previously also committed to disclosure of emissions from power sector projects. However, its reports in 2003 and 2004 disclose emissions only of new power generation projects financed by Citigroup, of which there were none in 2003 and one in 2004. Such data is of little use in getting a sense of the impact of the bank’s overall portfolio.

There are some practical hurdles to this approach. For one, most institutions have not historically gathered environmentally meaningful data about their transactions as they are made. This means that assessing, for example, the aggregate water intensity of a lending portfolio with hundreds or thousands of individual loans would require a resource-intensive effort to fill the informational gap by revisiting each individual transaction and gathering the relevant information on water use.

Still, undertaking this exercise may be worthwhile, at least for portfolios of relatively large transactions.

For portfolios consisting of a large number of relatively small transactions (such as residential mortgages), some way of automated data collection or approximation of environmental risk and impact data would be required. For example, if climate change risk data was available for individual postcodes, lenders would be able to use such higher level data to analyse their residential loan books without having to analyse each individual transaction.

Despite the hurdles, the data that will enable better estimates of portfolio-wide environmental characteristics is increasingly becoming available. One such tool in the Australian market is Balancing Act: A Triple Bottom Line Analysis of the Australian Economy, a study of the relative economic, social and environmental impacts of 135 industry sectors in Australia (available at www.cse.csiro.au/research/futures/balancingact/index.htm). By matching this data with an institution’s existing data on industry sector for each of its financings, one can begin to build a picture of the approximate total environmental impact and efficiency of its portfolio. This, in turn, could form the basis for public reporting and, more importantly, the institution’s decision-making on future financing patterns and actions to reduce existing environmental exposures.

**BENCHMARK:**

**Analysis of the Environmental Intensity of Syndicated Loan Activities in Australian Capital Markets**

Do the major banks active in Australia differ substantially in their contribution to environmental impacts through their institutional lending activities?

This is an important question: significant differences in indirect contributions to environmental impacts could well translate into higher indirect risks for the institutions that finance high-impact activities.

To test this, we compared the lending activities of 24 major banks active in the Australian syndicated lending market from 2000-2004.

The purpose of this analysis is to illustrate the differences between the greenhouse emissions and water use intensities underlying various lenders’ syndicated loan activities. The study is an initial demonstration of the practicality of benchmarking investment portfolios by environmental characteristics, and may show financially material differences in indirect environmental risk exposures.

**FINANCE PORTFOLIOS MAY BE WEIGHTED IN ENVIRONMENTALLY AND FINANCIALLY SIGNIFICANT WAYS THAT PORTFOLIO MANAGERS DO NOT MEASURE OR UNDERSTAND.**
SUMMARY OF METHODOLOGY

Information about the syndicated lending activities of key financial institutions in the Australian market from 2000-2004 was provided by Dealogic, drawing upon its proprietary Loan Analytics database. This database contains summary information for each syndicated loan during the period, including the borrower’s identity, the total amount of the loan, and the identities of the arrangers.

For each transaction, a climate change and water use intensity value was then assigned. These values depended on the industry sector of the borrower and were derived from the CSIRO Balancing Act report. This 2005 study measures the relative effects of 135 Australian industry sectors across a set of key economic, environmental and social indicators.

The result is a database containing for each loan during the relevant period: the identity of the arranger(s), the amount of the loan, and the greenhouse emissions and water use intensity of the activities financed. The calculation of the aggregate intensities for each institution’s syndicated loan activities is then a matter of averaging the environmental intensity values for the relevant individual transactions, weighted according to the value of the transaction.

A detailed explanation of the methodology, including key assumptions and possible sources of error, is set out in the Appendix.

RESULTS

The relative greenhouse emissions and water use intensities for the top ten lenders (by number of transactions) are shown on the two tables below.

A table setting out the full results for 24 institutions is included in the Appendix.

ANALYSIS

There is a wide variation among the environmental impact characteristics of syndicated loan activities of financial institutions in the Australian market from 2000-2004. For both greenhouse emissions and water use, the lender with the highest average indirect environmental impact had an intensity of about 2.5 times that of the lowest impact lender.

These differences suggest that changes in regulation and/or pricing of greenhouse emissions and water use in Australia could have a disparate impact on lenders to high-impact industries. All other things being equal, this could translate into material, previously unmeasured differences in indirect environmental risk exposure.

GREENHOUSE GAS EMISSIONS INTENSITY OF ACTIVITIES FINANCED BY TOP 10 LENDERS IN ANZ SYNDICATED LOAN MARKET, 2000–04
A significant change in water or emissions pricing over time, for example, would have a larger effect on those institutions that have financed relatively environmentally intensive activities, by imposing a disproportionate financial burden on their borrowers and increasing the likelihood of default, relative to more efficient borrowers.

It also may suggest that institutions that have invested in relatively low-intensity activities may be doing a better job positioning themselves for growth in future environmental and clean-tech markets.

It should be noted that this analysis is based only on syndicated lending activities over a 5-year period, and not on the institution’s financing activities as a whole or on its actual portfolio at any given point in time. Because of this focus, firm conclusions about relative exposure to environmental changes would require a more comprehensive study.

However, if differences of the magnitude identified in this study are present throughout finance portfolios more generally, it would be reasonable to conclude that the differences in environmental weightings are financially material. On this basis, a further and more comprehensive study is warranted.

In the meantime, financial institutions, as well as their investors and sector analysts, should pay greater attention to such environmental weightings and seek to ensure that underlying portfolio exposures to key environmental impacts are minimised. Individual financial institutions with access to more comprehensive and precise data about the full range of their own activities could conduct a more comprehensive and precise assessment of their own aggregate environmental intensities.

The assumptions and possible sources of error in this study are set out in the Appendix.

**CONCLUSION**

There are significant differences in the greenhouse emissions and water use intensities of activities financed by banks in the Australian market through syndicated lending.

The activities financed by the worst performing lender in each case were around 2.5 times as intensive, in environmental terms, as the activities financed by the best performing lender.

The substantial disparity in indirect environmental impacts could well translate into materially higher levels of environmental risk for those banks that are not adequately monitoring and reducing their indirect environmental impacts.

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**WATER USE INTENSITY OF ACTIVITIES FINANCED BY TOP 10 LENDERS IN ANZ SYNDICATED LOAN MARKET 2000–04**
2. ENHANCED CLIENT AND TRANSACTION ASSESSMENT PROCEDURES

SYNOPSIS:
Traditional credit risk and other forms of financial analysis fail to address environmental externalities a particular business may impose on other constituents of an overall portfolio. Further, credit risk analysis has in the past tended to undervalue long-term environmental, regulatory, and reputation risks. Credit risk assessment should be strengthened by more rigorous and specific analysis of salient environmental issues, and should be supplanted by additional procedures to ensure environmental externalities are fully considered.

BARRIER:
FAILURE OF FINANCIAL RISK ASSESSMENT PROCESSES FULLY TO CONSIDER POSSIBLE ENVIRONMENTAL ISSUES, INCLUDING REPUTATION RISK AND EXTERNALITIES.

The purpose of credit risk analysis is narrow: all that it seeks to do is determine the likelihood that a borrower will be able to repay a loan, with interest. Similarly, investment processes focus on the expected risk and return from investment in a single business.

Such processes are insufficient to furthering a financer’s overall interests, even if those are seen as purely financial. This is because the financed activities can have negative effects on a financer wholly separate from the risk of non-repayment. For example, traditional financial analysis does not include assessment of externalities, or reputation risk to the financer.

Further, even within the scope of traditional financial risk analysis, environmental risk assessment procedures until recently have been largely informal or ad hoc at most institutions. Twenty years ago, evaluating possible environmental risks in the lending context was left largely to the judgment of individual relationship managers and credit risk officers, who seldom had any particular expertise in the area, with little if any policy guidance.

According to our research, in some Australian financial institutions these informal methods remain more or less unchanged, especially in several of the mid-sized or smaller banks. Where no formalisation of environmental risk assessment policy has occurred, it is unlikely that environmental issues are consistently and meaningfully assessed.

Other institutions have undertaken revisions to their risk assessment procedures to encourage or require consideration of specific environmental issues.

SOLUTION:
IMPROVEMENTS TO ENVIRONMENTAL RISK ANALYSIS, AND STEPS TO SUPPLEMENT SUCH RISK ANALYSIS WITH BROADER CONSIDERATION OF ENVIRONMENTAL EXTERNALITIES.

Efforts to improve environmental risk assessment have taken a variety of approaches. In the lending context, these include the following:

• TRAINING
Training of individual relationship managers and credit risk officers about environmental issues can increase the likelihood that they will seek pertinent data on clients and transactions, and will incorporate reliable environmental assessments into their analyses.

Training also has the potential to inculcate a general environmental competence in all relevant decision-makers, and it works within existing banking structures. It should be an essential component of an integrated approach.

On its own, however, it is unlikely that training in environmental issues will transform credit risk analysis into something that it is not – ie, a way of assessing externalities or reputation risk. Further, while training is important, relationship managers and credit risk officers will never be experts in complex environmental risk assessment. At best, their role is as initial screening agents, but they cannot entirely supplant the role of expert in-house environmental assessors.

In addition, if the incentives of decision-makers are skewed towards short-term performance targets, they may discount the real risks of long-term environmental concerns, even if they are fully aware of them. Finally, it is difficult to ensure consistency of high-quality environmental risk analysis merely through a decentralised programme of training.
REQUIRED CONSIDERATION OF ENVIRONMENTAL ISSUES

Some banks have integrated consideration of environmental concerns directly into their transaction assessment forms or procedures. This can be as cursory as a single question addressing whether the proposal entails any significant environmental risk or impact, or can involve a thorough set of questions on specific environmental concerns that must be answered in an automated client or project assessment tool. In some cases, full environmental impact assessments of major transactions in certain areas are required. In general, the systems that inspire the greatest confidence are those that combine specific questions about frequent issues (such as site contamination, environmental licences and climate change exposure) with more general, open-ended questions about environmentally sensitive activities, and then link the answers to those questions directly into specific loan covenants.

SECTOR-SPECIFIC POLICIES

Some banks, including National Australia Bank and ABN AMRO, have adopted particular lending policies for specific industry sectors. These can range from absolute prohibitions on lending to activities or borrowers with certain characteristics, to various assessment processes, contractual assurances, and/or monitoring procedures for projects in sensitive industry sectors.

The type and level of detail of sector-specific policies vary greatly. Some examples are given below.

PARALLEL ENVIRONMENTAL ASSESSMENT PROCEDURES

A handful of institutions have set up assessment procedures that run in parallel to the usual structure of credit risk analysis. Such procedures can entail a required approval for all transactions or certain kinds of transactions, or they can be triggered on a discretionary basis by other decision-makers (e.g., credit risk officers) at various points in the approvals process.

Such parallel procedures can be very effective. Because the environmental assessment process is specifically divorced from the credit risk approvals, the analysis can be conducted with a modicum of independence. Further, since the staff responsible for such parallel assessments tend to work only on environmental issues (or on ethical or “sensitive” issues generally), they will tend to have greater expertise in these areas than an average banker. Finally, the creation of an independent locus of power within an organisation focused on environmental issues, possessing real authority in the financial decision-making process, can stimulate increased environmental awareness across the organisation. For example, a relationship manager will likely be more proactive in ensuring proper environmental management at a borrower’s operations if the manager knows that projects can be blocked if they do not measure up to environmental standards.

ENVIRONMENTAL RISK ANALYSIS PROCEDURES IN PRACTICE

A ROBUST, COMPREHENSIVE MODEL: ABN AMRO

Among the environmental risk analysis procedures reviewed in the course of this project, those of ABN AMRO engender the greatest confidence that environmentally sound outcomes are being reached. Through a combination of detailed policies on specific industries, training of relevant staff, creation of a sustainability assessment process parallel to credit risk analyses, and specialised client assessment tools, ABN AMRO’s lending systems are thorough, robust and likely to direct capital to relatively environmentally and socially sustainable investments.

ABN AMRO’s risk assessment procedures include the following salient elements:

1. The creation of a specialised Sustainability Business Advisory unit (SBA), which is internally independent of both relationship management and credit risk assessment functions. The SBA unit is global, but includes on-the-ground staff with expertise in the Australasian region. SBA staff focus on environmental, social and human rights issues in the lending process. Unlike their counterparts in many other organisations, SBA staff do not have substantial external communications or internal environmental management functions. This allows them to focus primarily on the core task of client and project assessments.

Sign-off of SBA is required for client engagement profiles and specified transactions. This arrangement supports consistency of application of the bank’s environmental lending policies, and means relationship managers will be more likely to investigate possible environmental issues before seeking approval of a proposed transaction.

2. A client diagnostic tool that is used prior to engaging with any new clients in the oil & gas and metals & mining sectors, and others on request from SBA. The tool includes an automated questionnaire which
allows a profile to be developed of a prospective client’s environmental management policies and competency. The profiles are worked up by relationship managers, but must be signed-off by the SBA unit. Client assessments are reviewed annually.

3. An automated environmental, social and ethical risk filter that is applied to all lending transactions. This is a detailed form designed to identify transactions where some additional scrutiny is required. For transactions that involve specified industries, activities or that otherwise raise concerns, the analysis and approval of SBA is required as part of the credit approval chain.

4. Detailed sector-specific policies covering Mining and Metals, Oil & Gas, Defence, Tobacco, and Forestry, with work underway on Nuclear Energy and Hydroelectric Power policies. These policies prohibit financing of certain risky practices, such as riverine disposal of mining waste, and set detailed parameters around lending otherwise.

5. A “Social and Ethical Country Risk Framework”, which allows the bank to identify countries where weak governance structures mean the bank must undertake additional due diligence and other measures to ensure that environmental, social and human rights considerations are respected.

6. Application of the Equator Principles to all project finance transactions, which means environmental impact assessments in accordance with World Bank/IFC procedure must be carried out for projects with significant environmental impacts.

7. An internal SBA case history database, covering all advice given by SBA since its inception in 2000. This informational resource allows accumulation of analysis of environmental issues in one easily accessible place for SBA staff, and facilitates consistency of application of the bank’s environmental policies.

8. Training of relevant client, risk and SBA staff.

As evidence of the independence of the SBA team, and the practical impact of their reviews on investment outcomes, of the 316 transactions worldwide that SBA reviewed in 2004, it declined 44 (14%), required corrective measures or conditions in a further 78 (25%) and fully supported 194 (61%).

As with any human system, there is always room for improvement. For example, ABN AMRO doesn’t yet appear to measure environmental characteristics of its portfolios in a systematic way, to give an overview of performance and overall risk exposure. Specific policies on climate pollution-intensive projects, biodiversity and other important areas would be further improvements. Nevertheless, it is clear that ABN AMRO had taken a thorough and well-considered approach to environmental and social issues in its lending practices, and that this approach is improving the environmental profile of the bank’s lending activities.

OTHER RECENT DEVELOPMENTS IN AUSTRALIA AND GLOBALLY

Westpac Bank, the only Australian bank to have endorsed the Equator Principles, has adopted a set of assessment procedures to fulfil its obligations under those principles and to address environmental risk more broadly. One unusual feature of Westpac’s strategy is the creation of a standing Social Responsibility Committee of the Board, with responsibilities including oversight of the bank’s reputation risk management.

National Australia Bank’s environmental risk assessment policies require heightened review of many major transactions, including loans of $500,000 or more in a wide range of industry sectors. Processes include questionnaires and checklists to facilitate identification of key environmental issues. Two environmental specialists are employed in-house to conduct reviews where heightened scrutiny is triggered, in addition to external consultants. This is an unusual resource; many Australian institutions rely solely on external expert reports, the independence and quality of which may vary, or on information provided by the borrower.

ANZ Bank has also initiated a comprehensive review of its environmental and social risk assessment practices. The findings of this review, which commenced in 2003, included the identification of 16 industries and 12 high profile issues on which ANZ should focus attention, and confirmation of the need for “significant changes” to existing lending procedures. ANZ remains in the process of implementing these changes. Many other institutions, including most of the medium and regional banks, continue to rely on ad hoc or informal systems of considering environmental risks, or are only at the very beginning of a process of reform.

Among multinational financial institutions, a good example of a relatively strong general environmental policy is that of Citigroup, issued in 2004 after a concerted campaign by the Rainforest Action Network.

The policy provides, in part, as follows:

“Citigroup will not finance any project or provide general corporate loans to any project (where the use of proceeds is known) if the project or use of proceeds is located within critical natural habitats,
unless the sponsor or borrower, as appropriate, has demonstrated to Citigroup’s satisfaction:

- The project sponsors have considered economic and technically feasible alternatives to avoid such areas and have addressed these issues in the publicly available EA.
- The project will not significantly degrade or convert the critical natural habitat;
- Project management has adequate capacity and willingness to ensure biodiversity protection and respect for the rights of indigenous communities whose livelihoods or cultural integrity could be adversely impacted;
- Indigenous peoples impacted by the project, whether directly or by induced impact, have the opportunity and, if needed, culturally appropriate representation, and have access to the information to engage in informed participation;
- The governmental authorities at the local, regional or national level have provided mechanisms for the affected communities to be represented or consulted, and international and local laws have been upheld; and
- An Environmental Impact Assessment has been prepared that takes into account such consultations and is publicly available."

It is noteworthy that this policy is not limited to project finance, but extends to general commercial lending as well, at least where the use of the proceeds is known. A commitment to make reasonable inquiries into the intended or likely use of funds would render the policy more watertight.
3. IMPROVED FINANCIAL ANALYSIS OF ENVIRONMENTAL ISSUES

SYNOPSIS:
Demand for rigorous financial analysis of the impacts of longer-term environmental issues and trends is low, in part because of the chronic short-term focus of capital markets. The investment community does not generate sufficient information to assess the long-term investment implications of climate change and other important issues. Deliberate dedicating of resources to financial analysis of key environmental issues helps facilitate meaningful incorporation of environmental issues into investment decision-making.

BARRIER:
LACK OF FINANCIAL ANALYSIS OF ENVIRONMENTAL ISSUES, WHICH IMPEDES INTEGRATION OF ENVIRONMENTAL CONCERNS INTO INVESTMENT DECISION-MAKING.

The lack of high-quality, credible and useful analysis in Australia of the long-term financial implications of environmental issues is a serious impediment to full and accurate consideration of those issues in financial decision-making. Ernst & Young, in a recent survey, noted that:

“The sector tends to rely heavily on subjective sources for information on environmental risks. This raises a possibility that finance sector participants may be receiving biased or a comparatively poor standard of information upon which to base assessments of environmental risks. It may also indicate an overall market absence of high quality environmental data that articulates potential economic or financial exposures from environmental risks.”

The result of these circumstances is a vicious circle: insufficient information about environmental risks means that analysis of financial dimensions of environmental issues can be speculative or subjective. The lack of reliable analysis contributes to a widespread perception that environmental issues are not material, which in turn diminishes the demand for the underlying data upon which such analysis must be based.

Lack of access to relevant information is thus a driver of lack of adequate understanding and analysis of environmental issues. According to Ernst & Young, “The level of understanding of how to deal with environmental risks and the sector’s perceptions of what represents quality information might be more sophisticated if the sector was able to readily access relevant expertise and more robust and independently verified environmental data.”

The very limited mandatory disclosure regime in Australia surely contributes to the relative paucity of analysis of environmental issues in Australian financial markets. Australia compares unfavourably to much more comprehensive schemes in place in a number of other jurisdictions, as explored in Part III.

However, the endemic short-term focus of financial markets is an equal contributor to the problem of insufficient analysis. A system that rewards short-term performance and discourages analysis of issues that may not be material in the very near term will by definition undervalue environmental issues that often play out over the medium- to long-term.

These shortcomings are to some degree common to all jurisdictions, yet there is reason to think that the perception of irrelevance of environmental issues is more pronounced in Australia. This may stem from the relatively trivial level of financial penalties and other environmental liabilities in Australia. For example, environmental fines are trivial; even a series of serious crimes such as those leading to the leak of uranium at Energy Resources Australia’s Ranger uranium mine led to a fine of a mere $150,000. The fine was of no significance in an investment sense; it represented 0.39% of the company’s profits for the year – less than two days’ profits. Though the fine was only half of the maximum allowable, the magistrate in the case observed dryly that, “even if I was to impose the maximum fine ... there would be very little bearing on ERA’s bottom line.”

Similarly, environmental remediation costs and damages awards are on the whole far lower than in the United States or other jurisdictions. It is, unfortunately, far less expensive for a corporation break Australia’s

11. Ernst & Young 2003, p. 2.
12. Ibid.
environmental laws and degrade our environment than it is to do so in the U.S. or Europe. Little wonder, then, than investment analysts pay scant attention to these risks in Australian financial markets.

Nevertheless, the low level of potential environmental fines and other direct costs may mask other significant environmental exposures, particularly to regulatory change, fluctuations in energy and other commodity prices, and market positioning in environmentally relevant areas.

Analysts’ views about the relevance of environmental issues appear to be well out-of-step with the views of the shareholders whom they ultimately service. For example, a recent survey in Australia found that over 50% of shareholders consider socially and environmentally responsible practices to be “very important” in investment decision-making, while only 21% of analysts, advisors and brokers agreed.14

Financial analysis of environmental and other ethical issues also requires different skill sets and methodologies than analysis of traditional financial issues. For example, as the mining industry has come under increased scrutiny for a raft of ethical issues such as pollution and remediation, HIV/AIDS and human rights violations, analysts have remained curiously obsessed with commodity prices and exchange rates – even though environmental and social issues have had serious impacts on mining operations.

The head of European steel research for a major investment bank commented on this preoccupation with commodity prices and other quantitative data as follows:

“Despite the (often extreme) volatility of these short-term factors, changes are at least easily identified on screens. Analysts also seem more comfortable forecasting their future direction than they are in identifying and quantifying changes in non-financial risk. … Few, however, have been successful in trying to outline the mining industries’ longer-term trends or the appropriateness of company business models.”15

Analysts tended to incorporate discussion of ethical issues only in a reactive way, once a potential risk had evolved into a likely large and immediate liability. Of course, by the time this occurs, the analyst is no longer forecasting future performance based on current position, but merely reporting on past events.

Other barriers include the overall lack of knowledge of most analysts in the area of social and environmental issues, lack of training, suspicion of and lack of relationships with NGOs, and a prevailing culture that relies heavily on financial criteria and ability to interpret financial accounts rather than a broader set of skills. Of course, all of these are reinforced by the structural short-term focus of the markets.

SOLUTION:
FORMAL COMMITMENT OF RESOURCES TO ANALYSIS OF ENVIRONMENTAL AND OTHER LONG-TERM "EXTRA-FINANCIAL" ISSUES.

Notwithstanding the barriers, there are scattered examples of high-quality financial analysis of environmental issues in Australia. AMP Sustainability Funds stands out for its high-quality analyses of the investment implications of key sustainability issues, many of which are publicly available.

One example is AMP’s 2004 report on “Emissions Trading and the Australian Aluminium Industry”, an impact and sensitivity analysis of a key regulatory issue. The innovative report focuses squarely on the investment implications of proposed regulatory changes, with clear analysis of the differential impacts on specific listed companies. The analysis required a very high degree of sophistication not only in discussion of mainstream issues such as commodity prices and the structure of the relevant markets, but also in environmental policy including the likely design parameters for an emissions trading scheme, and how companies would go about managing their obligations under such a scheme.

So despite the barriers, the generation of useful long-term analysis of environmental issues from an investment perspective is feasible and demonstrated, though so far sporadic. The challenge is to increase the prevalence and integration of such analysis into mainstream decision-making.

One innovative effort to improve sustainability research by sell-side analysts is the Enhanced Analytics Initiative. Participants in this initiative include major institutional investors and asset managers, each of whom allocate at least 5% of their brokerage commissions to “extra-financial research”, including environmental, social and governance issues.

Institutions that do not manage any funds in-house can also participate by becoming associate members and encouraging their external fund managers to become members of the initiative. According to the group’s website, some institutions are even using membership in the initiative as part of their fund manager selection criteria.17

The Enhanced Analytics Initiative is an outstanding model for improving environmental analysis. Though the current membership consists only of European organisations, and the research generated will therefore have a European focus, the model could easily be implemented in Australia.

Beyond a deliberate effort to fund analysis of environmental and other “intangible” issues (either by individual investors or by a collective initiative), investors and analysts can take the following steps to improve the quality and availability of environmental research and analysis:

- Demand that companies provide externally verified data on key aspects of their environmental performance;
- Require training of analysts to increase competencies in the areas of environmental and social issues and trends and how to analyse such issues in an investment context;
- Lobby governments to introduce relevant mandatory corporate disclosure requirements, such as disclosure of greenhouse emissions and comprehensive environmental compliance information;
- Ensure that compensation structures encourage the undertaking of long-term analyses by analysts, understanding that the payoff for high-quality long-term analyses may not be immediate.
- Increase average holding periods for securities, thus lowering transaction costs and increasing the relevance of long-term analysis.
- Free up analysts partially from the daily high-pressure demands of short-term quantitative analysis. Good analysis of sustainability issues will not occur unless analysts have the time and mental space to educate themselves, gather information, and focus on sophisticated and meaningful analysis, rather than numbers-heavy but thought-poor reports.
- Increase dialogue with companies on environmental and other ethical issues.

17. www.enhancedanalytics.com
4. INTEGRATION OF ENVIRONMENTAL PRICING AND INCENTIVES INTO FINANCIAL PRODUCT DESIGN

**SYNOPSIS:**
Most mainstream financial products do not encourage, and may discourage, consumers and businesses from pursuing sustainable practices. Conversely, niche financial products such as “green” mortgages include sustainability incentives, but have had only limited take-up. Environmental pricing and incentives can and should be built into mainstream financial products, rather than consigned to niche products.

**BARRIER:**
INADEQUATE CONSUMER AND BUSINESS ACTION TO REDUCE THE ENVIRONMENTAL IMPACTS OF INDIVIDUAL AND BUSINESS ACTIVITIES.

There is abundant evidence that many environmentally sound practices make sense financially as well. A recent study by The Climate Group, for example, identified 74 companies and 34 municipalities that have taken actions to reduce greenhouse emissions — sometimes dramatically — while at the same time saving the companies a total of US$11.6 billion and the municipalities US$745 million.\(^{18}\)

However, while the business case for environmentally sound behaviour is often compelling, there remain many circumstances in which other barriers inhibit environmentally responsible action or, in fact, some additional incentive is required to encourage improved environmental performance. The case for this is particular strong in the area of small business and residential impacts, where the barriers of transaction costs, upfront capital requirements, and lack of information, trust and attention can inhibit what are both environmentally and financially sound investments.

In these circumstances, communities can legitimately look to governments to play the leading role. However, it is in the interest of financial institutions to contribute further as well, both as a reputation and positioning matter and to reduce environmental externalities that rebound to the detriment of investment portfolios.

So far, the usual way for financial institutions to promote environmental responsibility among individual and small business consumers is by creating specialised green financial products, which sit alongside the institution’s “mainstream” offerings.

The following section discusses such initiatives, which have had a limited appeal and limited environmental benefits, despite much goodwill. First, however, we turn to the innovative and potentially more promising avenue of fully integrating environmental performance incentives into a mainstream financial product.

**SOLUTION:**
INTEGRATION OF ENVIRONMENTAL INCENTIVES INTO MAINSTREAM FINANCIAL PRODUCTS.

The best example of differentiation in the terms and conditions of a financial product based on environmental criteria is the goGreen car loan product offered by credit union mecu. This is not a specialised green product sitting alongside another car loan. All car loans offered by mecu are goGreen loans.

The product has two components. First, mecu differentiates in the interest rates it assesses on car loans based roughly on the environmental impact of the vehicle. The differentiation is substantial, with more than a 5 percentage point spread between cars with a greenhouse rating of 8 or better (7.24% apr) and, at the other end, used cars more than five years old (12.5% apr). Second, mecu has arranged (through GreenFleet) for trees to be planted every year to offset the emissions that result from its entire portfolio of car loans.

For mecu, the goGreen product has generated significant positive publicity and commercial success. In the roughly 16 months following launch of the product, mecu’s volume of car loans increased by 45%. This resulted in increased economies of scale and profitability. Counter-intuitively, the growth has not all been in lending for highly efficient vehicles, nor has the strong interest rate differentiation driven away purchasers of relatively polluting vehicles. Nearly half of mecu’s portfolio remains in the two highest interest rate categories:

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The goGreen car loan is notable as a model of interest rate differentiation and direct environmental impact abatement that succeeds even in a market where other lenders have not adopted such practices. It is fascinating proof that products with specific sustainability features will not appeal only to consumers whose purchasing and lifestyle habits are in some sense “deep green”.

<table>
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<td>12.5%</td>
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<td>12.96%</td>
</tr>
</tbody>
</table>

If replicated across the finance sector, the goGreen model could have a substantial impact on consumer behaviour.

However, there may be limits as to how far the model could be extended. Although it has been profitable for mecu, for which vehicle lending is a relatively small component and may be an adjunct to other products (such as mortgages), it could be more difficult for specialised vehicle finance companies, for example, which may operate on tighter margins to begin with. Furthermore, the practice of purchasing offsets for car pollution in the form of tree planting may work for hundreds or thousands of vehicles, but may not be practically scalable to the millions of vehicles currently on Australia’s roads. However, these issues do not undermine mecu’s substantial achievement with the goGreen product.

In fact, goGreen’s success may be leading to wider availability of such products across the sector. Bendigo Bank recently announced that it would soon be making available a car loan that includes an offset of the CO₂ emissions of the vehicle over the lifetime of the loan, while South Australian credit union Savings and Loan has introduced its “Breathe Easy” line of personal loans, with interest rate discounts for purchases of new fuel-efficient vehicles and solar hot water heaters.

**SOLUTION:**

**CREATION OF SPECIALISED “GREEN” FINANCIAL PRODUCTS.**

**LINKED DEPOSITS AND PHILANTHROPIC DEPOSIT AND CREDIT CARD PRODUCTS**

Linked deposit products have a successful history internationally as ways of mobilising modest amounts of capital for community investment. The concept is that funds deposited in such an account will be invested only for specified purposes.

Overseas, linked deposits have had some success, particularly when developed and marketed by specialist green or development banks such as Triodos Bank in the Netherlands, Belgium and the U.K., Co-operative Bank in the U.K. and South Shore Bank in the U.S.

Perhaps the most successful linked deposit product arose in the Netherlands in conjunction with specific government tax incentives for sustainable investments. Interest earned on deposits with qualifying “fiscal green funds” was exempt from taxation; in order to qualify, the fund had to direct its investments exclusively to businesses possessing a “green certificate” issued by the Dutch government.

In practice, the benefit of the tax exemption is shared by the borrower, the bank, and the depositors. Thus, the fiscal green funds are able to offer higher net returns to depositors, lower than market interest rates to borrowers, and still earn a comparable interest margin for the bank itself.¹⁹

In Australia, one example of a linked deposit with a philanthropic component is Bendigo Bank’s Ethical Investment Cash Management Account. Interest earned on funds deposited in this account are directed to the Ethical Investment Trust, a fund that invests in social infrastructure (such as education and health care). Profits of the trust are directed to Oxfam Community Aid Abroad to fund some of its development work.

Westpac has launched a term deposit product that similarly supports Landcare.

Another example of philanthropy-oriented consumer financial products are charity-linked credit cards through which a small percentage of purchases made is donated to specific charities, or where the consumer has the option to redeem “bonus” points for donations to charities. In Australia, ANZ, NAB and BankSA offer such charity-linked credit card products.
Green mortgage products - existing practice

Specialised green mortgage products have a chequered history in Australia and around the world. There have been some spectacular failures, and even the more successful products have not achieved market penetration beyond a narrow niche.

Macquarie Bank offered what it billed as the first Australian green mortgage product in 2000 in conjunction with the Housing Industry Association (HIA). The loan offered a 0.25% interest rate discount for houses that met certain energy efficiency standards, but was withdrawn after less than two years due to lack of demand. According to Macquarie, HIA members showed little interest in marketing the product to their clients.20

Currently, green mortgage or home improvement products are offered in Australia by Bendigo Bank, Maleny Credit Union, and mecu, with a pilot underway by ANZ Bank.

Bendigo Bank’s green home loan product is the most visibly marketed of these offerings. This loan, launched in April 2002, offers a 0.50% p.a. reduction on the Bank’s residential variable interest rate for qualifying Green Homes. A variety of homes qualify, ranging from those that achieve a certain environmental accreditation to those constructed by developments in areas that integrate innovating environmental features into building and community design. According to a March 2005 external study, uptake has been “lower than expected”,21 although the continued availability of the product after nearly four years indicates some degree of viability.

Bendigo also offers a green personal loan, which offers a similar interest rate reduction for purchases of environmentally friendly vehicles, high-efficiency whitegoods, and a range of home improvements that improve environmental performance.

Maleny Credit Union offers a “Cool Home Loan” for homes that satisfy five or more specified energy-saving criteria. As of late 2003, Maleny was reporting about five new loans per month, which enabled the product’s financial viability.

Mecu launched its goGreen Home Improvement loan in 2004, offering a full 1% off of its standard variable rate for investments in a variety of environmentally sustainable home improvements. Again, performance of the product highlights the difficulty of stimulating consumer demand in this area. Uptake has been very limited; mecu has acknowledged that the product is “early in its life cycle”.22

ANZ has conducted a pilot to assess demand for a green mortgage product that takes a different tack from the usual interest rate reduction. Working together with not-for-profit environmental consultancy easybeinggreen, ANZ’s product would bundle a home loan together with additional financing for easybeinggreen’s sustainability-related retrofit services. This type of product in theory could be more attractive for improving old housing stock, rather than just building high-efficiency new housing. Unfortunately, despite ANZ marketing research indicating that there was substantial consumer interest in retrofitting, according to easybeinggreen in August 2005, none of ANZ’s customers had yet taken up the offer of a mortgage-bundled retrofit, although some retrofit assessments were conducted.23 ANZ has reported that “greater customer education and marketing would be required to accurately assess customer interest in ‘green’ mortgage products.”24

The primary appeal of all of these products is that they reward proactive, responsible action by individual borrowers to improve their personal, and our collective, environmental performance.

Yet, on the whole, despite much goodwill and willingness to innovate, these products have not succeeded in achieved substantial environmental gains in the Australian housing market. In this respect, they mirror experience overseas. A thorough review of international experience in March 2005 by U.K.-based Centre for Sustainable Energy found no significant market penetration by green mortgage in the U.K., Australia, Canada, the U.S., and even the Netherlands.

where strong government incentives should have made green housing investments much more attractive.\textsuperscript{25} Even U.S. banking giant Citigroup reported that it was unable to sell its MyCommunityMortgage energy efficient mortgage product through the normal course of business, and that the evaluation of different marketing strategies and partnerships was required.\textsuperscript{26}

Many reasons for the lack of success of such products have been advanced, including the following:

- Lack of broad-based consumer awareness and interest in sustainable housing;
- Poor training of financial intermediaries and lack of incentives for intermediaries to market the products;
- Other priorities crowding out consideration of sustainability in mortgage and housing choices;
- Low demand for financing of retrofitting, with even those consumers interested in retrofitting likely to fund such improvements out of personal savings rather than debt;
- Lack of consumer confidence in the projected savings of energy efficiency improvements, and scepticism of financial institutions and/or contractors generally; and
- Poor marketing of green mortgage products.

Though the Bendigo Bank product, at least, demonstrates that there exists a small but important market for a specialised green mortgage product, the lack of success in achieving large-scale environmental improvements through the green mortgage model compels us to look at other options.

\textbf{GREEN POWER-ORIENTED MORTGAGE PRODUCTS}

It is a curiosity and a shortcoming of green mortgage products that they have focused exclusively on the physical infrastructure of residences, rather than the behaviour of their inhabitants, where greater environmental gains may be had. Giving consumers the incentive (or even obligating them) to purchase green power, for example, is an option worth exploring.

In this regard, it is worth reflecting on the implied subsidy for efficient housing embedded in existing mortgage products. For a $300,000 20-year mortgage, the 50 basis point reduction offered by Bendigo Bank equates to an effective average annual subsidy of $1,080. For this amount, Bendigo is achieving, or rather rewarding the achievement of, some improvement in energy efficiency and other characteristics of one residence – though the residents remain free to purchase heavily-polluting brown coal-generated power for their ongoing energy requirements.

To put this in perspective, Origin Energy offers its GreenEarth Extra power product (50\% wind and 50\% hydro power) for an indicative price of $3 per week, or $156 per year, more than its standard energy rates. (The actual fees would depend on usage.) A household purchasing such a green energy product can therefore abate much or all of its greenhouse emissions, possibly at much less cost, than a household that improves its energy efficiency but continues to purchase highly polluting power.

If environmental outcomes is a measure of success for such a product, then a green power-oriented mortgage product stacks up much better than a product geared at inspiring, or rewarding, energy efficiency retrofits. For the same price as the interest rate incentive for a single home, a bank could pay outright for the additional cost of green power for 7 households on an ongoing basis.

Indeed, given the very low additional cost of green power, it would not be impossible for a bank to ‘green’ an entire mortgage portfolio by making green power obligatory for borrowers, with the bank picking up the tab for the additional cost (subject to an annual cap). The current $100-200 additional annual cost of green power is similar to the value of other perks banks already offer to mortgage customers, such as waivers of various fees, initial interest rate reductions, insurance, etc.

For about $1.5 million per year, a bank could drastically improve the environmental performance of a portfolio of 10,000 home loans, with an annual reduction in greenhouse emissions of perhaps 70,000 tonnes CO\textsubscript{2}-e, or roughly the same amount as the total annual emissions from the operations of a large Australian insurer or medium-sized Australian bank.

There would be many ways of structuring and administering such a product – a bank could pay or share the cost of green power with the borrower, or could grant a small interest rate reduction (5-10 basis points) to purchasers of green power, for instance.

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\textsuperscript{26} Citigroup 2004 Citizenship Report.
OTHER SUSTAINABLE MORTGAGE MODELS

In general, an investment into energy efficiency or other environmental improvements may generate three streams of income:

1. The ongoing savings in terms of reduced energy and other resource demands, and possibly reduced maintenance and other ongoing costs;
2. The economic value of government incentives (such as abatement certificates (NGACs) generated under the New South Wales Greenhouse Abatement scheme); and
3. The value of greenhouse or other offsets that third parties may be interested in purchasing as part of a private or quasi-private voluntary abatement schemes (such as the federal Greenhouse Friendly program).

Actually realising each of these streams of income can be difficult, especially for diffuse small-scale improvements such as residential efficiency. For the first stream, owners may be dissuaded by the upfront costs or sceptical about the long-term benefits. For leased premises, the lack of alignment of incentives between owner and tenant further complicates matters. For the second and third income streams, the transactional costs for a very small project are often prohibitive.

Banks are in a unique position, by virtue of their relationships with large numbers of individual property owners, to overcome some of these barriers. For example, a bank could work with the administration of the NGAC scheme or even a private investor to develop a streamlined but reliable way of gauging offsets generated by residential efficiency measures (physical and behavioural), and could then aggregate the small offsets generated by its customers. Whereas individual small packets of offsets are basically unmarketable, a bank would be in a position to commercialise such aggregated offsets.

GIVEN THE VERY LOW ADDITIONAL COST OF GREEN POWER, IT WOULD NOT BE IMPOSSIBLE FOR A BANK TO ‘GREEN’ AN ENTIRE MORTGAGE PORTFOLIO ... THE CURRENT $100-$200 ADDITIONAL ANNUAL COST OF GREEN POWER IS SIMILAR TO THE VALUE OF OTHER PERKS BANKS ALREADY OFFER TO MORTGAGE CUSTOMERS.
Another possible model is the “paid through savings” approach to financing residential efficiency improvements. For some time large-scale industrial and commercial efficiency projects have had the option of being paid through savings. Under this model, a private financier pays the cost of improvements at a given facility and, in turn, is entitled to some or all of the savings achieved at the facility. The advantage of this is that the owner does not necessarily have to come up with up-front capital, and may not have to bear the risk of efficiency improvements actually occurring.

The paid through savings model has been used successfully overseas and in Australia. For example, in the U.S., the Federal Government has projected energy cost reductions of US$5 billion through energy savings performance contracts involving federal government operations. With $3.5 billion of that being used to repay project costs, net savings of $1.5 billion will be achieved.

On the residential side, paid through savings models could easily work for apartment complexes, for example. A bank that developed a product in collaboration with an energy performance contract provider, targeted at apartment buildings and including marketing of greenhouse offsets and credits, could achieve large-scale environmental improvements together with a financially viable model.

Individual residences present a greater challenge, but even here innovative thinking about how to realise and aggregate efficiently the income streams from a large number of small-scale efficiency improvements could be both rewarding and environmentally effective.

**COMMERCIAL LENDING PRODUCTS**

There is evidence that lenders are beginning to integrate environmental considerations into loan conditions, though this does not yet extend to systematic interest rate differentiation on the basis on environmental impact.

One major bank gave the example of a large commercial loan to a power generator, which was given on condition that the generator undertake particular environmental upgrades. The bank extended the additional financing for those upgrades as well. Other institutions were able to offer similar examples.

It is difficult to assess how widespread these practices are, and what the quality of monitoring and compliance is. At the level of project finance and large commercial lending, environmental impact assessments are common and environmental performance conditions may extend beyond strict legal compliance. At the level of small- to medium-business lending, environmental features in commercial loans appear to be much less frequent.

At least one institution in Australia is currently examining the possibility of offering differential interest rates based on the emissions levels of the borrower in commercial loan transactions.

**SUSTAINABLE INSURANCE PRODUCTS**

Despite increasing evidence that climate change and other environmental issues may have a large effect on the nature and magnitude of insurance claims arising out of storms, droughts and other climate change-related events, integration of environmental impact-based pricing into insurance policy premiums remains in its infancy in Australia.

CGU, a subsidiary of IAG, offers a premium discount for vehicles that travel less than 10,000km per year, while Allianz Australia offers 12 months of vehicle coverage for the cost of 11 to borrowers from mecu’s goGreen car loan product.

These are examples of premium differentiation, albeit on a very small scale, on the basis of environmentally relevant characteristics. There is tremendous scope for greater innovation in this area.

Japanese insurers have often led the way on environmental pricing and other sustainability innovations in product design. Several major insurers in Japan first offered discounts for low-emissions vehicles in the 1990s; Tokio Marine offers a full 1.5% discount for insurance of low-pollution vehicles.

Similarly, Aviva has introduced “pay-as-you-drive” vehicle insurance in the U.K. and Canada. This type of coverage gives drivers an incentive to drive less, by tying the premium to actual vehicle usage. This structure makes straightforward business sense, in addition to having potentially positive environmental benefits.

Other innovations include Tokio Marine’s “Eco-response coverage”, a construction insurance policy that pays out the additional costs of making environmental improvements during restoration following an accident.

27. There are various ways this can be structured. For more information, the website of the Australasian Energy Performance Contracting Association (www.aepca.asn.au) has a wealth of case studies and other useful information.
28. See http://www.eere.energy.gov/femp/financing/superespcs.cfm
5. STRUCTURES FOR COLLECTIVE FINANCE SECTOR ACTION ON SUSTAINABILITY

SYNOPSIS:
The incentives for an individual financial institution to undertake sustainable activities can be undermined by market failures arising out of collective action problems. For example, the costs for an individual shareholder of engaging with companies to improve environmental performance can outweigh the benefits for the shareholder, since the benefit of engagement accrues to all investors. To solve this problem, financial institutions – particularly in the investment field – can pool their resources to ensure effective and efficient engagement.

BARRIER:
THREAT THAT LEADERS IN FINANCE SECTOR SUSTAINABILITY WILL BE UNDERMINED BY FREE-RIDING OR COMPETITION FROM LESS ENVIRONMENTALLY SOUND COMPETITORS.

Many of the challenges in sustainable finance are variations on the well-known tragedy of the commons. Throughout the sector, it is in the best interests of all to reduce long-term environmental externalities, but a single institution may risk losing out if it takes action and its competitors do not.

These difficulties can be overstated. For example, in theory, a lender that imposes differential interest rates based on environmental criteria risks losing the “high impact” end of the market to lenders that may offer a lower rate. Yet the case of mecu’s goGreen car loan shows that in some circumstances borrowers falling within the higher interest rate brackets will not turn to other lenders, particularly if they have other relationships with the institution. This is particularly the case if the institution is able to offer some additional benefit, along with the somewhat higher interest rate. In the case of mecu, the purchase of emissions offsets for the entire vehicle loan portfolio may persuade some customers to accept the higher interest rate for higher polluting vehicles.

Another similar difficulty exists in the area of investor engagement with the companies in which they invest. Investors collectively have tremendous potential to drive continual sustainability improvements and a long-term perspective at the businesses in which they invest. Equity investors’ collective control over management appointments and compensation and ability to introduce shareholder resolutions gives them tremendous leverage. Debt investors have less formal power, but through appropriate structuring of conditions in securities documentation can also retain substantial ongoing influence.

However, it is often difficult for individual investors to act on this latent potential. The problem is that engagement activities are relatively time- and resource-intensive, while the benefits generated through those activities accrue to all investors, not just the one undertaking the engagement.

In other words, the individual investor bears all of the costs but receives a small fraction of the benefits of engagement. This means that it will frequently not be in an investor’s best interests, seen in isolation, to spend the resources improving a particular company’s performance. As a result, the investment sector as a whole underinvests in engagement.

Thus, while individual institutions often have at least some scope for action, in many cases collective action is more feasible and effective than uncoordinated efforts by individual institutions. This is particularly true where the individual institutions are small and may need to pool resources to achieve the economies of scale necessary to analyse and engage on complex issues. This is most clearly the case with superannuation funds, but also with credit unions and potentially the small- to mid-sized banks as well.

SOLUTION:
GREATER PARTICIPATION IN CURRENT COLLECTIVE FINANCE SECTOR INITIATIVES.

In Australia, a handful of collective finance sector initiatives aimed at improved environmental performance across the economy are already underway. These include the following:

BT GOVERNANCE ADVISORY SERVICE (GAS)

BT’s Governance Advisory Service is perhaps the best example of a pooled engagement initiative, designed to overcome the structural impediments facing individual investors in their efforts to drive sustainability improvements by the companies in which they invest.

The fundamental idea behind GAS is that engagement by a united front of investors is more efficient and effective than engagement by each of them separately. To accomplish this pooled engagement,
investors contribute a flat fee (based on assets under management) to GAS, which conducts engagement on behalf of all GAS participants on key environmental, social and governance issues.

GAS does not have any investment selection function; it operates solely as an engagement service for other funds. This gives investors great flexibility; they can sign-up to GAS with respect to any investment fund with holdings in the ASX 200, regardless of their particular asset mix or investment selection methodology.

To date, six superannuation funds participate in GAS: Catholic Superannuation Fund, CSS/PSS, Emergency Services Superannuation, Northern Territory Government and Public Authorities Superannuation Scheme, Northern Territory Police Supplementary Benefit Scheme, and VicSuper. Together they represent approximately $7 billion in Australian equity investments, or just under 1% of the ASX200.

GAS does not engage on issues that are specific to individual companies. Instead, it identifies issues that are likely to be of concern for a broader set of businesses, conducts research on those issues, and raises its concerns with all relevant ASX200 companies. To date, this program of “rolling engagement” has tackled the following issues:

- Executive remuneration
- Audit governance
- Workplace health and safety
- Energy use and greenhouse risk
- Environmental disclosure

The great advantage of the GAS approach is that, by pooling resources, the six institutional investors have the economy of scale to engage specialised expertise on sustainability and governance issues, and to press their concerns efficiency through the single engagement vehicle.

The approach is not without some potential drawbacks. These include the following:

- Among the participating investors, there may be a perception that engagement is “handled” by GAS, which could lead to a lower degree of engagement on company-specific issues that GAS does not address and on engagement with companies outside the ASX 200.
- By separating the functions of engagement from investment selection, the fund managers responsible for investment selection do not gain the unmediated insight and perspective on sustainability issues generated by the GAS team.
- Participating investors may exert less pressure on their mainstream fund managers to be aware of and to engage on sustainability issues.
- Engagement has not yet led to shareholder resolutions, either prompted by GAS or independently introduced by the six institutional investors. If such resolutions do not follow where informal engagement does not achieve the desired results, over time a perception could arise that GAS and the participating investors are all bark and no bite.

Still, these potential difficulties do not negate the real innovativeness of the service and the benefits for the participating investors.

**UNITED NATIONS ENVIRONMENT PROGRAMME FINANCE INITIATIVE (UNEP FI)**

This initiative involves a commitment by participants to the Statement by Financial Institutions on the Environment & Sustainable Development or a parallel statement by insurers. The statements set out broad principles for sustainability in the finance sector. By and large, the statements contain general principles or statements of encouragement and recognition of the importance of environmental issues, rather than firm commitments.

In addition to the statements, the UNEP FI has published reports, held events and generally operated as a forum for the exchange of views and experiences within the finance sector.

In Australia, the UNEP FI is coordinated by EPA Victoria, which publishes a newsletter as well as organising and facilitating meetings and other events. Currently there are nine Australian signatories: major banks Westpac, ANZ and NAB; insurers IAG, QBE and Medibank Private; superannuation fund VicSuper; and credit unions mecu and Savings & Loans Credit Union (S.A.). Representatives of other institutions are also listed as sitting on various UNEP FI Australasian advisory committees.

The UNEP FI is undoubtedly a useful industry forum for the exchange of ideas and development of research on sustainability across the sector. In this role, UNEP FI has contributed to the development of research and thinking about sustainable finance.

However, UNEP FI is not well suited as a mechanism for obtaining verifiable improvements in environmental performance. Most importantly, the principles are voluntary and non-binding, and there are neither legal sanctions for breach of the commitments, nor formal procedures for handling complaints or allegations of non-compliance.
In past years, the lack of monitoring and enforcement of signatories' compliance with their commitments has eroded the credibility of the programme. For example, at least one nominal Australian signatory (QBE) has failed to comply with its commitment to “actively communicate our environmental activities to the public.” QBE does not publicly report on its environmental activities.

Fortunately, in recent months UNEP FI has taken some steps to improve compliance. Signatories are now required to pay an annual fee, attend at least every other AGM, and submit an annual report to UNEP on its efforts to advance its commitments. A number of former signatories have been removed from the list. Nevertheless, the role of UNEP FI will probably remain that of an industry forum rather than a mechanism for coordinating collective action.

**CARBON DISCLOSURE PROJECT (CDP)**

The Carbon Disclosure Project is an effort by institutional investors to obtain information from large corporations about their greenhouse gas emissions and strategies for managing risks related to carbon emissions and climate change. Internationally, the CDP has focused on the FT500 largest companies in the world, which includes a handful of Australia's top companies. In 2005, the Australian investors requesting the information included AMP Capital Investors, BT Financial Group, Catholic Superannuation Fund, CSS/PSS, National Australia Bank and VicSuper.

In October 2005, an Australian version of the CDP was launched, which will elicit similar information from companies in the ASX100 and NZSX50.

The information obtained from the CDP is useful, although not a substitute for mandatory disclosure requirements that would better ensure comparability and credibility of information on emissions and risk management. If the supporters of the CDP genuinely feel that this information is material to their investment decision-making, one would expect them to lobby their respective governments to introduce mandatory reporting.

An additional challenge is incorporating information generated through the CDP into actual financial decision-making. It is by no means clear that this is occurring, even among the institutions that have lent the project their name and resources. For future reports and events, the CDP investors may wish to illustrate precisely how the CDP has improved their investment selection or engagement processes. Some specific indication by analysts or fund managers about how they are actually using CDP data would be more convincing than speeches by corporate sustainability practitioners or even CEOs.

Furthermore, now that the CDP has run for 3 years, the logical next step for the CDP investors would be to introduce shareholder resolutions compelling disclosure by those companies that have consistently refused to respond. A failure to take this step would indicate a lack of genuine interest in the data and erode the current credibility of the initiative.

**INVESTOR GROUP ON CLIMATE CHANGE (IGCC)**

This initiative, also launched in October 2005, consists of twelve investors and is also supported by EPA Victoria. It aims to provide information to the investment industry on climate change and best practice approaches to inclusion of climate change impacts into investment decision-making. At the launch of the initiative, the IGCC released “A Climate for Change”, an important report addressing how superannuation trustees should go about addressing climate change issues in a practical way.

The IGCC in Australia has not yet indicated that it will actively advocate for public policy measures to address climate change, as its counterpart in Europe (The Institutional Investors’ Group on Climate Change) has done. Nor have the members themselves committed to particular actions, though they are among the investors that have been more active in addressing the issue in Australia in general.

**EQUATOR PRINCIPLES**

The Equator Principles are a statement of commitment by major banks to comply with the environmental standards and procedures utilised by the World Bank / International Finance Corporation. They apply to project finance transactions of US$50 million and over. Currently, Westpac is the only Australian institution to have adopted the principles, though many multinational banks active in Australia are signatories.

The Equator Principles are a demonstration of the potential for collectively agreed standards to be adopted even in the absence of legislation. In fact, since many large project finance transactions (particularly in developing nations) will involve at least of the Equator signatories, who will require compliance by the project sponsor, the agreement may effectively ratchet up performance even by non-Equator signatories.

On the other hand, the Principles apply only to project finance transactions, not other types of capital...
raisings such as open credit facilities, public equity or bond issues, syndicated loans and so on. There are many ways of structuring large commercial lending. If standards are pushed too high for project finance alone, project proponents may simply choose to finance projects through other modes.

Monitoring and enforcement of the standards is another area of difficulty. A series of reports by BankTrack, an independent NGO that monitors private finance sector activities, has highlighted the lack of transparency of the Principles and some of the institutions that have adopted them.30

The Principles are a valuable first step, but need to be extended to cover all large financing proposals with significant environmental impacts, regardless of the specific financing structure. Further, major improvements to transparency and monitoring of compliance are required.

SOLUTION: MOBILISATION OF INDUSTRY GROUPS TO DRIVE SUSTAINABLE FINANCE COMMITMENTS AND INITIATIVES.

Industry groups are a natural place for collective finance sector research on sustainability issues, the development of best practice standards and their enforcement, and public policy engagement. Unfortunately, so far in Australia the major finance sector industry groups have been dormant or, in some cases, have opposed action to improve environmental performance.

In the banking sector, the Australian Bankers Association (ABA) develops codes and standards, but has none that pertain with any particularity to environmental or social issues. On occasion, the ABA has contributed to joint efforts to address specific environment issues – for example, in June 2004 the ABA joined with the National Farmers’ Federation and the Australian Conservation Foundation to urge Australian political leaders to adopt key principles for a National Water Initiative.

However, in its policy advocacy, the ABA has opposed proposals to improve laws related to corporate responsibility and disclosure of environmental and social performance. While its preference for voluntary initiatives is predictable, one would expect an industry group advancing that argument to be a leader in proactive development of innovative and effective voluntary sustainability initiatives. So far, the ABA has failed to engage in this way.

In the superannuation investment sector, the two major industry groups are the Australian Council of Super Investors (ACSI) and the Association of Superannuation Funds of Australia (ASFA). Since its formation in 2001, ACSI has consistently produced high-quality reports and guidance for investors on key corporate governance and responsibility issues, and corporate responsibility was a primary focus of ACSI annual conference in 2005. ASFA has devoted much less attention to environmental issues, although in what one hopes is a change of direction it arranged for Al Gore to speak at its 2005 annual conference on the topic of sustainable investment.

The Investment and Financial Services Association (IFSA) is the primary group representing the funds management industry. It has displayed no leadership on sustainability issues. A review of IFSA’s publications and other materials on its website reveals little related to environmental concerns, aside from a “fact sheet” on ethical investment, which contains few facts and many unsupported critical opinions. IFSA has also consistently opposed rules requiring disclosure by issuers of financial products of information about their consideration of environmental and other ethical issues.

In the credit union sector, the Credit Union Services Corporation (Australia) Limited (CUSCAL) is the main industry association. CUSCAL appears to be working on a Corporate Social Responsibility Toolkit for its constituents. Otherwise, its main policy activity in the environmental arena so far has been to oppose any change to corporate laws that would promote better corporate responsibility, without suggesting any alternative means by which the federal government might encourage environmental responsibility.

The Insurance Council of Australia (ICA), with a mandate to represent the interests of Australia’s general insurance industry, had shown no sustained interest in environmental concerns, after an initial burst of enthusiasm.

Beginning in 2000, the ICA for some time issued a newsletter called “Greenhouse Cuttings” and committed, as part of the federal government’s “Greenhouse Challenge” program, to facilitating efforts by the insurance industry to address climate change. It convened an Insurance Environment Working Group, the stated purpose of which was to develop an “insurance industry policy position” on environmental issues.

Alas, these initiatives quickly dissipated. The work of the environmental working group was effectively

suspended in 2002 when the group was rolled into the ICA’s more general risk zone accumulation guide working group. The planned environmental policy positions do not appear to ever have been issued. Greenhouse Cuttings was discontinued in 2003, after 10 issues. The ICA does not appear to have any current significant activities in the area of sustainability. The regrettable collapse of the ICA’s environmental activities stands in stark contrast to, the Association of British Insurers (ABI), which has been and continues to be a vocal advocate of responsible action on climate change.

On the whole, the record on the finance sector industry groups on the environmental is far from impressive. By and large these groups have taken a reactive stance to environmental issues, opposing regulation that would directly affect their members without showing any creativity or leadership role in developing long-term solutions.

**SOLUTION:**

**NEW DIRECTIONS FOR COLLECTIVE ACTION.**

This brief overview shows that there is some creativity and innovation in the sector, and the tentative success of ventures such as the CDP and BT’s Governance Advisory Service are demonstrations of the feasibility and efficiency of collective action.

Unfortunately, participation in these initiatives continues to be limited. The lack of participation by more than a handful of superannuation funds is particularly striking: there are around 1,786 superannuation entities (excluding small funds) in Australia, yet fewer than ten are associated with any collective initiative to promote environmental sustainability in the investment process. The complete absence of regional and mid-sized banks is also striking, and not explicable by resources constraints, given the positive steps taken by several credit unions.

In addition, many of these initiatives focus on institutional investors and, in particular, how they select and engage with publicly-listed companies. Though these are positive initiatives, it is worth noting that aside from the catch-all UNEP Finance Initiative, there are no working vehicles for collective action on sustainability in the areas of consumer products, small- and medium-sized commercial lending, property and infrastructure investment, or insurance.

Even within the institutional investor context, there is a glaring gap in the absence of coordinated shareholder activism. Australia compares very poorly in this regard to the United States, where well-organised major shareholder groups such as the Interfaith Center for Corporate Responsibility (ICCR) and CERES proactively sponsor shareholder resolutions on key sustainability issues. In some cases, institutional investors in the U.S. explicitly divvy up the work of introducing environmental and social shareholder resolutions through such collective vehicles. Each year, hundreds of such resolutions are introduced in the U.S., with many being withdrawn after successful negotiation of an acceptable outcome with the company. The contrast to Australia is striking, where institutional investors – even those few that seek to engage with companies on ethical issues – have consistently failed to sponsor relevant shareholder resolutions.

In the current set of initiatives there is also a heavy focus on climate change. This is entirely appropriate; the environmental and financial challenges posed by the issue are tremendous. Nevertheless, other major Australian environmental issues such as habitat and biodiversity loss, water scarcity, pollution and land clearing should not be neglected in the process.

Finally, the performance of finance sector industry associations on sustainability issues has been reactionary, moribund, and completely lacking in leadership. Among the major industry groups, ACSI is alone in showing any sustained interest in environmental issues. It is incumbent on the members of such associations, and the individual leaders of those associations, to change this state of affairs.

**MORE INFORMATION:**

- UNEP Finance Initiative:
  - www.unepfi.org
  - www.epa.vic.gov.au/Programs/UNEP

- Carbon Disclosure Project:
  - www.cdproekt.net

- Institutional Investors’ Group on Climate Change: www.iigcc.org

- Investor Group on Climate Change Australia/New Zealand:
  - www.igcc.org.au

- BT’s Governance Advisory Service:
  - www.btinsto.com.au/content/investments/gas.htm

- Equator Principles:
  - www.equator-principles.com
6. EFFECTIVE SUSTAINABLE INVESTMENT

SYNOPSIS:
Mainstream investment markets, in pursuit of short-term financial goals, are structured around investment selection and engagement methods that discount heavily the long-term interests of their constituents. Investment selection and engagement methods that have a more balanced approach to short-term and long-term goals, and that adequately consider environmental and social externalities, have achieved demonstrated success and should be widely adopted.

BARRIER:
AUSTRALIAN INVESTMENT MARKET MECHANISMS AND INCENTIVES THAT DISCOURAGE LONG-TERM ENVIRONMENTALLY AND SOCIALLY ECONOMIC BEHAVIOUR.

The characteristics of modern investment markets that tend to undervalue or ignore the importance of environmental and other long-term issues have been well analysed and are frequently accepted even by those in traditionally conservative sectors of the business and financial community.

For example, the Business Council of Australia (BCA) in a recent report concluded that “we are discounting benefits that result from long-term thinking and strategic planning, and not adequately planning and investing for our future.”

Among the factors the BCA identifies as possible or probable contributors to a short-term investment market focus are the following:

- Compensation of fund managers based on assets under management and short-term performance measures;
- Diverging incentives among fund managers, trustees and the ultimate shareholders or beneficiaries of managed funds;
- Excessively high frequency of performance monitoring of investment portfolios;
- Economically “irrational” preferences for short-term growth and/or smooth earnings, even at the expense of long-term benefit; and
- High rates of management turnover, resulting in intense pressure to deliver short-term profits rather than long-term strategic positioning and growth.\(^{31}\)

Representatives of some 25 major financial institutions, including all of Australia’s big banks, are members of the Business Council of Australia; it is worth asking what actions they are taking to redress the investment market defects identified in the BCA report.

The BCA’s findings are much in line with the conclusion reached by Schmidheiny & Zorraquin in their groundbreaking 1996 study on sustainable development and the finance industry:

“Do the financial markets support sustainable development ...? There are reasons to believe they do not, in that they may encourage short-term goals, undervalue environmental resources, discount the future and favor accounting and reporting systems that do not reflect environmental risks and opportunities.”\(^{32}\)

In light of the above, what would the ideal sustainable, long-term focused public capital markets structure look like? We suggest the following features would stand out as especially important:

- Utilisation of investment analysis and selection methods that integrate long-term environmental and social considerations and price externalities.
- Investor insistence on continual sustainability performance improvements and reduction in environmental externalities by owned companies.
- Exercise of active share ownership by proxy voting and introduction of resolutions to improve performance where engagement is unsuccessful.
- Minimisation of investment churn and lengthening of average holding periods, and more realistic time frames for monitoring performance.
- Incentive structures for institutional investors and asset managers that encourage a long-term view, and penalise short-term gain at the expense of long-term performance.
- Empowerment of institutional investors to act in the long-term interests of their constituents, broadly construed.


SOLUTION:

UTILISATION OF INVESTMENT SELECTION METHODS THAT INTEGRATE LONG-TERM ENVIRONMENTAL AND SOCIAL CONSIDERATIONS AND PRICE EXTERNALITIES.

The investment selection methodologies of “ethical” or “sustainable” investment managers are increasingly gaining acceptance as effective components of an optimal long-term investment strategy.

As evidence of this, one need look no further than the award of the “mainstream” Standard & Poor’s 2005 Australian Fund Award in the category of Balanced Funds – Neutral to the Australian Ethical Balanced Trust.

The fact that an explicitly “ethical” fund has topped its mainstream competitors for this award by achieving consistently solid performance over a long period of time means that responsible fund managers can no longer dismiss sustainable investment techniques out of hand.

Nor is the award an isolated instance. More generally, AMP Capital Investors in a recent study found that companies with higher corporate responsibility ratings tended to outperform by about 3.0% over the medium to long-term.\(^{33}\) The same study cites an earlier study by AMP, which found that the median Australian SRI manager outperformed the ASX200 by 2.1% in the five years ending July 2003.

To get to this point, sustainable investment managers have had to overcome great resistance from the traditional investment sector. The most common theoretical objection is that the practice of screening out particular investments on the basis of involvement with negative environmental or social practices was an unjustifiable narrowing of the universe of possible investments, which risked excluding profitable investments.

On this view of sustainable investment, negative or positive screens are an arbitrary process, following which the “real” financial investment selection analyses are applied. This view fails to appreciate such screens as an integral part of the investment selection process. In effect, sustainable fund managers are taking a long-term view that certain harmful activities, though legal and profitable, will on balance be poor investments in the long-term compared to other opportunities.

Thus, the techniques of sustainable investment (such as analysis of non-financial issues and application of negative or positive screens for social and environmental performance) are best seen as simply part of the primary task of investment managers in winnowing down the universe of all possible investments to the ones in which the manager actually invests.

A screen against environmentally risky activities is thus no different in principle than the strategy pursued by a large cap investment fund that imposes a negative screen against all small- and mid-cap stocks, regardless of their profit-making potential. Just as a large-cap focus is accepted as a valid basis for determining the universe of investments for a particular fund, so should a sustainability focus be recognised as a legitimate investment strategy.

WHICH APPROACH?

\(\text{\textbf{\# NEGATIVE SCREENING}}\)

Negative screens exclude specified investments – such as companies active in uranium mining or nuclear energy – from the pool of possible investments. Such screens are administratively fairly low-cost, though there are always borderline cases. While negative screens continue to be useful components of some investment strategies, a negative screen by itself is not suited to capture the long-term benefits of superior environmental and social performance.

\(\text{\textbf{\# BEST-OF-SECTOR SCREENING}}\)

Best-of-sector funds seek to identify the top performing companies in terms of sustainability in each industry sector. It is both an advantage and a disadvantage of such funds that they do not deviate from the overall structural composition of the economy. The advantage is that such funds can hew closely to the performance of market indices, which many investors prefer. The disadvantage is that such funds are unable to account for long-term structural trends that may favour relatively efficient sectors of the economy over high-impact sectors.

\(\text{\textbf{\# BEST SUSTAINABILITY PERFORMANCE SELECTION}}\)

Some funds use an initial screen based on absolute, rather than best-of-sector, sustainability criteria. Such funds attempt to capture the long-term benefits of sustainable businesses without seeking to conform to overall market performance over short-term time horizons.

These funds can have high “tracking error”, which is not an “error” at all but rather a measure of the extent

to which the holdings of a portfolio diverge from those of an overall market. Because sustainability funds can diverge substantially from the market, some investors remain irrationally wary of them, even if they perform better over the long term. (Curiously, arguments about excessive “tracking error” are frequently raised with sustainability funds, but not with other types of investments that similarly diverge from the market.)

**INTEGRATED ENVIRONMENTAL, SOCIAL AND FINANCIAL ASSESSMENT**

Funds adopting an integrated approach to assessing the future prospects of a company based on its past and projected financial, environmental, social and strategic outcomes probably represent the most innovative and promising of sustainability investment techniques. Rather than adopting a traditional two-stage approach of screening investments based on sustainability criteria, then selecting investments based on traditional financial analysis, the integrated approach seeks to weigh all relevant factors together.

An integrated approach is likely to avoid excluding or including companies in the investment universe in favour of seeking to determine appropriate weightings based on sustainability and other criteria. For example, a company that produced heavy carbon emissions might be underweighted, depending on how it is managing the risk, rather than simply excluded.

While some may criticise this approach as a watered-down form of ethical investment, it is likely to be the most attractive technique for mainstreaming sustainability investment techniques. Mainstream asset managers may continue to resist wholesale exclusion of successful companies that nevertheless have significant environmental issues, but may be receptive to arguments for adjusting the risk-weighting of projected returns for such companies. Combined with an effective engagement strategy, this offers the best prospect for widespread meaningful integration of sustainability into mainstream investment practice.

**INDEX INVESTING**

Some have argued that an index-based investment strategy is inherently oriented towards sustainability. Some superannuation funds pursue an index-based strategy on the basis that the low fees of such a strategy more than compensate for the uncertain benefits of active, high-turnover approaches. Index investors may also have a greater stake in engaging with companies about long-term environmental performance, since an index investor typically does not have the option of divesting itself of poor environmental performers.

The actual sustainability of an index strategy depends greatly on the criteria by which the index is constituted. Many of the most widely used indices are based solely on the market capitalisation of companies in a certain market.

Because such indices stick to the overall structure of the market, an investor in these indices essentially mimics the choices other investors make, and relies on them to drive changes in the market over time. If those other investors are short-term focused, then by default so is the index and, by extension, the investor in that index.

In effect, rather than being a long-term strategy, ongoing reliance on a market index embeds short-term fluctuations in the composition of investment into the investment selection process. At any given time, an index investor will be invested across the market, including in companies with unsustainable, short-term focused strategies.

On the other hand, an index that is not based exclusively on the size or market capitalisation of companies, but includes some additional criteria related to sustainability, is more likely to be genuinely long-term focused. One example is the AuSSI, an index created by Sustainable Asset Management that includes aspects of size (market capitalisation) and sustainability (best-of-sector approach) in determining which companies are included.

**LONG/SHORT OVERLAYS**

A few investors have taken the approach of supplementing their existing portfolio with a “long/short” sustainability overlay. The idea is to refrain from “interfering” with the investment strategies of external fund managers, while still eliminating financial exposure to companies with poor environmental or social performance. Where an unacceptable investment is identified, the investor takes a short position corresponding to the long position their fund manager has chosen, and then replaces the investment with a long position in another stock.

Though a clever idea, in the end this approach does little to improve environmental outcomes. For one, it does nothing to encourage fund managers to modify their investment selection behaviour, even though inappropriate investments are identified. Further, the process of taking a long position, then neutralising it with a short position, involves unnecessary transaction costs. Finally, a long/short position in the same company has the effect of diminishing likely engagement with the company. The investor itself remains the legal owner of shares in the company, but has no incentive to pay attention to the performance...
of the company, since it has neutralised its financial exposure to any changes in the value of the stock. The shares are thus inert, and will not be used to exert any pressure on the company to improve its performance.

Thus, by assuring that they will not profit from an unsustainable company, a long/short sustainability overlay may assuage the consciences of the investors who utilise it, but it is difficult to discern any actual environmental benefit.

ENGAGEMENT

Engagement strategies and active share ownership are crucial aspects of sustainable investment, but are sorely neglected in the Australian investment community. An engagement strategy is likely to particularly appeal to very large diversified investors, or “universal owners”, for which divestment of holdings in large corporations may not be a practical option. Examples of engagement include the engagement overlay products offered by BT and State Street Global Advisers, discussed below.

INVESTMENT OUTCOMES?

Whatever the methodology, the contribution of sustainable investment funds to promoting an environmentally sound future for Australia must be measured by the degree to which such funds actually result in positive environmental outcomes. This can result either from directing capital away from unsustainable businesses and towards sustainable ones, or by improving the environmental performance of financed activities.

Unfortunately, it’s not always clear that this is the result. Consider, for example, the following lists of top 10 holdings for two large-cap Australian equities funds. One is said to be a sustainable investment fund, the other is the mainstream large-cap fund of the same manager. We challenge the reader to determine which is which.

The sustainable and mainstream portfolios are remarkably similar. Seven of the top ten investments (which represent nearly half of the total assets of each portfolio) are the same, though somewhat re-ordered.

Fund B is in fact the “sustainability” fund. However, it’s hard to tell how that fund is more long-term focused or how it is meant to have improved environmental performance. The presence of seven major financial institutions in the portfolio is troubling, since those institutions may well re-allocate capital to unsustainable uses. Indeed, at least four of those financial institutions do not report publicly on their environmental performance, and do not appear to manage or seek to improve the effects of their financial decision-making on the environment.

Some of these appear to be included partly for very superficial reasons. Fund literature explaining the stock selections claims that these banks and insurers, as significant investors, “play a gatekeeper role in facilitating social responsibility through its corporate governance and investment decisions.” Of course all financial institutions have a potential gatekeeper role, but that does not mean this role is exercised in any meaningful way. In fact most of the financial companies in the sustainability portfolio have been utterly passive on sustainability issues in their roles as investors and shareholders.

Further, the sustainability fund actually holds a greater percentage of BHP Billiton – owner of the massive Olympic Dam uranium mine – than the mainstream
fund. This is despite research by the manager concluding that the uranium industry:

“is relying on future generations to deal with the problems currently being created. Inter-generational equity is a fundamental tenet of sustainability and on this basis, the uranium and nuclear power industries are not sustainable.”

A better demonstration of the possible mix of investments for a large-cap sustainability fund is the Australian Ethical Large Companies Share Trust offered by Australian Ethical Investment. The top ten holdings of that fund (as at 30 November 2005) differ substantially from a traditional mainstream profile:

<table>
<thead>
<tr>
<th></th>
<th>Company Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Telecom Corporation of New Zealand</td>
</tr>
<tr>
<td>2</td>
<td>ABC Learning Centres</td>
</tr>
<tr>
<td>3</td>
<td>Alinta</td>
</tr>
<tr>
<td>4</td>
<td>Brambles Industries</td>
</tr>
<tr>
<td>5</td>
<td>Macquarie Communications Infrastructure Group</td>
</tr>
<tr>
<td>6</td>
<td>Fairfax (John) Holdings</td>
</tr>
<tr>
<td>7</td>
<td>Toll Holdings</td>
</tr>
<tr>
<td>8</td>
<td>Cochlear</td>
</tr>
<tr>
<td>9</td>
<td>Insurance Australia Group</td>
</tr>
<tr>
<td>10</td>
<td>Origin Energy</td>
</tr>
</tbody>
</table>

**SOLUTION:**

**INVESTOR INSISTENCE ON CONTINUAL SUSTAINABILITY PERFORMANCE IMPROVEMENTS AND REDUCTION IN EXTERNALITIES FROM FINANCED ACTIVITIES.**

BT’s Governance Advisory Service is a pooled investor engagement service, offered for a fee by BT to institutional investors. The service allows investors to engage collectively with companies on issues of long-term concern, thus making engagement more efficient and effective than if each investor acted separately. The service is discussed in more detail in section 5.

State Street Global Advisers also offers an engagement overlay service, known as the “Responsible Engagement Overlay”. Unlike BT’s service, which is open to all investors, the Responsible Engagement Overlay appears to be offered only as an adjunct to other State Street products.

As more major investors sign up for such services, the quality and breadth of engagement will increase, the cost of the service may decrease, engagement will have greater authority and weight, and the costs of engagement will be more fairly distributed among all investors, to reflect the fact that all benefit.

**SOLUTION:**

**EXERCISE OF ACTIVE SHARE OWNERSHIP BY PROXY VOTING AND INTRODUCTION OF RESOLUTIONS TO IMPROVE PERFORMANCE WHERE ENGAGEMENT IS UNSUCCESSFUL.**

The effectiveness of informal engagement between institutional shareholders and companies always depends greatly on the implied threat of formal shareholder action. While it’s true that a major investor can damage a company by simple divestment, it is really the power derived from the ability to file and vote on shareholder resolutions that gives institutional investors their influence.

It follows that the occasional exercise of that power is necessary, not only to compel improved performance where informal engagement has proven fruitless, but also to demonstrate the investors’ willingness to proceed to formal action.

Australian mainstream investors, and even the Australian ethical investment community, have been mostly inert in this respect. The few shareholder resolutions on environmental or social issues in Australia are typically filed by small shareholders, often in connection with campaigns being waged by activists or unions.

While it is important that institutional investors consider such resolutions and vote on them appropriately, ultimately the investment community cannot rely on activists to raise key environmental or social issues through shareholder resolutions. For one, activist organisations are far too limited in their resources to cover all relevant issues. More importantly, small shareholders or activists are perceived to have interests that are not necessarily the same as those of large investors. “Activist” resolutions thus lack the same credibility that a resolution introduced by a major superannuation fund would have.

In some overseas jurisdictions, collective investor groups have been effective in using shareholder resolutions to press sustainability issues and achieve positive outcomes. For example, in the United States, the Interfaith Center on Corporate Responsibility (ICCR) and its members have already filed over 100 resolutions for 2006. Environmental issues addressed by these resolutions range from labelling of

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genetically-modified food sources, disposal of PCBs, disclosure of involvement with nuclear weapons and depleted uranium, petroleum drilling in protected areas and climate change.

ICCR has over 275 members, representing US$110 billion in assets under management. Individual members often take the lead on specific shareholder resolutions. In effect, ICCR is a way of efficiently divvying up the work of engagement through shareholder resolutions. Each member can focus on one or a small number of resolutions, while still being confident of the backing of a large number of investors when it comes to a vote.

Nothing comparable exists in Australia, either among mainstream or religious-based or otherwise ethical investors. There do not appear to have been any shareholder resolutions relating to environmental issues in Australia during 2005.

In this light, the inadequacy of an investment policy that merely commits to voting on resolutions introduced by others should be obvious. Active share ownership means not only voting on resolutions, but introducing them where necessary to ensure long-term sustainable performance.

**SOLUTION:**

**MINIMISATION OF INVESTMENT CHURN AND LENGTHENING OF AVERAGE HOLDING PERIODS AND MORE REALISTIC TIME FRAMES FOR MONITORING PERFORMANCE.**

The market capitalisation of all companies listed on the Australian Stock Exchange was $975 billion as of 30 June 2005; this same amount is traded on the exchange about every 14.5 months. This equates to a rate of turnover of publicly-traded Australian equities of about 83% per annum.

Turnover rates for individual, actively-trading funds can be much higher. A report by two Credit Suisse First Boston managers in 2002 noted that average annual turnover rates at U.S. mutual funds increased from around 20% in the 1950s to over 110% by 2002, with one out of ten funds exceeding 200% turnover per annum.  

This hyperactivity in capital markets shortens investment time horizons and tends to shift the focus of investment managers from actual long-term company value to short-term strategies to “beat the market” by second-guessing the likely actions of other market participants. A manager that expects to turn over most stocks in under one year will have little interest in an environmental issue that might play out over the next decade.

Further, there is strong evidence to suggest that higher rates of turnover steadily erode investment returns. A comprehensive analysis of turnover and annual returns of U.S. Equity Funds in 1997 by Morningstar showed a strikingly consistent out-performance by funds with low turnover over all time periods:

<table>
<thead>
<tr>
<th>Turnover Rate</th>
<th>1-year annual return %</th>
<th>3-year annual return %</th>
<th>5-year annual return %</th>
<th>10-year annual return %</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;20%</td>
<td>27.0</td>
<td>23.9</td>
<td>17.2</td>
<td>12.9</td>
</tr>
<tr>
<td>20–50%</td>
<td>23.1</td>
<td>21.9</td>
<td>16.6</td>
<td>12.5</td>
</tr>
<tr>
<td>50–100%</td>
<td>21.8</td>
<td>21.8</td>
<td>17.0</td>
<td>12.6</td>
</tr>
<tr>
<td>&gt;100%</td>
<td>17.6</td>
<td>19.8</td>
<td>15.0</td>
<td>11.3</td>
</tr>
</tbody>
</table>

Increasing the average holding period of investments may follow from many of the other strategies discussed in this section. However, investment managers can also build prohibitions against excessive turnover, or penalties if certain levels are exceeded, directly into their investment mandates.

**SOLUTION:**

**INCENTIVE STRUCTURES FOR INSTITUTIONAL INVESTORS AND ASSET MANAGERS THAT ENCOURAGE A LONG-TERM VIEW, AND PENALISE SHORT-TERM GAIN AT THE EXPENSE OF LONG-TERM PERFORMANCE.**

A key driver for the other reforms discussed in this section is an improved alignment of the incentives of fund managers and institutional investors with the long-term sustainability objectives of society. This entails a shift away from short-term performance measurement and towards more innovative long-term strategies.

How this might occur is discussed in more detail in section 7.

SOLUTION:
EMPOWERMENT OF INSTITUTIONAL INVESTORS TO ACT IN THE LONG-TERM INTERESTS OF THEIR CONSTITUENTS, BROADLY CONSTRUED.

The current legal structure does not encourage full consideration of sustainability issues in investment decision-making. Although the increasing appreciation of the financial dimensions of sustainability performance has enabled some trustees to integrate sustainability into investment decision-making to some degree, law reform in this area remains desirable.

This topic is discussed in more detail in Part III.

BENCHMARK:
ANALYSIS OF INVESTMENT PRACTICES OF MAJOR INSTITUTIONAL INVESTORS.

MAINSTREAM SUPERANNUATION FUNDS

VicSuper
The clear leader in terms of sustainability among Australia’s mainstream institutional investors is superannuation fund VicSuper.

VicSuper is unique among mainstream superannuation funds in allocating 10% of its listed equities, private equity and property portfolios for explicitly sustainable investments. For listed equities, VicSuper’s SRI allocation is invested in the SAM Sustainability Leaders Australia and International funds, which are screened investments utilising a best-of-sector approach.

For private equity, the 10% sustainability allocation is earmarked for early-stage and expansion-stage companies with a focus on resource-use efficiency and ecological impact reduction.

In its 2002 tender process for its direct property investments, faced with a lack of suitable sustainable investments, VicSuper specifically asked tenderers to demonstrate how they would integrate sustainability across their business and portfolio. VicSuper then worked closely with Colonial First State Property, the successful tenderer, to develop a set of sustainability principles for its Direct Property Investment Fund. VicSuper receives quarterly briefings on progress in implementing these principles across the commercial properties in the portfolio. Though quantitative data on the actual performance of these properties are not yet available, the initiative shown by VicSuper in driving sustainable product innovation in the asset management industry is admirable.

VicSuper also offers its members a 100% Sustainable Equity option, again using the SAM funds. According to the 2004 Sustainability Report, members had chosen to place only 0.6% of VicSuper’s total assets under management into this option. A sustainable growth or capital stable fund might attract more interest.

Aside from these investment selection tools, VicSuper utilises BT’s Governance Advisory Service (GAS) to engage with companies on key environmental, social and corporate governance issues. It is not clear that VicSuper regularly engages with companies on issues not addressed by GAS, or that it requires its external asset managers to do so. VicSuper votes all proxies for Australian companies — and publishes its voting record — and has committed to extending this to international equities.

VicSuper is also unique among Australian superannuation funds in having issued Sustainability Reports in 2004 and 2005. The 2004 report was perhaps the first such report by a mainstream pension fund worldwide. VicSuper is an enthusiastic participant in a range of collaborative environmental initiatives, including the Carbon Disclosure Project and the Investor Group on Climate Change, and has entered into sustainability performance commitments through a Sustainability Covenant with EPA Victoria.

Public Sector and Commonwealth Superannuation Scheme (CSS/PSS);
Catholic Superannuation Fund;
Northern Territory Government and Public Authorities Superannuation Scheme; Northern Territory Police Supplementary Benefit Scheme; Emergency Services Superannuation

These funds all subscribe to BT’s Governance Advisory Service, as described above. In addition, CSS/PSS and Catholic Superannuation Fund are sponsors of the Carbon Disclosure Project, and Catholic Super is a member of the Investor Group on Climate Change, both of which are described in greater detail in section 5.

HESTA
HESTA was the first major industry superfund to have introduced an ethical investment option for its members, offering its “Eco Pool” fund from February 2000. While the pool is mostly managed externally, HESTA also specifically excludes a small number of companies, including those involved in uranium mining. Following the acquisition of WMC by BHP Billiton, HESTA consulted its members and retained its exclusion of uranium investments, in contrast to several other funds (including BT and Glebe) that lifted uranium exclusions around this time.

HESTA is also an inaugural member of the Investor Group on Climate Change, an important new initiative in Australia.
UniSuper

UniSuper introduced an ethical investment option for its members in 2002. The following year, the fund abstained from voting on a shareholder resolution at Gunns Limited aimed at forcing that company to cease old-growth forestry operations in Tasmania. The abstention was widely interpreted as implicit support for the resolution. UniSuper subsequently sold down its holdings in Gunns significantly.

More recently, UniSuper bolstered its internal capacity by appointing a manager of Governance and Sustainable Investments. As of 30 June 2005, UniSuper had $91 million, or about 1% of its total listed equities assets, placed with specifically ethical funds. In addition, it requires all external managers to vote shares held on its behalf in accordance with ACSI guidelines, although the extent of engagement with companies beyond shareholder voting is unclear.

Local Government Superannuation Services (LGSS)

In 2005, LGSS introduced a policy of eliminating exposure across its portfolio to certain companies through a process of short selling to offset long positions held through external managers. While this long/short overlay does limit financial exposure to those companies (which include some engaged in environmentally damaging activities), the ultimate environmental benefit may be questionable, as discussed above under “Long/short overlays”.

IFS

Perhaps the most significant move towards environmentally sustainable investment by superannuation funds in recent years has not come from the initiatives of a particular fund. In 2005, Industry Funds Management (IFS), a consortium of 9 industry funds, acquired Pacific Hydro, Australia’s largest renewable energy company. This very substantial move by major super funds into renewable energy heralds a greater alignment between the long-term investment goals of such funds and the long-term environmental and financial benefits and growth positioning of renewable energy.

Insurance companies

Discussions of sustainable investment have tended to focus very heavily on superannuation funds, while neglecting almost entirely the position of insurance companies. This is an immense oversight; according to the Australian Bureau of Statistics, Australian life insurance offices had over $191 billion in assets under management as of September 2005.  

In contrast to the more sustainability-minded superannuation funds, insurers have shown little attention to sustainable long-term management of their assets. This is counterintuitive, given many insurers’ double exposure to significant environmental events. For example, a prolonged drought may cause an increase in claims at the same time as it degrades the value of equity and property assets that an insurer holds to back its policies.

Even industry leader IAG, which has shown admirable initiative on the product side, in its research efforts and in internal and supply chain performance, has only begun to address sustainability in its substantial asset management activities. While it has a policy of voting all shares, there is little evidence that IAG has gone further in terms of sustainable asset selection, engagement or proactive exercise of share ownership rights. Investment policies merit just 14 lines in IAG’s 2005 Sustainability Report and, while it claims that
its investments “typically … will have a focus on promoting the environmental and social wellbeing of the wider community”, the lack of any supporting detail in the report or elsewhere about selection or engagement policies would justify a cautious evaluation of this claim.

Of course, it would be unfair to single IAG out on this basis; a review of all available materials did not uncover any sustainable investment practices by any Australian insurer, including QBE, Promina, AXA and Allianz. None of the twelve members of the IGCC are insurers.

▶ OTHER POOLED INVESTMENT STRUCTURES

Among the large diversified financial institutions in Australia, specifically sustainable or ethical investment options are offered directly by Westpac (through its subsidiary BT) and AMP. ANZ offers such options through its partnership with funds manager ING, while NAB’s asset management subsidiary MLC, as an exclusively multi-manager business, offers access to SRI funds of other managers. In all cases, the SRI or sustainable investments constitute less than 1% of total assets under management.

Colonial First State, the asset management subsidiary of Commonwealth Bank of Australia, does not directly offer any specifically ethical or sustainable equity investment options. However, Colonial First State Property, in conjunction with VicSuper, has developed a property portfolio incorporating sustainable management approaches, and is a member of the Investor Group on Climate Change.

Among specialist funds managers, Hunter Hall and Australian Ethical Investment offer a range of convincingly sustainable and financially successful funds. While the approaches of these two managers have significant differences, both focus on identifying investments that not only avoid harmful environmental and social practices, but have positive social and environmental value. They then seek to add value through a strategy of close engagement over a much longer holding period than would be typical in a mainstream active fund. This investment philosophy diverges substantially from the more mainstream, large-cap focus of other sustainable investment funds.

Sustainable Asset Management (SAM) manages the AuSSI, an Australian sustainability-based equities index fund, using a best-of-sector approach. The attraction of this fund lies primarily in low rates of turnover – the composition of the index is reassessed typically on an annual basis – which frees up analyst time for considered, in-depth engagement and research. The disadvantage of the fund is that its best-of-sector, large-cap focus can mean inclusion of businesses with only mediocre environmental performance records, especially in a small, concentrated public equity market such as Australia’s.

In addition to these offerings, several other fund managers (including Perpetual, IOOF, Tower and Challenger) offer SRI funds, while at least 119 master products offer investors access to sustainable investment products.38

A full analysis of the methodologies and approaches adopted by these various SRI funds is beyond the scope of this report.

Outside of the specifically ethical or sustainable funds (including engagement overlays), and with the exception of Portfolio Partners (see case study), pooled investments managed by mainstream managers share certain common characteristics:

- Typically, mainstream funds do not consider environmental issues systematically, but rather on a reactive basis when a particular issue crystallises into an actual or probable major liability or impact on operations.
- Some mainstream funds have adopted shareholder voting requirements and policies, and a few publish their voting records publicly. However, none demonstrate any appetite for introducing shareholder resolutions on environmental issues.
- Engagement with companies on sustainability issues tends to be ad hoc. Environmental issues are seldom considered unless there is an immediate material liability or operational impact.

There are some shades of difference here. For example, because of the integration of BT’s ethical funds and governance advisory teams into the day-to-day workings of BT generally, it is reasonable to expect that mainstream managers there are more likely to be attuned to significant environmental concerns and can draw on the expertise of those in-house staff.

However, much greater integration of environmental concerns into mainstream investment management is possible, as demonstrated by Portfolio Partners. The announcement by Mercer Investment Consulting that it would commence evaluating mainstream managers’ integration of environmental, social and governance issues into its assessments of Australian fund managers may spur this process along considerably.

CASE STUDY:
Portfolio Partners: integration of environmental considerations into the business of a mainstream funds manager

Recognising the long-term importance of environmental risk management and positioning to share value, Portfolio Partners has taken steps to improve its own assessment of environmental issues, as well as the environmental performance of those companies in which it invests.

One key step in this process was the articulation of Portfolio Partners’ expectations regarding environmental disclosure by the companies in which it invests. As part of its Corporate Governance policy, Portfolio Partners sets out an 8-page, flexible but detailed set of guidelines, differentiated based on the size and nature of a company’s operations.\(^\text{39}\)

In brief, the guidelines state an expectation that all ASX100 companies will produce a separate environment report, that ASX200 companies in 20 identified high risk sectors will do so as well, and that other companies in high risk sectors will address environmental issues in their other disclosure documents.

The guidelines also explain the key disclosure principles of relevance, completeness, format, content, comparability, impact and verification. They go on to discuss at some length specific environmental risks and concerns and how Portfolio Partners would like to see them addressed.

In terms of enforcement, the preferred approach is through dialogue, but Portfolio Partners also states that “We will apply our guidelines flexibly but, where appropriate, we will vote against resolutions which do not comply with our guidelines.”

Currently, the vast majority of Australian companies would not be in compliance with the spirit or letter of the guidelines.

In addition to throwing down the gauntlet on environmental disclosure, Portfolio Partners has entered into an agreement with sustainable research firm SIRIS to deepen its understanding and analysis of key environmental issues, including climate change, energy and sustainable consumption.

Following on from these initiatives, Portfolio Partners launched a new Long/Short Sustainability Trust in February 2006. This fund takes long positions in business regarded as relatively sustainable, while selling short those companies that it deems have substantial sustainability risks. In addition, some of Portfolio Partners’ funds have performance assessment periods that extend over rolling 3-year periods, rather than the standard annual or quarterly incentive systems.

\(^{39}\) Available at www.portoliopartners.com.au/Portals/0/Corporate_Governance_policy.pdf
7. SUSTAINABLE COMPENSATION AND INCENTIVE STRUCTURES

**SYNOPSIS:**
Fund managers, corporate executives and others often have little personal incentive to pay attention to long-term environmental concerns, because their individual financial incentives are to maximise profits and/or increase assets over very short time frames. The behaviour of fund managers in particular is shaped by their quarterly and annual financial performance assessments. Personal and institutional compensation structures that utilise longer time horizons, smooth performance over assessment periods and balance financial and non-financial performance criteria are more likely to drive sustainable outcomes.

**BARRIER:**
**COMPENSATION AND OTHER PERSONAL INCENTIVE ARRANGEMENTS FOR CORPORATE EXECUTIVES, FUND MANAGERS AND ANALYSTS THAT REWARD SHORT-TERMISM AND DISCOURAGE LONG-TERM RESPONSIBLE DECISION-MAKING.

One of the most formidable obstacles to sustainability in the finance sector is the pervasive set of personal and institutional compensation arrangements that discourage decision-makers from adopting a long-term perspective.

These arrangements skew most corporate and financial decision-making towards the generation of short-term financial terms. Examples of such arrangements include the following:

**CORPORATE MANAGEMENT**
Incentive-based compensation arrangements for top corporate executives tend to be a mix of annual bonuses and medium-term stock options. The bonuses are typically heavily or exclusively based on short-term financial performance criteria. Stock options are almost exclusively linked to some measure of shareholder returns over a 3- to 5-year time period. Although intended to align the executive’s interests with those of the shareholders, stock options can have the opposite effect. Once options have vested, for example, executives can pay more attention to short-term fluctuations in the value of their own shares than to the interests of a superannuation fund that might have a 30-year time horizon.

These arrangements penalise executives who may choose to reduce short-term earnings in favour of improved long-term risk management, investments in new technologies, or environmental improvements with long pay-back periods.

There is some evidence that incentives are becoming even more short-term oriented in recent years. A recent study conducted for the Australian Council of Super Investors (ACSI) reported a “boom” in short-term incentives, which rose from 25.7% of total executive pay in 2001 to 38.7% in 2004, with a corresponding decrease in the importance of medium-term stock options.

This short-term skew operates on two levels: it affects both the managers of many large financiers (such as banks, insurers and superannuation funds), and the managers of the companies they finance. Indeed, short-term profit-maximising incentives at the level of the head of the major banks can have substantial flow-on effects across the economy. After all, how is a bank to maximise its own short-term profits if it does not insist that the executives of the companies that it finances adopt a similarly short-term time horizon?

A report by the Business Council of Australia (BCA) found that executives that do not deliver strong returns over a 2-3 year time frame are at serious risk of dismissal in Australia, making it much less likely that CEOs will undertake a strategy that involves negative short-term returns in exchange for improved long-term performance.

The BCA recommended that companies adopt compensation packages that encourage performance over a 5-10 year time frame. So far, neither institutional investors nor companies themselves have taken up that challenge. Such attention as there is on executive compensation focuses heavily on absolute remuneration levels and “golden parachutes”, rather than the time horizon that is embedded in the structure of remuneration packages.

**LENDING**

At most banks, relationship managers are expected to generate certain levels of business for the bank. This is reasonable enough, but bonuses or performance reviews can nevertheless discourage proper attention to long-term risks.

Existing incentives offer some motivation for relationship managers to reject excessively risky proposals, since too high a default rate will reflect poorly on the manager, and may in any event be rejected by credit risk procedures.

However, there is little incentive for a manager to pay attention to externalities of a proposal as such, especially if those externalities do not have a major impact on credit risk. Thus, managers may pursue projects that are good credit risks, even if they affect other investments of the bank or the economy in which the bank operates generally. Citigroup, among other banks, found this to their dismay when their investments in unsustainable forestry began to cause reputation damage to its consumer business that was potentially far out of proportion to the profits being derived from the forestry investments.

**Funds Management**

Mainstream fund managers are selected and compensated on the basis of assets under management and/or short-term financial performance expectations. Compensation arrangements that are based on increasing assets under management can transform the task of the manager into one of gathering assets, rather than maximising financial performance. These sort of incentives assume, perversely, that investors would prefer to belong to a large fund rather than a successful fund.

When financial performance is the measure, performance targets are based on annual, quarterly and, in some cases, even monthly reviews. Given these time horizons, asset managers have little incentive to consider longer-term environmental issues.

One firm interviewed for this report has a reputation as a relatively long-term manager, focused on seeking out “deep value” and working closely with a company to improve its performance over an extended time frame. This firm stated that they seek to realise an investment over roughly an 18-month average time horizon. This represents the outer limits of the time horizon within which mainstream fund managers operate, but it remains far shorter than the time frame over which material environmental issues are relevant.

Furthermore, the increasing reliance on index benchmarks, and avoidance of “tracking error”, tends to tie fund managers to ever-shorter time frames and encourages clustering of fund managers around similar investments and strategies. Investors’ aversion to tracking error in particular limits a manager’s ability to pursue a long-term investment strategy that entails selecting investments that differ substantially from the current composition of the economy.

Further, performance bonuses are typically available for outperforming a benchmark, but there are no corresponding penalties for underperformance. The result is a skewed set of incentives that encourage managers to take unjustifiable risks because they get the benefit of the upside but not the full detriment of the downside.

Consider, for example, a fund manager whose cumulative performance is 10 basis points above the benchmark at the end of year one, 10 points below the benchmark at the end of year two, and 5 points below the benchmark at the end of year three. The investor who entrusts funds to this manager would have good reason to be dissatisfied with the performance – at the end of 3 years, the investor is worse off than he or she would have been simply sticking with the benchmark index.

However, if the manager’s performance is assessed on annual increments, the manager could be awarded performance-based incentives in 2 of the 3 years. Since the manager outperformed the benchmark in year one and year three, performance-based fees could be payable, notwithstanding the catastrophic plummet in year two that rendered performance over the whole 3-year period sub-optimal.

This example shows how a fund manager’s incentives can be structured to reward volatile performance, even if over the medium- to long-term such a strategy generates poorer returns than the benchmark.

If the performance fee is calculated on the basis of 3-year rolling averages, than the manager would get no bonus for year one, because the fund did not outperform the benchmark over the 3 years. The performance fee for year 2 would depend ultimately on performance in year 4, although the manager is not off to a good start with net underperformance in years 2 and 3. In this way, an incentive-based compensation arrangement based on multiple year assessment cycles is more likely to encourage a true long-term investment strategy, rather than a strategy based on maximising volatility.
A fund manager operating under quarterly or annual incentives structures has no financial reason to consider issues or analyses that are unlikely to be material in the immediate future. These incentives also undermine any instructions an institutional investor may give to the fund manager to engage with companies on issues of more long-term concern.

Again, the BCA has recognised the problem with fund manager incentives with great clarity:

“As the only way to climb the fund manager league tables is currently one quarter at a time, there are strong competitive pressures to achieve results on a short-term basis. In circumstances where fund performance has been poor, quarterly performance can take on a heightened significance.”

**INVESTMENT ANALYSIS**

The short-term incentive arrangements for fund managers have a detrimental effect on the market for investment analysis of environmental issues. If analysis does not contribute to a fund manager’s ability to meet quarterly or annual performance targets, it is likely to be disregarded.

The market for analysis of issues that may be material over a 2- to 30-year time horizon is correspondingly limited. In Australia, roughly six small sustainability analysis teams account for the vast majority of such analysis, mostly conducted for specifically ethical or sustainable funds.

According to one fund manager we spoke with, “It is very difficult to put effort into researching climate change, for example, and including it into your investment process if your intention is to buy a stock and sell out of it within 11 months...”.

**EFFECTS ON LONG-TERM INVESTMENT COMPETENCIES**

Unsurprisingly, an investment system that is geared up to maximise short-term returns does not reward competency in analysis of long-term environmental and social issues and development of optimal long-term strategies.

According to a recent study by AccountAbility, “most analysts are focused on creating and selling information to fund managers mainly interested in free cash flow, major short-term risks and opportunities, and the likely behaviour of other fund managers.” Such analysts are not rewarded for their ability to analyse long-term strategic issues.

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Fund managers who are good at generating value out of short-term market fluctuations will tend to excel at market psychology, or what drives market volatility, rather than what drives long-term company value. Such managers may have no idea what environmental or social issues are relevant to a longer time horizon, much less how to measure performance against those issues and to design an appropriate long-term investment strategy.

**SOLUTION:**
**ALIGNMENT OF CORPORATE MANAGEMENT INCENTIVES WITH LONG-TERM PERFORMANCE.**

There are several ways businesses can better structure executive compensation to encourage long-term performance. One is to condition some portion of incentive-based compensation on non-financial performance criteria that will position the company for success over the long-term. Environmental criteria, such as pollution reduction or resource efficiency, should be an important part of these criteria.

For financial institutions, meaningful measurement of environmental characteristics of investment portfolios (see section 1) would enable companies to set individual executive performance targets for reducing aggregate indirect environmental risks.

Aside from non-financial targets, companies could also provide that incentive-based compensation must be repaid in the event of under-provisioning for future social or environmental liabilities incurred during that executive’s tenure. (The U.S. Sarbanes-Oxley Act contains a similar “claw-back” of executive compensation in the event of a restatement of financial accounts.) Ideally, this would be implemented through legislation, but companies could also implement it on their own initiative through contracts with senior management.

**SOLUTION:**
**ALIGNMENT OF INVESTMENT INCENTIVES WITH LONG-TERM PERFORMANCE.**

In 2003, Universities Superannuation Scheme, a U.K. pension fund, held a competition for the best design of a long-term investment strategy for a hypothetical 30 billion euro mandate.

The winner was Henderson Global Investors. Among the innovations in their proposal was a compensation scheme that included a base fee as well as a performance element awarded only if the fund outperforms an inflation-linked benchmark over rolling 5-year periods. The effect of the scheme would have been that no performance payments would be made during the first five years of the mandate, and thereafter only for consistently good performance rather than for “having just one good year”.

Such a scheme has been demonstrated effectively by U.K.-based Generation Investment Management (GIM). GIM offers performance-based fees that are calculated on the basis of rolling 3-year performance measures, rather than quarterly or annual measures. (See case study.)

In Australia, Portfolio Partners has adopted similar rolling 3-year assessment periods for performance-based fees for some of its funds.

For any institutional investor, an integrated package of alignment of incentives with long-term interest would include the following:

- **Lengthen the duration of asset management mandates and performance review periods.**
- **Implement innovative compensation structures for asset managers.** For example, award some portion of compensation for each year based on how the end-of-the-year portfolio performs over the next five years (whether the investor continues to hold them or not). Or, award performance-based compensation based on 5-year rolling average performance rather than annual performance.
- **Require asset managers to invest some proportion of fees into analysis of long-term issues and/or engagement with companies on those issues.**
- **Decouple assessment of performance of asset managers from short-term market-tracking indices, or substantially lengthen the time frame over which such comparisons will be made.**
- **Ensure that asset consultants are considering long-term incentive structures in advising on appropriate asset managers.**
- **Ensure that internal incentive systems (such as for superannuation trustees and internal fund managers) are aligned with long-term objectives.**
- **Engage with companies to introduce a balanced mix of short-term and true long-term incentives into executive compensation packages.** If necessary, introduce and vote in favour of shareholder resolutions that achieve that objective.

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43. This and other proposals available online at [www.usshq.co.uk](http://www.usshq.co.uk)
**CASE STUDY:**

**A performance-based fund manager fee structure with a longer-term horizon**

Traditionally, fund managers are compensated on the basis of the volume of funds under management and/or quarterly or annual financial performance targets, in addition to fixed fees. These incentives are not aligned with the best interests of long-term investors.

U.K.-based Generation Investment Management (Generation) has broken with this industry practice and developed a novel, innovative fee structure that reflects a longer-term perspective.

Under Generation’s fee structure, no performance-based fees are payable for the first three years of an investment mandate. Thereafter, annual performance-based fees are calculated on the basis of rolling 3-year performance. For example, the performance-based fee payable at the end of year 4 is based on the average returns over years 2, 3 and 4.

According to Director Mark Mills, the structure is designed to encourage clients to think long-term, and to accept underperformance in some periods in return for superior long-term returns.

While the 3-year time horizon adopted by Generation is still shorter than the time frame over which many environmental issues play out, there is good reason to think that a fund manager operating with a 3-year time horizon is much more likely to consider such issues than a fund manager with a shorter time horizon. For example, while government policy tends to be highly predictable over a span of weeks or months (outside of elections), it can change significantly over three years. The manager with a 3-year time horizon is thus more likely to pay attention to future regulatory risks and opportunities for companies.

The introduction of rolling 3-year performance fees is not without some complexity. For example, the calculation of the bonus is practicable only for discrete tranches of funds, and would be less suitable for a fund with daily or weekly inflows and outflows of capital. Furthermore, the fact that fees for a given year do not finally crystallise until two years following the end of that year complicates the task for investors of specifying fees when members trade in and out of funds.

Investors that have placed funds with Generation accept these complexities in return for the benefits of aligning the manager’s incentives with the investor’s own long-term perspective.


8. PUBLIC AND POLITICAL ADVOCACY ON KEY ENVIRONMENTAL ISSUES

SYNOPSIS:
With some notable exceptions, the Australian finance sector is largely absent from public and political debates about the environment. This disengagement means that Australian business is represented in such debates by more vocal sectors, particularly resource- and pollution-intensive industries such as mining and manufacturing. The result is public policy uninformed by the expertise of the finance sector and skewed towards environmentally unsustainable outcomes. The finance sector should invest more resources and expertise into contributing constructively to the development of sound public environmental policy.

BARRIER:
SPORADIC, UNEVEN CONTRIBUTIONS BY THE AUSTRALIAN FINANCE SECTOR TO THE DEVELOPMENT OF SOUND PUBLIC POLICY SOLUTIONS TO ENVIRONMENTAL CHALLENGES.

If many of the pressing environmental issues in Australia require collective solutions, then sound public policy will have to play a central role in coordinating such solutions. For example, many financial institutions recognise that placing a price on emissions of CO\textsubscript{2} will be essential to reduce Australian and global greenhouse emissions. However, it would be commercially difficult for any one financial institution to impose such a price itself, because clients could switch to competitors that do not impose a carbon price.

If a price is to be attached to the externality of greenhouse pollution, it must therefore be coordinated through some form of government intervention. For a financial institution that determines it is in their long-term interest to ensure that the market adequately prices the externalities imposed by greenhouse gas emissions, a key question is therefore what steps the institution is taking to promote, or oppose, such responsible public policy action.

LACK OF ENGAGEMENT IN GOVERNMENTAL PROCESSES TO ADDRESS ENVIRONMENTAL ISSUES:

Unfortunately, the Australian finance sector has largely recused itself from environmental debates in public policy decision-making processes.

Recent examples include the following:

- Parliamentary inquiry into the extent and economic impact of salinity: 38 submissions; 0 from the finance sector.
- Inquiry into developing Australia’s non-fossil fuel energy industry: 72 submissions; 1 from the finance sector (AMP Capital Investors Sustainable Funds Team). This is particularly striking, given the number of financial institutions claiming a strong interest in the renewable energy industry.
- Parliamentary inquiry, “The Heat is On: Australia’s Greenhouse Future”: 227 submissions; 1 from the finance sector (Sydney Futures Exchange). Again astonishing, given the expressed level of interest by the sector in climate change.
- Productivity Commission report on energy efficiency: 155 submissions; 0 from the finance sector.
- Inquiry on impacts of native vegetation and biodiversity regulations: 162 submissions; 0 from the finance sector.
- Victorian greenhouse challenge for energy consultation paper and position paper: 97 submissions total; 0 from the finance sector.

The lack of finance sector participation in these processes mean that policy solutions are adopted without the benefit of the largest concentration of financial analytical capability in Australia. It also suggests that institutions themselves are probably not doing the internal work to understand how these key environmental issues relate to their own businesses.

By and large, the finance sector appears mostly content to let the businesses that would be directly disadvantaged by environmental regulation drive the formulation of public policy on those issues. But this is patently not in the finance sector’s best interests. Because large banks and investors are exposed across the entire economy, their interests diverge very substantially from those of the big resource and manufacturing firms that are currently influential...
in environmental policy development. Banks have substantial investments in, for example, the tourism, residential property and agriculture sectors, all of which are more diverse and small-scale, and far less able to influence government policy than the well-funded, highly-centralised resource and manufacturing sectors.

Allowing narrow sectoral interests to dominate policy discussions threatens optimal investment outcomes from the perspective of a diversified financial investor. To give but one example, the head of coal at mining company Xstrata recently responded to calls for a carbon tax or trading scheme in the following terms:

“In the short term, any of that is counter-productive since it would drive people down the path of least resistance and we wouldn’t be spending money on developing new, expensive technology.”

It is difficult to understand Xstrata’s preference for “expensive” technology over the “path of least resistance” (ie, the least-cost means of abating pollution) as anything other than a vacuous defence of the coal industry’s interests at any cost. The argument flies in the face of the standard market efficiency theory so vigorously propounded by industry in most contexts.

This is just one example of the willingness of heavily polluting industries to deploy any argument to preserve their ability to impose environmental externalities on other sectors of the economy and the community. By absenting itself from debates on environmental policy, the finance sector consents to high-impact industries setting an unsustainable policy agenda.

One of the few public processes in which the sector has expressed any interest is the 2005 Parliamentary inquiry into corporate social responsibility (CSR). The inquiry received submissions from six finance sector businesses and at least five industry groups representing the sector or with major finance industry members.45

Unfortunately, the purpose of these submissions was overwhelmingly to oppose any change to corporate laws regarding fiduciary duties and environmental and other reporting requirements, without suggesting any alternatives to improve corporate sustainability.

ANZ Bank, National Australia Bank, Westpac, Insurance Australia Group, BT Governance Advisory Service (on behalf of six superannuation funds), the Australian Bankers’ Association, the Business Council of Australia, the G100 and the Credit Union Services Corporation all filed submissions opposing such legislative changes.

The submission on behalf of the six funds by the BT Governance Advisory Service is particularly puzzling. Though these investors openly acknowledged that existing disclosure requirements “do not give investors sufficient information to understand the extent to which companies are managing social and environmental risks”, they nevertheless rejected even the most modest of improvements in disclosure standards.

NAB’s stance was similarly perplexing. As a participant in the Carbon Disclosure Project, NAB writes to large companies every year demanding to know how they are managing their climate change risk, with mixed responses, yet apparently declined to support any effort to make this information available through a specific public reporting requirement. Submissions by Westpac and ANZ were to much the same effect.

The AMP Capital Investors Sustainable Funds team was alone in a modest proposal to require reporting of compliance with environmental laws, occupational health and safety performance, greenhouse gas emissions and political donations. No other finance sector submissions referred to AMP’s perspective or suggestions.

The point is not simply that businesses opposed specific reform proposals, but that the corporate sector as a whole and the finance sector in particular failed to engage in the process constructively by suggesting any alternative legal or regulatory changes that would encourage companies to behave in an environmentally sound manner.

For example, few corporate submissions acknowledged that the government may have a role in pricing externalities, or in steering investment through the provision of tax or other incentives. Consequently, there were no substantive suggestions for reform in these areas. Nor did any finance sector participant deploy their expertise to suggest, for example, how governments might establish or improve pricing of business impacts on the climate, biodiversity and water resources. Nor were there suggestions for how government incentives might steer investment into environmentally sound technologies, in which most banks now profess a strong interest. In fact, most institutions envisioned no role for the government whatsoever in corporate responsibility other than some vague role in education and, perhaps, a few more awards.

The failure of the Australian members of the World Business Council on Sustainable Development (WBCSD) deserves special mention. As early as 1994, the WBCSD endorsed the notion that companies should be required to internalise the true environmental costs of their operations. One key report by the group urged governments around the world to adopt “new and flexible market based approaches” to sustainable development, including “a tax shift away from labour and investment to value-depleting activities such as pollution and the inefficient use of environmental resources.”

Yet, more than 10 years on, these concepts are absent from all submissions to the CSR inquiry by WBCSD members, save one. The submissions of WBCSD members Alcoa, BHP Billiton, BP, KPMG, Shell, Unilever and Westpac all neglected to address the government’s role in developing tax policy and other incentives to drive responsible behaviour, insisting instead that private market drivers were sufficient to inspire responsible corporate action. Alone in suggesting any regulatory change at all was IAG, which pointed out the perversity of the Fringe Benefits Tax rules that “encourage increased road usage instead of providing incentives to reduce motor vehicle usage.” The bulk of the submission, unfortunately, was similar to the other contributions in narrowly seeking to block perceived increases in regulation.

With very few exceptions, the environmental policies and other key policy documents of Australian financial institutions and industry groups do not include positions on key environmental issues. At best, some Australian institutions express a generalised commitment to contribute to public policy formulation, and a handful include broad statements about their policy activities in their annual reporting.

Of course, submissions and public policies and statements are not the only ways in which policy advocacy occurs. One-on-one meetings between business and government, consultative forums and other similar events are important, sometimes more so than public statements. There is little way of evaluating the strength of an institution’s efforts in this regard. However, it would be surprising to find a business that engages consistently with governments behind the scenes to promote positive environmental policies without any accompanying public messages.

SOLUTION:
DEVELOPMENT OF POSITIVE PUBLIC POLICY CONTRIBUTIONS TO SOLVING ENVIRONMENTAL ISSUES.

In 2005, JP Morgan Chase staked out an unusually strong public position on climate change policy. In its new environmental policy released that year, JP Morgan Chase committed to implementing “a policy dialogue to advocate that the U.S. government adopt a market-based national policy on greenhouse gas emissions, which includes all sources of emissions and is fair. Options include either a cap-and-trade or tax policy to reduce greenhouse gas emissions at the lowest possible cost.”

BY ABSENTING ITSELF FROM DEBATES ON ENVIRONMENTAL POLICY, THE FINANCE SECTOR CONSENTS TO HIGH-I MPACT INDUSTRIES SETTING AN UNSUSTAINABLE POLICY AGENDA.

The public endorsement by a major investment bank of regulation of greenhouse gases in the United States was a watershed moment in sustainable finance.

In a series of welcome developments, some leaders in the Australian finance sector have begun to take a similar position.

Westpac and IAG took early leadership role in their expression of support for changing the position of the Business Council of Australia to support Australia’s ratification of the Kyoto Protocol in 2002 and 2003. IAG also contributed resources and expertise to the Australian Climate Group, which advocated a 60% reduction in Australian greenhouse emissions by 2050 and market-based regulation of greenhouse gas emissions.47

Finally, six major Australian businesses (including three finance sector institutions – IAG, Swiss Re and Westpac) formed the Australian Business Roundtable on Climate Change, together with the Australian Conservation Foundation. The report of this Roundtable, released in April 2006, included a joint call by the CEOs of the participating businesses for strong action on climate change. These business leaders recommended that Australian governments:

- Design a ‘long, loud and legal’ framework to establish a carbon price signal;
- Encourage innovation and investment in emerging and breakthrough technologies;
- Build national resilience to the impacts of climate change.48

Crucially, these views were founded on external environmental and economic modelling, rather than on merely subjective viewpoints about environmental issues.

The manufacturing and resources sectors will not represent the interests of banks, insurers and investors in how they influence public environmental policy: they will represent the interests of the manufacturing and resources sectors. If the finance sector wants to have the full range of its interests represented in environmental debates, there is no alternative but to put the time and resources into assessing the relevance of key environmental threats and opportunities to the sector, and using those as the basis for ongoing, vigorous input into policy debates.

The Roundtable is a positive and innovative example of how the finance sector can achieve this with respect to a discrete issue.

Another promising model is the establishment by Goldman Sachs of an internal environmental policy institute. Unlike a one-off initiative, this institute holds the potential for ongoing and consistent input by the bank into positive environmental policy formulation. Specifically, Goldman Sachs committed to the following:

“We will establish and fund a Center for Environmental Markets to undertake independent research with partners in the academic and NGO community to explore/develop public policy options for establishing effective markets around climate change, biodiversity conservation and ecosystem services. Our public policy views will be informed by this research. At the same time, we recognize that the climate change problem cannot be solved through voluntary action alone and will work to develop partnerships with other organizations to help identify and promote effective and efficient regulatory/policy approaches to reducing greenhouse gas emissions. Goldman Sachs will disseminate this information through a combination of website postings, strategic communications and targeted outreach to engage and educate policy makers and clients on key issues.

- We will develop a research agenda focusing on how markets can contribute to helping solve environmental and related social problems.
- We will convene policy makers, investors, and experts on issues related to climate change, ecosystem services, and economic development.
- We will design an outreach strategy tailored to various audiences, including clients and policy makers in the US, Europe and emerging markets.
- We will develop and disseminate policy papers.”49

The creation of a permanent policy research organisation by Goldman Sachs is potentially a major advance over previous finance sector policy initiatives internationally, which by and large have been ad hoc and focused on single issues, rather than ongoing efforts to address environmental policy in a holistic manner. The establishment of a similar organ by an Australian institution would be a significant step in improving the environmental outcomes of the finance sector.

9. EFFECTIVE, PRACTICAL SUSTAINABLE SUPPLY CHAIN MANAGEMENT

SYNOPSIS:
While some institutions have implemented extensive supply chain management programs, the expertise, capacity and interest of many other institutions in improving the sustainability of their supply chain is lacking. Individual finance sector businesses can develop effective supply chain management systems by focusing on key suppliers and issues related to core business activities.

BARRIER:
LACK OF EXPERTISE, CAPACITY AND INTEREST IN IMPROVING THE SUSTAINABILITY OF SUPPLIERS TO THE FINANCE SECTOR.

The environmental impacts of suppliers of goods and services to the finance sector can exceed the impacts of the actual direct operations of finance sector businesses.

For example, according to CSIRO data, only about 34% of the greenhouse emissions attributable to banking sector activities result from the electricity use and air travel of banking institutions themselves. The remaining (roughly) two thirds is generated mostly through the production and supply of goods and services used by the banking industry. These include property services, IT equipment and paper.

Interestingly, food and hospitality services are a major supply chain impact, though overlooked in supply chain policies. For example, in the banking sector, the largest component of water use is not the direct office use by banks themselves, but the water embedded in the production of wine and spirits consumed in the course of banking sector activities. This is followed by the water needed to generate electricity used by banks, and only then by general water supply, sewerage and drainage.

Similarly, over 40% of the land disturbance impacts attributable to the banking sector are caused by the production of beef consumed in the course of finance sector operations.

Especially large financial institutions may have substantial capacity to improve the environmental performance of their suppliers, and some of the larger Australian institutions are implementing thorough supply chain management programs.

However, there are barriers for both large and small institutions and for their suppliers. Some of the main barriers include:

- Perceived absence of direct financial benefits in improving sustainability in the supply chain;
- Lack of resources or capacity to monitor supplier behaviour, and to assist suppliers in improving their performance;
- Large number of suppliers for any given business, including many smaller suppliers, which makes the task of engagement more resource-intensive; and
- Lack of expertise in the sustainability issues concerning the relevant products and businesses.

SOLUTION:
DEVELOPMENT OF TARGETED SUPPLY CHAIN IMPROVEMENT INITIATIVES, FOCUSING ON KEY SUPPLIERS TO FINANCE SECTOR BUSINESSES.

Insurer IAG has developed a thorough program of supply chain management that includes a number of initiatives designed to improve the sustainability performance of its key suppliers.

One of the most innovative tools IAG has developed is the “Risk Radar”, an interactive self-assessment tool designed to assist IAG’s preferred vehicle repair suppliers in reducing workplace and environmental risks and improving efficiency.

The Risk Radar is notable because it provides the tools for a supplier to improve its performance, thus filling an important capacity and expertise gap among smaller smash repair businesses. The approach is thus not to demand improvement from suppliers, but to reward improvement and to supply the tools for achieving that improvement.

Further, the Risk Radar has tangible benefits for IAG itself. For example, since IAG may be the insurer as well as a major customer of preferred smash repairers, reducing environmental and other risks may reduce insurance claims. Reductions in risks will also decrease the chance of business interruptions at the preferred suppliers.
IAG has recognised that the Risk Radar model could be extended to other aspects of its supply chain as well, and has developed a version for the hospitality sector and is developing additional versions for the rural and motor fleet industries.

The Risk Radar is only one aspect of IAG’s overall supplier engagement practices. IAG also monitors the performance of about 30 key suppliers and works with them to improve performance, offers training in sustainable building techniques to its preferred builders, and encourages its customers to select environmentally sound replacements for damaged or lost household appliances and goods.

IAG’s supply chain management is a model of a deep engagement with suppliers in a way that makes business sense as well as leading to improved sustainability outcomes. It is certainly a model other insurers can and should follow.

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**IMPROVING INTERNAL ENVIRONMENTAL MANAGEMENT IS NOT INCONSISTENT WITH IMPROVING ENVIRONMENTAL FINANCIAL DECISION-MAKING. IDEALLY, THE TWO WOULD REINFORCE EACH OTHER.**
10. INTERNAL ENVIRONMENTAL MANAGEMENT

**SYNOPSIS:**
Most sustainability programs at financial businesses overemphasise internal environmental management, given that the direct environmental impacts of finance sector operations are trivial compared to the impact of finance decision-making. Moreover, even within the bounds of internal environmental management, most institutions lag far behind international best practice. Internal environmental management programs should complement, rather than supplant, more important reforms in the area of finance decision-making, and should pursue international best practice, such as full carbon-neutrality.

**BARRIER:**
OVEREMPHASIS OF INTERNAL ENVIRONMENTAL MANAGEMENT COMPARED TOL INVESTMENT PRACTICES, AND UNEVENNESS OF OPERATIONAL ENVIRONMENTAL PERFORMANCE IMPROVEMENTS.

▶ THE SCALE OF DIRECT IMPACTS
In the context of the overall Australian economy, the direct effects of the financial services sector on the environment is minimal. According to CSIRO data, the entire Australian financial services sector accounts for only 0.39% of Australia’s greenhouse gas emissions, 0.28% of water use, 0.10% of land disturbance and 0.49% of primary energy use.50

To put these numbers in perspective, the total annual greenhouse emissions attributable to the entire Australian finance sector are just under 11% of the annual emissions of the Loy Yang power plant in Victoria.51

▶ THE RELATIVE SCALE OF DIRECT AND INDIRECT EFFECTS ON THE ENVIRONMENT
It is worth reflecting on whether the great effort and expense directed at marginal improvements in direct environmental performance wouldn’t be better focused on improving investment decision-making. For example, the stationary energy sector in Australia generates about 250 Mt CO₂-e greenhouse pollution per year, while the finance sector is responsible for about 2 Mt of emissions from operations. This means that if the finance sector were able, through loan covenants and additional financing, to improve the efficiency of energy generation in Australia by only 1%, it would have a greater environmental benefit than abating all of the greenhouse emissions from the direct operations of the entire Australian financial services industry.

Of course, improving internal environmental management is not inconsistent with improving environmental financial decision-making. Ideally, the two would reinforce each other.

Nevertheless, there are good reasons to think that the heavy emphasis on internal management measures is at the expense of addressing more environmentally meaningful, but more challenging, core financial business issues.

For example, many corporate sustainability reports give as much or more space and emphasis to initiatives aimed at improving internal environmental performance as they do to discussing the indirect environmental effects of financial decision-making. According to its 2005 Stakeholder Impact Report, all five of Westpac’s environmental objectives for 2005 were related to internal environmental management, and all five of its objectives for 2006 are as well. Westpac claims interest in the environmental impacts of its financial decision-making, and has some general commentary about these issues, but it has no meaningful quantitative reporting, no targets for improvement, and not even any articulated goals for the future.

Most other institutions demonstrate a similar myopic focus on direct environmental impacts. National Australia Bank’s Corporate Responsibility Report for 2005, though giving roughly equal space to direct and indirect impacts, claims that its top three environmental “aspects and impacts” are all related to its direct operations. ANZ’s inaugural report similarly provides a

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50. CSIRO 2005. Data includes banking, non-bank finance, insurance, and services to finance sectors. Electricity use, airline travel, paper use, direct water use and beef consumption (through catering functions) are the major contributors to these impacts.

51. 2,005 kt CO₂-e/year for the finance sector; 18,530 kt CO₂-e/year for Loy Yang Power (source: 2005 AGL Sustainability Report).
wealth of quantitative information and detail about its efforts to reduce direct impacts, but only a very general discussion of processes for addressing environmental issues in financial decision-making.

Unfortunately, sustainability investment analysts and ratings agencies probably encourage this preoccupation with direct impacts by overemphasizing internal environmental management and supply chain issues in their surveys and analysis. While such a focus may be appropriate for manufacturing and other industries, it is completely misplaced as the basis for evaluating the environmental performance of a bank, which should centre on financial decision-making.

Furthermore, major financial institutions struggle mightily to achieve even modest reductions in direct energy use, water use and greenhouse emissions. Following initial improvements, even industry leaders find it difficult to make much headway. IAG, which is far and away the most environmentally active of Australia’s general insurers, saw its emissions go up by 18% from 2004 to 2005, mostly due to increased electricity use in absolute terms and per full-time employee. Yet even if drastic improvements were being achieved by the direct operations of financial institutions, they would have little impact compared to the potential gains to be had by reducing impacts of financed activities.

WHY FOCUS ON DIRECT IMPACTS AT ALL?

In light of the above discussion, it may be tempting to conclude that attention to internal environmental management is completely misplaced. This would be wrong; sound internal management does have benefits beyond the direct environmental improvement. These include the following:

- **Financial benefits** – energy and water efficiency measures are often cost-effective and thus sensible irrespective of environmental benefit.
- **Educational and morale benefits** – by inculcating an overall environmental ethic, sound environmental management can lead to greater awareness of environmental issue in core financial services business areas, like lending and asset management. It can also contribute to improved staff satisfaction, morale and health.
- **Demonstration projects** – particularly innovative building design or environmental programmes can be models for more widespread adoption, even if the impact of the demonstration project itself is small.
- **Creation of demand for environmental goods and services** – by supporting businesses developing or providing important environmental goods and services, such as carbon offset and renewable energy products, financial institutions can help build stable demand and ensure growth of these initiatives.

- Consistency and persuasive power with suppliers, clients and others – a financial institution can credibly demand improvements from its suppliers, clients and others only if it is itself acting to improve its internal environmental performance.

So, while financial institutions cannot content themselves with undertaking internal environmental management initiatives (and analysts shouldn’t be hoodwinked on this score), they do remain important and meaningful.

Financial institutions should, however, ensure that internal environmental management initiatives complement rather than supplant the more important and difficult tasks of integrating environmental concerns into investment decision-making.

**SOLUTION: FULL CARBON NEUTRALITY FOR INTERNAL OPERATIONS.**

The flipside of the fact that financial services have relatively low direct impacts is that impressive reductions can actually be achieved through offset programs without prohibitive cost.

In December 2004, HSBC demonstrated this by becoming the first major bank to commit to becoming fully carbon neutral. Less than one year after the commitment was announced, HSBC attained its goal of reducing its carbon emissions to zero through a combination of reducing energy use, purchasing green power and investing in greenhouse emissions reduction projects around the world, including an organic waste composting project in Victoria.

Though a much smaller institution, Australian Ethical Investment has been carbon neutral since 2003 through a combination of green power and offsets for natural gas and travel emissions. Insurer Swiss Re has committed to carbon neutrality by the year 2013, through efficiency measures and investments into the World Bank’s Community Development Carbon Fund. On a smaller scale, Bendigo Bank in 2005 entered into an agreement with Greenhouse Balanced, a Victorian company, to offset all emissions from its vehicle fleet.

These institutions have set a high bar, but also demonstrated the financial viability of zero net greenhouse impact, even for a large multinational bank. No financial institution can claim environmental “best practice” until it achieves zero net greenhouse emissions.
Against such ambitious performers, institutions adopting 5% or 10% emissions reductions targets begin to look tentative, even feeble, in terms of the ambitions of their internal management program. Similarly, against the backdrop of HSBC’s performance, holding “carbon neutral” events, publishing “carbon neutral” reports, or otherwise undertaking very small-scale initiatives will increasingly appear to be tokenistic PR stunts, unless they are backed up by real substantive improvements.

SOLUTION:
OTHER SIGNIFICANT IMPROVEMENT IN ENVIRONMENTAL MANAGEMENT

The near-zero impact greenhouse gas emissions performance by HSBC paves the way for similarly dramatic improvements in other environmental performance areas. Australian financial institutions should look to the following performance objectives:

- Full carbon neutrality;
- Full offset of water use by investments in water efficiency technology and/or purchase of water rights for return to environmental flows;
- Use of 100% recycled paper; investments in habitat preservation and revegetation to offset paper consumption; major reductions in paper use;
- Large-scale reductions in waste generation and 100% recycling of paper and other relevant materials; and
- Encouragement of sustainable transport by staff through salary packaging of sustainable transport options; provision of suitable bike parking, shower and other facilities; removal of subsidised car parking incentives; education; and use of videoconferencing and other alternatives to travel where practicable.

LESS THAN ONE YEAR AFTER THE COMMITMENT WAS ANNOUNCED, HSBC ATTAINED ITS GOAL OF REDUCING ITS CARBON EMISSIONS TO ZERO.
THE TEN PRIVATE SECTOR REFORMS outlined in Part II can be achieved without any government intervention or support, as demonstrated by the key initiatives highlighted. Nevertheless, an improved regulatory structure would dramatically increase the pace, scope and effectiveness of such reforms.

Currently, the legislative and policy framework underlying the operation of the Australian finance sector often discourages sustainable policies and practices by private business. Changes are particularly desirable in the areas of directors’ and trustees’ duties, taxation and spending policies, and governance of managed funds. Further, governments can play an essential role in helping to overcome the problems of collective action by, for example, pricing environmental externalities and ensuring transparency of ownership and environmental and social performance in the corporate sector.

The following ten legislative and policy reforms would catalyse and amplify the private sector reforms outlined above. While these reforms must of course be ultimately adopted by governments, many of them are unlikely to occur without the concerted support of the private business sector.

PART III
STRUCTURAL REFORM FOR A SUSTAINABLE FINANCE SECTOR: THE ROLE OF GOVERNMENT
1. REFORM OF CORPORATE DIRECTORS’ DUTIES

Directors of corporations in Australia are obliged to exercise their powers and discharge their duties “in good faith in the best interests of the corporation” and “for a proper purpose”.\(^\text{52}\)

While this duty runs to the corporation and not directly to its shareholders, the most common interpretation of the duty is that the obligation to act in the company’s interests means acting in the best interests of the shareholders, not some wider notion of the “corporation”.

For example, the Australian Securities and Investment Commission – an authority that a corporate board would ignore at its peril – recently stated bluntly that, in the context of the Corporations Act, “the company means the shareholders and, in certain circumstances, the creditors.”\(^\text{53}\)

Further, the interests of the shareholders are generally understood to mean their financial interest in the company, not any other interests. Thus, a corporate partner of a major Australian law firm recently observed that:

The traditional view under the Corporations Act and at common law is that a director’s duty to act in the best interests of the corporation requires a director to govern solely in the interests of shareholders by maximising profits. Directors are not required to consider social or environmental issues in the discharge of their duty.\(^\text{54}\)

This traditional view has not gone unchallenged, and the words of the statute permit a more inclusive view of what a “corporation” is and even a broader, less pecuniary view of what the “interests” of a shareholder might be.

Though such alternative views may have the better of the argument, in practice the paradigm of shareholder profit maximisation remains overwhelmingly predominant in Australian boardrooms.

In recent years, the so-called “enlightened shareholder” theory has been advanced by some as a way of integrating non-shareholder constituencies without disturbing the framework of shareholder profit maximisation. Under this view, even a shareholder-value maximising corporate board would do well to consider non-shareholder interests, because increasing shareholder value requires a company to maintain good relationships with the community, attracting qualified personnel, avoiding risks, etc.

While “enlightened” shareholders are undoubtedly better than unenlightened ones, arguments in favour of this view tend to be either naïve in supposing that shareholder and non-shareholder interests will never conflict, or incomplete by failing to explicitly address how such conflicts are to be resolved when they do arise.

The current statutory expression of directors’ duties, as commonly interpreted, views shareholders as one-dimensional creatures, concerned only with maximising the financial returns from one single investment at any cost. This legal caricature is inconsistent with the views of actual Australian shareholders. In a recent survey, 68% of Australian shareholders said they would accept a lower investment return from a company with an excellent social reputation, while 73% would accept a lower return from a company with an excellent environmental reputation.\(^\text{55}\)

The traditional interpretation, however misguided and narrow, inhibits organisational decision-makers from considering interests beyond the financial interests of the shareholders. Nowhere was this more clear than in the James Hardie controversy. One of the very few things upon which James Hardie Chair Meredith Hellicar and ACTU Secretary Greg Combet agreed during the fight to obtain full compensation for the victims of asbestos was that the Australian directors’ duties inhibited James Hardies’ Board from topping up the compensation fund because of a fear of shareholder lawsuits, and that these duties need to be expanded to encompass other corporate constituencies.\(^\text{56}\)

\(^{52}\) Corporations Act 2001 (Cth), section 181.


Indeed, Ms Hellicar compares Australian law unfavourably to Dutch law, where consideration of the relationships among the company and all those involved in its organisation is permissible. For those steeped in the Anglo-American legal tradition, it may come as a surprise that the very concept of shareholder primacy is completely alien to the half of the world that operates under a civil law model.

**REFORM:**

To remedy the inadequate and socially destructive concept of shareholder primacy, the Corporations Act should clarify that the duty of a director to act in the best interests of the corporation entails an obligation to consider all corporate constituencies, including the community’s interest in a healthy environment.

2. **REFORM OF INSTITUTIONAL INVESTORS’ DUTIES**

**OVERVIEW OF CURRENT LEGAL FRAMEWORK**

The duties of institutional investors in Australia encompass both common law and statutory duties. These are usefully summarised in a recent cross-jurisdictional review of consideration of environmental, social and governance (ESG) into institutional investment decision-making by major international law firm Freshfields Bruckhaus Deringer.\(^{57}\) In brief:

- **Trustees of superannuation funds** are bound by the terms of the trust deed, which in turn contains provisions set in part by section 62 of the *Superannuation Industry (Supervision) Act 1993*. Under that law, trustees must ensure that the fund is maintained solely for the purpose of generating and providing monetary benefits to members upon their retirement. This ‘sole purpose’ test cannot be overridden by the trust deed.

  The statutory duties of trustees coexist with common law duties, which include duties to adhere to the trust deed and properly to invest the trust funds, exercising reasonable care.

- **Regulation of statutory insurance reserves** is largely through the *Life Insurance Act 1973*. Section 48 of that act requires that a life insurance company, in the investment, administration and management of assets of a statutory fund, give priority to the interests of owners and prospective owners of corresponding insurance policies. Section 43(2) of the act further requires that funds be invested in a way that is likely to “further the business of the fund”.

  The directors of a life insurance company will also be subject to the common law and statutory directors’ duties, as described above.

- For other managed investment schemes, the Responsible Entity is bound by duties set out in sections 601FC – 601FE of the *Corporations Act*. These duties include, among others, the duty to “act in the best interests of the members” and to “exercise the degree of care and diligence that a reasonable person would exercise if they were in the responsible entity’s position”.

  As with the trustees of superannuation funds, a Responsible Entity has co-existing common law duties. These include the duty of care and diligence and the duty to prioritise members’ interests over its own interests.

**DO THE DUTIES OF INSTITUTIONAL INVESTORS INHIBIT INTEGRATION OF ENVIRONMENTAL AND OTHER ETHICAL ISSUES INTO INVESTMENT DECISION-MAKING?**

The usual interpretation of the above duties is that consideration of environmental issues is impermissible if it is inconsistent with the overriding obligation to maximise the financial returns of the assets under management.

To be sure, consideration of environmental issues is increasing, as managers become more aware of the relevance of those issues to the long-term financial performance of companies and other assets. It is this greater awareness, and the demonstrated financial success of a number of explicitly ethical investment funds, that largely underpins the modest increases in ethical investment in Australia. This change in awareness should not be overstated – at least as recently as 2002, law firm Allens Arthur Robinson was advising that selecting investments on the basis of environmental or social considerations could “threaten to contravene the fiduciary duties of a trustee not to fetter his or her discretion and to maximise the financial return on investments.”\(^{58}\)

Further, the modest increase in acceptance of the financial relevance of environmental and other ethical considerations should not cause us to lose sight of just

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how narrow the legal expression of trustee’s duties actually is.

For example, while case law on the consideration of ethical issues in investment decision-making is sparse in Australia, the U.K. case of Cowan v Scargill is frequently cited in Australia for the proposition that the duty to maximise returns precludes managers from considering any interests of the beneficiaries outside their interest in the fund itself.\(^{59}\) For Australian superannuation trustees, the usual interpretation of the “sole purpose” rule reinforces this perception that only the financial return of the funds under management, not other financial or non-financial interests of the beneficiaries, may be considered.\(^{60}\)

Australian public opinion would appear to be strongly against such a strict profit maximisation obligation: 68% of Australian shareholders in a recent survey said they would accept a lower investment return from a company with an excellent social reputation, while 73% would accept a lower return from a company with an excellent environmental reputation.\(^{61}\) Because many Australians still do not have free choice of superannuation investments, the system compels some individuals to invest their own funds in companies to which they may have deep-seated ethical objections.

But even from the perspective of investors interested only in maximisation of their own financial position, the current expression of trustees’ duties can lead to quite perverse outcomes. This is because the law’s blinkered focus on the returns of a discrete investment portfolio appears to prohibit a manager from acting even in the best financial interests of the beneficiaries, broadly conceived.

The interests of beneficiaries of managed funds can usefully be divided into three categories:

1. The interest in the financial returns from the investment fund itself;
2. Other financial interests, outside of the fund; and
3. Interests that are not directly financial, such as enjoyment of a healthy environment, vibrant and just communities, personal health and wellbeing, moral interests, etc.

There can be little doubt that, where an investment decision is consistent with all three of these interests, there is no conflict with any duty. After all, what could possibly be the argument against such a decision?

However, the more interesting case is where a fund manager faces a trade-off between these three categories of interests. In that case, the traditional interpretation of a manager’s duty would require the pursuit of financial maximisation of an investment portfolio, even if there is a detriment to the broader financial and non-financial interests of the beneficiaries, and even if the net effect on the beneficiaries’ interests, taken as a whole, is negative.

This is a startling conclusion. Consider, for example, the position of a fund invested in a manufacturer that is faced with potentially large product liability compensation payments. Maximising the financial return of the portfolio could entail pressuring the company to take steps to oppose payout or otherwise limit the claims. But what if some of the fund’s beneficiaries are themselves victims of the defective products leading to the claims? The fund’s pressure on the company to limit claims could then cause those victims to lose out on compensation payments which they might otherwise have received. The net effect on those victims could be catastrophic, and the effect on the beneficiaries of the fund taken as a whole could be negative. Nevertheless, the law would appear to prohibit the fund from considering how denying compensation would affect some of its members, unless that could be tied back to the share price of company itself.

**REFORM:**

The law should not require the trustees of a fund to pursue a profit maximisation objective that blinds them, legally, to the collateral damage their investments may inflict on the supposed beneficiaries of the fund, and any doubt on that score should be removed. The relevant duties of superannuation trustees, insurance statutory fund managers and responsible entities of other pooled investment funds should be modified to require managers to act in the best interests of their members and beneficiaries in the broadest sense, including their financial and non-financial interests outside of the fund itself.

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59. Cowan v Scargill [1984] 3 WLR 501 at 513-524. Interestingly, the recent review by Freshfields suggests that Cowan is widely misinterpreted and in any case may of limited relevance today. See Freshfields, pp. 8-9. While this revisionist view is preferable, we are concerned here with the effect of the prevailing legal interpretation, which views Cowan as imposing narrow limits on what managers may consider in acting in the interests of the beneficiaries.

60. Some have argued that the “sole purpose” test does not prevent managers from considering non-financial factors. Again, however, this is not the generally accepted view, and the effect of the provision in practice (if not at the outer bounds of legal theory) is to inhibit managers from considering anything beyond maximisation of the financial returns of the portfolio. See Freshfields, pp. 45-46.

3. MEANINGFUL CORPORATE DISCLOSURE LAWS

Currently, there are three specific environmental disclosure obligations under Australian law:

- **Corporations Act** section 299(1)(f), which requires annual disclosure of “details of … performance in relation to environmental regulation”, if an entity is subject to any “particular and significant” environmental regulation. However, this law is so vaguely worded that corporations routinely fail to disclose details of significant breaches of environmental legislation.

- The National Pollutant Inventory (NPI), which requires annual facility-level disclosure of emissions of a range of hazardous or toxic substances. The NPI does not mandate disclosure of greenhouse gas emissions, though there has been some governmental support for broadening it to include such pollution.

- **Corporations Act** sections 1013D(1)(l) and 1013DA, which require issuers of many financial investment products to disclose the extent to which environmental and other ethical considerations are taken into account in investment decision-making.

These disclosure requirements do not require a company to address key environmental issues, such as waste generation, resource consumption, energy and water use, and environmental risk in its business. Even basic compliance data is hard to come by.62

In practice, the weakness of Australia’s disclosure laws has allowed very poor transparency by international standards. KPMG’s latest international survey of sustainability reporting shows that only 23% of Australia’s top 100 businesses issue a stand-alone annual sustainability report, compared to 80% in Japan and 71% in the U.K. Australia lags behind many other countries in this respect.63 Furthermore, 13 of these Australian reports were not externally verified in any way; only 10 had the assurance of some external audit.

The weak disclosure laws and practice in Australia hinders the ability of analysts to make meaningful judgments about environmental aspects of potential investments and also unfairly insulates poor performers from criticism.

The need for better disclosure laws was highlighted by the Labor members of the Parliamentary Joint Committee on Corporations and Financial Services, who concluded in 2003 that, “Given the quality of disclosures made in relation to section 299(1)(f), it would appear that in the absence of any mandated requirement to do so, it is unlikely that meaningful disclosure of social and environmental issues will be made.”64

Reform:

Improvement of corporate transparency on basic environmental performance is an absolute prerequisite for the ability of the market to take into account environmental considerations in investment decision-making. Australian law should require at least annual disclosure of key environmental performance and risk data. This could be based on broad principles, prescriptive elements (such as disclosure of greenhouse gas emissions if over a certain threshold according to a set methodology), or a combination of the two. The disclosure framework of the Global Reporting Initiative is an obvious starting point.

4. DEMOCRATIC GOVERNANCE OF MANAGED FUNDS

With few exceptions, the investors in many kinds of pooled investment vehicles, including most superannuation funds, have little or no say in the investment selection, proxy voting and engagement strategies of the funds.

Members who are dissatisfied with the policies or practices of a fund typically have little recourse other than letter writing or, at best, switching funds. Funds do not typically consult their members on such matters, and there are no formal mechanisms through which members may seek to influence fund policy. In this respect, managed funds are considerably less democratic than even the dollar democracy of

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62. The CLERP 9 reforms, which introduced a general requirement to report on the operations, financial position, and prospects of the reporting entity, in theory broadens the scope of environmental risk reporting. However, with no specific mention of social and environmental issues in the new section 299A of the Corporations Act, it is highly unlikely that this provision will result in greater disclosure of specific environmental data for most companies, and it does not appear to have had this effect to date.


corporations, where shareholders have at least the nominal right to introduce shareholder resolutions.

The market's capacity to provide a range of real alternatives has proven very limited. While in theory some dissatisfied members can switch funds, in reality the lack of fund transparency, heavy monitoring costs for individual members, and the transactional costs of engagement and fund switching, conspire to frustrate all but the most dedicated of investors from effectively engaging. Furthermore, many superannuation investors continue to be compelled to invest in particular funds, with not even the theoretical possibility of switching funds.

The lack of mechanisms for member participation in investment policy means funds can be well out-of-step with what their members actually desire. For example, strong majorities of the Australian public and shareholders are willing to accept lower investment returns from companies with strong social and environmental records, yet most funds make no effort to tailor their investment strategies appropriately.

**REFORM:**

The facilitation of real member participation in how funds are invested would require a serious redesign of the governance and participation structures of superannuation and other investment funds. Mechanisms such as an annual meeting of fund members, ability of members to introduce and vote on issues of investment policy and practice, and improved transparency of fund holdings could be key elements of such a reform.

**5. PRICING OF ENVIRONMENTAL EXTERNALITIES**

This report opened by discussing how environmental externalities are not considered in traditional financial analysis and decision-making. As a consequence, such decision-making will often not optimise social progress or finance sector success over the long term.

Many of the steps outlined in this report therefore provide ways for the finance sector to address, directly or implicitly, that problem. However, this is not to deny that the simplest and most efficient way to address many environmental externalities in many cases will be for government to establish a price on them or otherwise to regulate.

There are a variety of ways to ensure that externalities are priced, including taxation, polluter- or user-pays fee structures, and market mechanisms. All have the advantage of being centrally coordinated and imposed on all market participants, thus avoiding the difficulties of collective action.

Currently, perhaps the most urgent and clear need for pricing of environmental externalities is in the area of greenhouse pollution. The failure of Australia to put a price on carbon emissions so far is inhibiting the development of low-emissions technologies like renewable energy and increasing the inevitable long-term costs of adapting to a low-emissions future and to climate change.

Former oil industry executive Ian Dunlop recently highlighted the need for such pricing mechanisms in Australia:

“[The Environment Minister] implies we need a carbon emissions trading system to put a price on carbon pollution, but that it would be premature to introduce it before appropriate clean technologies are developed. This is a peculiarly contradictory position for a Government so attached to market-based solutions. These technologies are not new but are unlikely to appear in commercially viable form until a price is placed on carbon; the faster that happens, the more rapidly the technology will appear.”

Outside of the climate change context, the government has a role in ensuring that public resources such as water and access to forestry and mineral resources are fully priced, and that market participants fully internalise costs of other externalities, such as waste generation, pollution and activities like landclearing that contribute to loss of biodiversity and habitat.

**REFORM:**

Australian governments should facilitate the direction of financial capital to sustainable industries by ensuring that businesses are forced to internalise environmental costs. Whether through fees, taxes, market-based trading systems or other mechanisms, businesses should bear the full costs of climate and other pollution, generation of waste, resource consumption and environmental degradation.

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65. Indeed, the Trustee Corporations Association of Australia noted in 2002 that there was little that individual investors can do to rectify even poor or improper governance. See TCAA, Submission to Senate Select Committee on Superannuation, May 2002, p. 4.
67. Ian Dunlop, “It’ll be a dirty old mess if we don’t act now”, Sydney Morning Herald, 31 January 2006.
6. ENVIRONMENTAL TAXATION REFORM

The structure and details of Australian taxation laws often inhibits sustainability and distorts investment away from sustainable uses.

Sometimes, the environmentally detrimental effects of taxation rules are patent. The Fringe Benefits Tax rules are a well-known example: they provide a tax benefit for the use of company vehicles (even for private purposes), but not more sustainable public transit options, and indeed reward high use of such vehicles. Other clear examples of taxation incentives for relatively polluting activities are the 150% tax deductibility of certain petroleum exploration expenses, and the lower rate of import duties on inefficient four-wheel drive vehicles, compared with cleaner passenger vehicles.

These are relatively blatant preferences for environmentally undesirable activities, but perverse effects can also be unintended consequences of the way taxation regimes are structured. For example, 100% of equipment maintenance and repair costs are tax-deductible in the year in which the costs are incurred. In contrast, investments in new equipment are treated as capital costs, and are deductible only over time as the assets depreciate. One effect of this combination of rules is to make investments in new, potentially more energy-efficient equipment more expensive, relative to the costs of simply maintaining old, possibly more polluting equipment.

At the broadest level, our system of taxation has been criticised as based on taxing things we wish to encourage, such as labour and productivity, rather than things we wish to discourage, such as pollution, waste, and resource consumption. A general shift from taxing desirable activities to taxing undesirable activities could be politically and environmentally a powerful instrument of positive change.

Taxation can also be used to shift undesirable behaviour within the finance sector itself, such as excessively short-term investment horizons. The trend towards short-term performance and monitoring is exacerbated by the steadily decreasing average holding period of investments. In the mid-1960s, the average holding period for an investment was around 7 years, while today it is less than one year for managed investment funds. Reform of the capital gains tax system could re-adjust market incentives to encourage a longer-term focus by shareholders and companies.

REFORM: The issues of environmental tax reform range from the minutiae of expense and depreciation rules to fundamental structural questions about what we should tax and why. While solutions to some of the more obvious problems can be advanced, a more systematic approach is desirable. First steps may include a full public inquiry into environmental taxation reform, and the creation of a well-resourced environmental taxation policy unit drawing on the expertise of the Treasury, the Department of Environment and Heritage, and other governmental and external experts.

Recalibrating the capital gains tax (CGT) systems to encourage a longer-term focus by investors is another reform that holds great promise. If the rate of CGT payable on an investment decreased the longer the investment was held, investors would have a real incentive to invest for the long term, rather than seeking to profit from short-term market volatility. Such long-term investors would have a greater incentive to engage proactively with companies to improve their performance, and would tend to lessen the intense pressure on corporate executives to generate immediate improvements in earnings, often at the expense of longer-term business strategy and investment.

7. LEVERAGING PRIVATE INVESTMENT

There is great potential, largely untapped, for Australian governments to mobilise private investment into environmentally and socially positive activities. Tax and other incentives available to such projects can be much more effective than direct government expenditure.

The use of government incentives to stimulate private economic activity is widely practiced – the 150% tax deductibility of certain petroleum exploration projects is a clear and explicit example of this.

The Dutch green investment funds are a perfect example of a moderate government tax incentive that triggered large private investments into sustainable environmental projects. Beginning in 1992, interest and dividends on certain certified “green” projects were exempted from taxation. By the end of 2000, around 2.3 billion euro had been invested in sustainable projects, and it is estimated that the policy achieved an astonishing 1:45 leverage ratio.

In Australia, the possibilities of large-scale leveraged investment were explored in a report by Allen Consulting for a group of major businesses, together with CSIRO and ACF, in 2001. The report concluded that an investment by government of $3.6 billion over a 10-year period could leverage an additional $12.7 billion in private investment into projects aimed at addressing the problems of salinity and biodiversity loss. Other Australian examples include government rebates on certain consumer energy efficiency, water conservation and renewable energy investments.

There is great scope for Australian governments to build on and generalise these proposals and programmes.

8. SENSIBLE INDICATORS OF OUR SUCCESS AS A SOCIETY

The flaws of the Gross National Product (GNP) and Gross Domestic Product (GDP) as measures of societal development and progress are well known, but these measures remain the dominant drivers of public policy, particularly public investment and macro-economic policy.

From an environmental perspective, policy that is fixated on growth in GDP as a proxy for “economic growth” undermines sustainable public policy and true national development. This is because GDP is a measure of economic throughput that ignores such factors as depletion of natural resources, the value of ecosystem services such as the provision of clean air and water, and the harmful effects of environmental externalities. Perversely, if we become sick or pollute the environment, for example, we are deemed to contribute to “economic growth” because we are stimulating expenditures in health care and environmental remediation.

There has been a great deal of creative thinking about alternatives to the GDP. The Genuine Progress Indicator (GPI) championed by The Australia Institute is an effort to devise a more balanced and sustainable approach to measuring our progress as a society, including a range of environmental, social and economic issues.

69. See Marcel Jeucken, Sustainability in Finance, pp. 196-202. The 1:45 ratio appears to be calculated on the basis of government tax revenues foregone; it is unclear whether any other expenses were taken into account (eg, expenses in assessing and certifying the qualifying green investments).
The Australian Bureau of Statistics has also identified 15 summary indicators of Australia’s progress, which include some environmental indicators. Unfortunately, the ABS’ more prominent “Key National Indicators” focus exclusively on financial and macro-economic indicators, with no attempt to attempt to track issues of environmental health, economic and social equity, and societal wellbeing more broadly.

**REFORM:**

Australian governments must begin to make decisions and measure outcomes based on more than growth in economic throughput, as measured by the GNP/GDP. The objectives of genuine sustainable economic growth and progress as a society will not be achieved unless policy is guided by measurements and indicators that reflect a comprehensive effort to assess the full social and environmental costs and benefits of our activities and policies.

A measure such as the GPI should have first place in government reporting on economic progress and in modelling and assessment of proposed public policies, and should replace the GDP as the headline indicator in places such as the ABS’ “Key National Indicators” publication.

### 9. INVESTMENT TRANSPARENCY

The ability of communities to identify clearly and easily who is ultimately behind environmentally and socially controversial or destructive activities is a fundamental aspect of accountability. Without such transparency in investment, the ability of the public to apply pressure to irresponsible companies is greatly diminished.

The use of nominee holding companies is a well-known way of obscuring the ultimate beneficial shareholders in a company from public scrutiny. For example, if a community affected by a polluting facility wishes to ascertain who the ultimate shareholders are, they will in most cases be stymied by an impenetrable curtain of nominee companies, who are the registered but not beneficial shareholders.

Thus, while the nominees have no real interest in the shares or ability to affect how the real owners behave, they do act as a veil, obscuring the community’s ability to find out who the real owners are. Nominees should not expect to remain free from criticism for this role, even if their intent in offering nominee services was not to obscure ownership.

There was some modest improvements in the ability to trace beneficial shareholder ownership in the CLERP 9 legislation passed in 2004. A company must now disclose some details of beneficial ownership, but only if it is aware of the beneficial owners. Many companies do not make a practice of obtaining such information, though it is within their power to do so.

Banking secrecy laws are another area where the legal regime inhibits investment transparency. Under a variety of laws and industry codes, most notably the Australian Prudential Regulation Authority Act 1998, banks are prohibited from disclosing most non-public information about their customers and financial transactions.

While motivated by legitimate privacy and commercial confidentiality concerns, these laws can have unintended consequences. For example, one major financial institution had plans to disclose voluntarily to the public an industry sector breakdown of their major corporate lending portfolio, including information about the number and amount of major loans and some general descriptive data about the nature of activities financed. In the end they did not do so, because of secrecy concerns. Even though the public disclosure did not reveal the identities of any of the bank’s customers, the concern was that because of Australia’s relatively small and concentrated market, the identity of some customers might be clear even though not specifically disclosed.

Finally, transparency by institutional investors on their investment holdings varies greatly. Some superannuation funds publish regularly updated, comprehensive lists of all companies in which they have invested, which gives their members a clear view of the activities their funds are supporting. Other funds do not provide such information, or provide only information on the top 10 holdings of particular funds.

**REFORM:**

Reform of the Corporations Act should provide for full transparency of beneficial ownership of publicly listed companies. Options for achieving this could include an affirmative requirement for nominee companies to disclose details of the ultimate beneficiaries, or amendment of sections 672A(2) and 672C(b) to remove ASIC’s discretion to refuse to issue a tracing notice at the request of a member of a company.

Banking secrecy laws should allow banks to disclose details of the environmental and social characteristics of their investment activities.
Superannuation funds and other pooled investment funds should be required to publish a quarterly list of all investment holdings. This need not include specific amounts invested or percentages of assets under management, as some funds may legitimately regard that information as commercially sensitive. The purpose is to ensure that fund beneficiaries can determine the identities of companies and other funds in which their money is being invested.

10. LEADING BY EXAMPLE

Australian governments are substantial managers of financial assets and, in addition, can be both substantial providers and consumer of financial services in their own right. This creates opportunities for governments to use their procurement power to influence private sector financial services, as well as to spearhead development of sustainable finance in their own financial services operations.

At the Commonwealth level, most government agencies obtain transactional banking services from the Reserve Bank of Australia or, since 1998, by tender from the private sector. Investment activities are generally bound by statute to very conservative investments, such as bank deposits and Australian Government securities.

However, a range of Commonwealth Authorities and Companies have specific internal or external financial roles. For example, the Government is an insurer of its own activities through Comcover and Comcare, and an insurer of private sector activities through agencies including the Australian Reinsurance Pool Corporation (ARPC) and the Export Finance and Insurance Corporation (EFIC).

EFIC also operates as a lender or guarantor to the private sector, a role that it has in common with other government investment corporations such as the Film Finance Corporation. The government is a private health insurer through Medibank Private, a Government Business Enterprise.

Through CSS/PSS, it operates as an institutional investor, managing the superannuation assets of government employees.

A MEASURE SUCH AS THE GENUINE PROGRESS INDICATOR (GPI) SHOULD HAVE FIRST PLACE IN GOVERNMENT REPORTING ON ECONOMIC PROGRESS AND IN MODELLING AND ASSESSMENT OF PROPOSED PUBLIC POLICIES.
Most prominently, the newly-created Future Fund will manage an initial allotment of around $18 billion, to be invested in the private sector to fund future superannuation liabilities of the Commonwealth.

State governments have similar points where they act as substantial providers or consumers of financial services. For instance, the Victorian Funds Management Corporation invests over $30 billion on behalf of Victorian government agencies, primarily the Government and Emergency Superannuation schemes and funds of the Victorian WorkCover Authority and the Transport Accident Commission. In New South Wales, the Resources & Crown Directorate of the Office of Financial Management performs a similar function.

The degree to which Australian governmental agencies have pursued sustainable finance practices in their own operations varies widely, even within a particular government. EFIC, under pressure for its heavy investment in fossil fuel and other polluting projects, has made some progress in improving its environmental assessments, for example, and Medibank Private and CSS/PSS have taken some initial steps towards integrating long-term sustainability into their investment activities. On the other hand, it’s not clear that the Commonwealth insurance and investment arms have given much thought to sustainable financial practices. At the state level, the entities responsible for financial asset management tend to invest (or are even bound to invest) without any regard to the broader sustainability goals the state may be pursuing.

An example of a jurisdiction that has aligned its financial asset management strategies with other priorities is Connecticut. Under the statute governing the State’s pension fund, for example, the Treasurer is explicitly permitted to consider the social, environmental and economic implications of its investments.72 The Treasurer of Connecticut has further stated that the State has firm expectations regarding the corporate citizenship of external financial service providers, including commitments to the Connecticut community, equal opportunity and environmental and consumer compliance. Annual reports from providers are required.73

In addition, the Connecticut Treasurer utilises the State’s position as a major shareholder to promote sustainability by sponsoring relevant shareholder resolutions, supporting discussion forums, and similar activities. For example, the state pension fund sponsored resolutions for three years running with American Electric Power, seeking to compel that company to report publicly on how they are addressing climate change and pressure to reduce carbon dioxide emissions. The company finally agreed to comply with the resolution.

Similarly, the massive Norwegian State Pension fund, which manages the equivalent of AU$350 billion of funds derived from petroleum revenues, has a thorough ethical investment policy that applies to all investments. The purpose of the fund is to “generate a sound return in the long term, which is contingent on sustainable development in the economic, environmental and social sense”, and the investment policy reflects this balanced, long-term stance.74

The proactive stance of public funds in other jurisdictions such as Connecticut and Norway contrasts to the passivity of most Australian government-managed funds. The upcoming development of an investment mandate for the Future Fund is a unique opportunity for the government to show leadership on responsible sustainable investment.

As consumers of financial products and services, Australian governments should require the highest standards of responsible conduct from suppliers, and should actively promote and monitor such conduct.

More importantly, as managers of large pools of financial assets, Australian governments should exercise their shareholder rights and market power in a way that promotes the public interest in environmental sustainability. This should include sponsoring shareholder resolutions to compel ethical and sustainable behaviour, as other state pension funds around the world are doing. When external fund managers are utilised, they should be under explicit instructions to engage with companies on sustainability issues.

In many cases, the legal frameworks under which such funds are managed should be amended to clarify the relevant agency’s obligation to consider sustainability issues in the selection of investments and the exercise of shareholder rights. The newly-created Future Fund should have a best practice responsible investment mandate and policy.

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72. Connecticut General Statutes, Section 3-13d(a).
THE NATURAL environment’s capacity to provide resources, absorb waste and pollution, and otherwise support human communities is not boundless. The paradigm of endless growth in material production and consumption that has driven industrialised economies is increasingly under question as a root cause of environmental distress and degradation.

Increases in population can, of course, drive increased consumption and its attendant burdens on the environment, but so too can over-consumption by wealthy societies.

In their recent book *Affluenza*, Clive Hamilton and Richard Denniss describe the pernicious social, personal and environmental effects of Australia’s unhealthy obsession with material acquisitiveness:

“...Instead of our growing wealth freeing us of our materialist preoccupations, it seems to have had the opposite effect. People in affluent countries are now even more obsessed with money and material acquisition, and the richer they are the more this seems to be the case.

...The rapid expansion of consumption has imposed high costs, on the overconsumers themselves, on society and on the natural environment.”

As Hamilton and Denniss explain, our houses get ever larger, our possessions ever more numerous and expensive, and yet little of it appears to increase our personal happiness or wellbeing. To the contrary, the increase in consumption leads to overwork, indebtedness, the breakdown of social networks and strain on the environment.

The role of financial products as a catalyst for affluenza deserves close scrutiny.

For example, what role do the marketing and design of credit card products play in encouraging overconsumption? According to Hamilton and Denniss, affinity schemes and other inducements to spend contribute to a perverse perception that “the only way to save a lot is to borrow a lot”. Some affinity schemes allow redemption of accumulated “points” for non-material awards, such as contributions to various charities, but the focus remains overwhelmingly on material goods. Consumption is rewarded by more consumption, while spending those accumulated “rewards points” feels much easier than spending one’s own hard-earned cash.

The link between debt and consumption is no doubt strengthened by the fact that issuers of credit cards do not profit from customers that regularly pay them off, but rather from customers that remain persistently indebted. There is thus a financial incentive for credit card issuers to encourage consumers to ratchet up their spending through interest-free periods, higher credit limits and bonus schemes, to a point where the consumer cannot easily pay off the debt.

To be clear, it is not the mere existence of credit cards that seems to be a problem. Social and environmental damage is caused by the way in which the design and marketing of debt products encourages unsustainable and unnecessary consumption, rather than credit cards as such. However, in this context, it is extremely difficult to disentangle what we should regard as legitimate competition that may benefit consumers and what is undesirable pushing of indebtedness.

The relatively recent innovation of no-deposit home loans is another area requiring careful examination. What effect have such loans had on Australian society and the environment? The question is again highly nuanced. On the one hand, such loans can make it easier for first-time buyers to begin saving money through accumulating equity in a home, rather than trapped in a cycle of paying rent and being unable to save. In practice, however, some borrowers may simply increase their consumption of other goods, while others may buy a bigger house than they need and can really afford. It would be worth investigating the extent to which such easy financing has contributed to the rapid growth of the sprawling

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outer-suburban housing developments that are taxing the physical and ecological infrastructure of Australia’s major cities.

The recent prominence of leveraged, relatively risky investment products (so-called “geared” investments) as a way to attain consumption-related goals is yet another way in which financial products can encourage financially and environmentally dubious behaviour. One major investment firm actually encourages customers to “reclaim a debt-free future” by going further into debt in this way. Marketing literature put out by the firm pushes so-called “efficient debt” products (geared investments funded by borrowing) as a way to achieve the “dream of indulging yourself with a new sports car, overseas holiday, or even a new home” even while somehow emerging “debt-free”.

In all of these product areas, we are witnessing a race to the bottom. Driven by stiff competition for the profits from consumer debt, financial institutions devise ever-easier, creative ways for consumers to overspend. Many large banks have “financial literacy” programs aimed at educating consumers about the dangers of excessive debt. Without slighting the good intentions of such programs, and some positive outcomes, the messages they send are utterly swamped by pervasive marketing campaigns pushing indebtedness to fund excessive consumption. On the whole, financial services companies overwhelmingly encourage instant gratification at the expense of saving, all without much regard to the consequences for the environment and personal financial stability.

While this report has only touched on these entrenched links between financial services, consumption and the environment, even this brief outline suggests that environmental sustainability in the finance sector can not be couched merely in terms of improving large-scale corporate lending practices.

A responsible finance sector must recognise excessive indebtedness not only as a social ill affecting a few individuals with an unusually low degree of financial sophistication or self-control, but as a deep social and ecological problem, for which the marketing and product design practices of the finance sector bear partial responsibility.

As with a healthy environment generally, it is ultimately in the finance sector’s own long-term interests to reverse rather than exacerbate the problem of overconsumption. One reason for this is the potential reputation risk: if branch closures and fees have been a major focus in recent years, encouraging indebtedness and overconsumption may well be the next big consumer issue on the horizon.

More broadly, the sector’s own long-term interest in reining in affluenza is the same as its long-term interest in the environment generally. Profits generated from highly indebted consumers, like profits generated from a declining natural environment, cannot be sustained indefinitely. This can be seen in the example of South Korea, where the government had to intervene in 2003 to prevent the collapse of credit card providers due to excessive defaults. According to a BBC report, in early 2004 about 10% of South Koreans had debts they were unable to repay.

Ultimately, an institution that encourages overconsumption damages the environment in a more diffuse way, but just as surely and severely, as an institution that finances a highly-polluting power plant or mine. Adopting a responsible and forward-looking stance on consumption will ease the burden on our environment, and thus better protect the future of the finance sector and our society generally.

ACF has a number of professional relationships with a range of private businesses across the finance sector. This statement summarises relationships in which ACF may have an interest or that have resulted in some support for ACF and/or its initiatives since 1 January 2003.

Westpac, IAG and Swiss Re are participants in the Australian Business Roundtable on Climate Change, together with ACF. Each participant committed financial resources to commissioning external research on climate change issues. ACF has not received any financial benefit from these participants.

ACF received donations from Hunter Hall in 2003, 2004 and 2006.

ACF is a beneficiary of ANZ Bank’s online customer donations program. ANZ customers may use this facility to donate funds to ACF. In 2005, such donations were matched by ANZ up to $1,000.

The superannuation investments of many ACF employees, including the author, are managed by Australian Ethical Investment. One of the Directors of Australian Ethical Investment is also a member of the ACF Council, the 37-member governing body of ACF elected by ACF’s membership.

In 2004-2005, ACF participated in National Australia Bank’s community consultative forum, which met quarterly to discuss sustainability and community issues. ACF received no payment or other benefit for this, aside from reimbursement of travel expenses.

ACF has arms’-length commercial relationships as a banking or insurance customer of a number of the institutions discussed in this report.
A BIBLIOGRAPHY
OF SUSTAINABILITY IN
FINANCIAL SERVICES


Jeucken, Marcel, Sustainability in Finance: Banking on the Planet, Eberon Delft, 2004

Jeucken, Marcel, Sustainable Finance and Banking - The Financial Sector and the Future of the Planet, Earthscan, 2001


Sullivan, Rory & Mackenzie, Craig (eds), Responsible Investment, Greenleaf 2006


**IMPORTANT POLICY DOCUMENTS**


Ethical Guidelines, Norwegian Government Pension Fund (sustainable investment principles for one of the world’s largest institutional investors): http://www.norges-bank.no/nbim/pension_fund/framework/

Equator Principles: www.equator-principles.com


UNEP Statement of Environmental Commitment for the Insurance Industry: http://www.unepfi.org/signatories/statements/index.html


**MAJOR SUSTAINABLE FINANCE INITIATIVES**

Australian Business Roundtable on Climate Change – group of six major Australian businesses, including 3 finance sector companies, concerned about climate change issues: www.businessroundtable.com.au

BT Governance Advisory Service – pooled corporate engagement service offered to institutional investors in Australia: http://www.btinstitutional.com.au/content/institutional/gas.htm

Carbon Disclosure Project – institutional investor group pursuing greater corporate disclosure of climate change-related risk and performance: www.cdproject.net
Enhanced Analytics Initiative – collaboration of asset owners and managers to encourage improved research of corporate sustainability and governance issues: www.enhancedanalytics.com

Equator Principles – commitment by major international banks to improve environmental assessment of project finance transactions: www.equator-principles.com

Global Compact – UN program of voluntary business commitment to broad principles of human rights, labour standards, environment and anti-corruption: www.globalcompact.org


Institutional Investors Group on Climate Change (IIGCC) – investors active on climate change issues: www.iigcc.org

Investors Group on Climate Change Australia/New Zealand – Australasian version of the IIGCC: www.igcc.org.au

United Nations Environment Program Finance Initiatives – main international forum for industry collaboration on research and education in the area of sustainable finance: www.unepfi.org


**SOME OTHER SITES OF SIGNIFICANT INTEREST**

BankTrack – independent monitor of private finance sector activity: www.banktrack.org

Business & Human Rights Resource Centre – important web-based clearinghouse for information about corporate effects on human rights, including environmental issues: www.business-humanrights.org

Corporations and Markets Advisory Committee (CAMAC) – government advisory group on Australian corporate law; discussion paper and submissions into current inquiry into corporate responsibility available online; report in preparation: www.camac.gov.au


Environmental Manager – Australian weekly newsletter focusing on corporate environmental issues: http://services.thomson.com.au/default.asp?svc=EnviroMgr&pm=1

Ethical Investment Association – industry group for ethical and sustainable investment businesses: www.eia.org.au


Profundo – economic research consultancy, with focus on investigating financing of sensitive activities: www.profundo.nl

Reputex – sustainability ratings and research on Australian corporations: www.reputex.com.au

This appendix provides additional information about the methodology, findings and key assumptions used in the analysis of syndicated lending activities set out on pages 21-23.

**METHODOLOGY**

The study compares the greenhouse emissions and water use intensities of syndicated loan activities of financial institutions in the Australian market from 2000-2004. The decision to focus on syndicated loans rather than other types of financing was based on the availability of comprehensive data on lenders’ activities in this area; comparable data on other single-lender activities and other modes of financing is generally treated by institutions as commercially confidential and is not publicly available.

**STAGE 1: COLLECTION OF DATA ON SYNDICATED LENDING ACTIVITIES**

Dealogic is a private company that collects information about a range of commercial banking activities and offers it on a commercial basis to interested parties. One of its products is a database entitled Loan Analytics. This contains basic information on syndicated loans reported by financial institutions, including the identity of borrower and arranger(s), the amount of the transaction, and information about the geographic market, industry sector, dates and other details.

For purposes of this analysis, Dealogic generously granted ACF access to Loan Analytics on a pro bono basis. Included in the analysis were all syndicated loans listed on the Loan Analytics database as having been signed between 1 January 2000 and 31 December 2004 and that either occurred in the “ANZ” market or involved an Australian borrower. There were a total of 423 such transactions.

Following is an example of relevant data extracted from Loan Analytics regarding two transactions:

<table>
<thead>
<tr>
<th>Signing date</th>
<th>Mkt</th>
<th>Borrower full name</th>
<th>Borr Nat</th>
<th>Borr Business</th>
<th>Cur</th>
<th>Cur Amt (Tr. Total)</th>
<th>Instrument type</th>
<th>US$ equiv amt (Tr. total)</th>
<th>Mty date</th>
<th>Arranger</th>
</tr>
</thead>
<tbody>
<tr>
<td>23 Aug 2002</td>
<td>ANZ</td>
<td>Centenial Coal Co Ltd</td>
<td>AUZ</td>
<td>Mining &amp; natural resources</td>
<td>A$</td>
<td>576.600</td>
<td>Term loan</td>
<td>312.165</td>
<td>23 Aug 2008</td>
<td>SG Australia Ltd, ANZ Investment Bank, WestLB, Westpac Banking Corp</td>
</tr>
<tr>
<td>27 Sep 2004</td>
<td>ANZ</td>
<td>OneSteel Ltd</td>
<td>AUZ</td>
<td>Steel &amp; aluminum</td>
<td>A$</td>
<td>800.000</td>
<td>Term loan</td>
<td>571.715</td>
<td>24 Sep 2007</td>
<td>Citibank NA, National Australia Bank Ltd</td>
</tr>
</tbody>
</table>
STAGE 2: COLLECTION OF INFORMATION ON GREENHOUSE EMISSIONS AND WATER USE INTENSITY OF AUSTRALIAN INDUSTRY SECTORS

In 2004, CSIRO released a Balancing Act: A triple-bottom line assessment of the Australian economy. This 4-volume work assesses 136 specific industry sectors against 10 key environmental, social and economic indicators.

For each sector, data is provided on the direct and indirect contribution of that sector to each key indicator, in both absolute and relative terms. For example, the report on the “black coal” sector includes the following information, setting out intensity values for each of the key indicators:

<table>
<thead>
<tr>
<th>TBL multipliers – commodities*</th>
<th>Per $ GNE/GNT</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Direct</td>
</tr>
<tr>
<td>Gross operating surplus ($)</td>
<td>0.50</td>
</tr>
<tr>
<td>Exports ($)</td>
<td>0.76</td>
</tr>
<tr>
<td>Imports ($)</td>
<td>0.04</td>
</tr>
<tr>
<td>Employment (min)</td>
<td>0.19</td>
</tr>
<tr>
<td>Income ($)</td>
<td>0.08</td>
</tr>
<tr>
<td>Government revenue ($)</td>
<td>0.06</td>
</tr>
<tr>
<td>GHG emissions (kg CO₂-e)</td>
<td>1.96</td>
</tr>
<tr>
<td>Water use (L)</td>
<td>10.18</td>
</tr>
<tr>
<td>Land disturbance (m²)</td>
<td>0.06</td>
</tr>
<tr>
<td>Primary energy (MJ)</td>
<td>1.53</td>
</tr>
</tbody>
</table>

*refers to GNE/GNT produced in the actual year; excludes decreases in stocks

The GNE/GNT measure is an indication of final demand for the commodity. Thus, using the above table, for every dollar of final demand generated by the black coal mining industry, 1.96 kg of carbon dioxide emissions are produced directly by black coal mining operations, with a further .36 kg generated indirectly by suppliers to the black coal mining industry. Each dollar of final demand also results in the creation of .19 minutes of employment directly and a further .40 minutes of employment with suppliers to the black coal mining industry, and so forth.

The greenhouse gas emissions and water use intensity values from this report were used as the key environmental impact data for the analysis of the environmental impact characteristics of each of the syndicated loans.

STAGE 3: MATCHING OF DATA ON GREENHOUSE EMISSIONS AND WATER USE TO SYNDICATED LOAN TRANSACTIONS

For each transaction identified in Stage 1, a greenhouse emissions intensity and water use intensity value were assigned, based on the industry sector or sectors in which the borrower operated. These values were based on the data from the Balancing Act report. In many cases, this was straightforward, as the borrower was clearly involved exclusively or predominantly in one sector analysed in the CSIRO report.

However, for roughly one quarter of the transactions, the borrower was active in more than one sector. In these cases, the most important sectors were identified and an average of the relevant environmental impact values was used. Where this was necessary, inevitably the determination of the relevant sectors and the weighting of those sectors was a matter of judgment based on a review of available materials about the borrower’s key activities.

In the “electricity supply” sector, a further refinement of the CSIRO data was warranted. Because the CSIRO impact values for this sector were based on an average of all electricity generation activities, it would not have been appropriate to use them for projects that vary as widely in their environmental impacts as a coal-fired power plant and a wind farm. Accordingly, we adjusted the average impact scores given in the CSIRO report by the following amounts, to reflect the differences among these projects:

<table>
<thead>
<tr>
<th>Type of project</th>
<th>Multiplier for CSIRO greenhouse emissions intensity value</th>
<th>Multiplier for CSIRO water use intensity value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brown coal energy generation</td>
<td>150%</td>
<td>176%</td>
</tr>
<tr>
<td>Black coal energy generation</td>
<td>110%</td>
<td>100%</td>
</tr>
<tr>
<td>Gas-fired energy generation</td>
<td>52%</td>
<td>34%</td>
</tr>
<tr>
<td>Wind power and other renewable energy generation</td>
<td>5%</td>
<td>5%</td>
</tr>
</tbody>
</table>

For coal- and gas-fired generation, these values were derived from the average per-MWh differences between the various methods of energy generation, based on electricity industry data.79 Association of
Australia. For renewable energy facilities, emissions and water use of ongoing direct operations for facilities relevant to this study (mostly wind farms) are near zero. The 5% values are a rough, conservative estimate of the emissions and water use embedded in physical facilities and construction, as well as from associated infrastructure and ongoing support operations (maintenance, management, etc).

There is no separate sector in the CSIRO report for electricity distribution. For loans to this sector, the impact values for the pipeline transport sector were used, as this sector was judged to best approximate electricity distribution activities, in terms of construction and ongoing maintenance requirements.

As an example of this approach, consider again the sample of data received from Dealogic on two specific transactions:

For the Centennial Coal transaction, the greenhouse emissions and water use intensity values from Balancing Act for the “black coal” sector were used, being the industry sector in which Centennial is exclusively active.

For the OneSteel transaction, the situation was a bit more complex, because OneSteel’s activities span more than one industry sector used in the Balancing Act report. Accordingly, a review of OneSteel’s activities was conducted, resulting in a determination that the “basic iron and steel”, “structural metal products” and “sheet metal products” were the predominant sectors in which OneSteel was active. For OneSteel’s greenhouse emissions and water use intensity values, the mean of the values for those three sectors was used. While this approach is a simplification of the complex operations across many sectors actually undertaken by the enterprise, it provides in our view a reasonable estimate of the likely aggregate impact of a business active in these areas.

In this way, carbon and water use intensity columns were added to the Dealogic data, yielding the following table (some columns deleted for purposes of clarity):

<table>
<thead>
<tr>
<th>Signing date</th>
<th>Mkt type</th>
<th>Borrower full name</th>
<th>Borrower Nat</th>
<th>Borrow Business</th>
<th>Cur Amt (Tr. Total)</th>
<th>Instrument type</th>
<th>US$ equiv amt (Tr. total)</th>
<th>Mty date</th>
<th>Arranger</th>
</tr>
</thead>
<tbody>
<tr>
<td>23 Aug 2002</td>
<td>ANZ</td>
<td>Centennial Coal Co Ltd</td>
<td>AUZ</td>
<td>Mining &amp; natural resources</td>
<td>A$ 576.600</td>
<td>Term loan</td>
<td>312.165</td>
<td>23 Aug 2008</td>
<td>SG Australia Ltd, ANZ Investment Bank, WestLB, Westpac Banking Corp</td>
</tr>
<tr>
<td>27 Sep 2004</td>
<td>ANZ</td>
<td>OneSteel Ltd</td>
<td>AUZ</td>
<td>Steel &amp; aluminum</td>
<td>A$ 800.000</td>
<td>Term loan</td>
<td>571.715</td>
<td>24 Sep 2007</td>
<td>Citibank NA, National Australia Bank Ltd</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Signing date</th>
<th>Borrower full name</th>
<th>Borrower Nat</th>
<th>Borrow Business</th>
<th>Cur Amt (Tr. Total)</th>
<th>US$ equiv amt (Tr. total)</th>
<th>Arranger</th>
<th>CSIRO Industry sector</th>
<th>Carbon intensity</th>
<th>Water use intensity</th>
</tr>
</thead>
<tbody>
<tr>
<td>23 Aug 2002</td>
<td>Centennial Coal Co Ltd</td>
<td>AUZ</td>
<td>Mining &amp; natural resources</td>
<td>576.600</td>
<td>312.165</td>
<td>SG Australia Ltd, ANZ Investment Bank, WestLB, Westpac Banking Corp</td>
<td>Black coal</td>
<td>2.3</td>
<td>13.69</td>
</tr>
<tr>
<td>27 Sep 2004</td>
<td>OneSteel Ltd</td>
<td>AUZ</td>
<td>Steel &amp; aluminum</td>
<td>800.000</td>
<td>571.715</td>
<td>Citibank NA, National Australia Bank Ltd</td>
<td>33% each basic iron &amp; steel, structural metal, sheet metal</td>
<td>1.66</td>
<td>12.51</td>
</tr>
</tbody>
</table>

STAGE 4: CALCULATION OF AVERAGE INTENSITY FIGURES FOR EACH FINANCIAL INSTITUTION

Once the task of assigning carbon and water use intensity values to each transaction was complete, the calculation of average intensities for each lender was a matter of calculation. First, for each lender, the relevant transactions were identified and isolated. The following formula gives the intensity per transaction for each lender:

\[
\frac{\sum \text{intensity value of transaction}}{\text{total number of transactions}}
\]

The calculation of average intensities weighted per dollar of financing is complicated by the fact that the Dealogic information did not include details of the relative participation of each institution in transactions with multiple lenders. For example, in the loan to OneSteel set out above, Citibank and NAB were the arrangers, and the total value of the loan was AU$800 million, but it is not clear what proportion of the AU$800 million is attributable to each arranger.

In these circumstances, an equal portion of each transaction was attributed to each lender that participated in the transaction. Weighted intensity values for each lender were therefore calculated as follows:

\[
\frac{\sum \left( \frac{\text{intensity value of transaction}}{\text{number of arrangers}} \times \frac{\text{dollar amount of transaction}}{\text{number of arrangers}} \right)}{\sum \frac{\text{dollar amount of transaction}}{\text{number of arrangers}}}
\]

KEY ASSUMPTIONS

1. There may be syndicated loans in the ANZ market or to Australian borrowers not reflected in the Loan Analytics database, since Loan Analytics depends on the voluntary provision of relevant information by financial institutions. Most institutions provide such information regularly, but some transactions may nevertheless be missing.

2. The data available indicated when a financial institution was an arranger of a particular loan, but did not indicate its relative share of that transaction. In the absence of such information, each identified arranger was assumed to have an equal share of the transaction. This assumption would not affect the unweighted (per-transaction) average intensity values for each institution, but could be a source of error in the weighted (per-dollar) intensity values.

3. The study is based on industry sector-level aggregate impact data, available from CSIRO, rather than specific entity- or facility-level environmental impact data, which are not available in Australia due to the absence of consistent and comparable reporting by companies. The environmental performance of individual borrowers may be better or worse than the sector average.

4. The capital raised in some transactions, though obtained from Australian capital markets, may have been used in part or in whole to finance activities occurring outside of Australia. Since the CSIRO impact data is based on Australian activities, the actual environmental impacts of loans for overseas activities could differ substantially. This assumption is likely to affect only a very small number of transactions.

5. The selection of appropriate industry sectors to use as the basis for intensity values of borrowers active in more than one sector entailed a judgment call on what sectors were predominant and what weighting should be assigned to each. While every effort was made to ensure that these judgments were well-informed, inevitably the resultant impact values are an approximation.

Though we acknowledge these sources of possible variance from the results, we do not believe that any of them entail systematic bias for or against any particular lending institution.
## RESULTS

The results, which should be read together with the preceding explanation of methodology and possible sources of error, are as follows (all arrangers with more than 10 transactions are displayed):

### CLIMATE AND WATER INTENSITY OF AUSTRALIAN SYNDICATED LOAN TRANSACTIONS FOR SELECTED FINANCIAL INSTITUTIONS, 2000-2004

Note: Climate intensity is expressed in kg CO\(_2\)-e per $ final demand (GNE/GNT) of financed activities. Water intensity is expressed in Litres per $ final demand (GNE/GNT) of financed activities. Weighted intensity values are weighted by dollar value of transactions (ie, a large loan has more weight than a small loan).

<table>
<thead>
<tr>
<th>Arranger</th>
<th>Number of deals</th>
<th>Aggregate estimated participation (US$m)</th>
<th>Average climate intensity of deals</th>
<th>Weighted average climate intensity</th>
<th>Average water use intensity of deals</th>
<th>Weighted Average water use intensity</th>
</tr>
</thead>
<tbody>
<tr>
<td>ANZ</td>
<td>161</td>
<td>15,525</td>
<td>1.96</td>
<td>1.70</td>
<td>41.90</td>
<td>34.66</td>
</tr>
<tr>
<td>Westpac</td>
<td>125</td>
<td>17,364</td>
<td>1.80</td>
<td>1.24</td>
<td>26.67</td>
<td>20.24</td>
</tr>
<tr>
<td>NAB</td>
<td>116</td>
<td>16,950</td>
<td>2.33</td>
<td>2.09</td>
<td>32.16</td>
<td>29.30</td>
</tr>
<tr>
<td>CBA</td>
<td>112</td>
<td>11,058</td>
<td>1.99</td>
<td>1.56</td>
<td>26.84</td>
<td>24.37</td>
</tr>
<tr>
<td>Citigroup</td>
<td>61</td>
<td>9,623</td>
<td>1.42</td>
<td>1.29</td>
<td>13.36</td>
<td>15.86</td>
</tr>
<tr>
<td>ABN AMRO</td>
<td>54</td>
<td>6,992</td>
<td>1.41</td>
<td>1.26</td>
<td>13.70</td>
<td>14.20</td>
</tr>
<tr>
<td>JP Morgan Chase</td>
<td>40</td>
<td>5,276</td>
<td>1.65</td>
<td>1.15</td>
<td>19.12</td>
<td>14.95</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>39</td>
<td>3,346</td>
<td>2.88</td>
<td>2.58</td>
<td>25.31</td>
<td>24.64</td>
</tr>
<tr>
<td>Barclays</td>
<td>38</td>
<td>8,053</td>
<td>1.39</td>
<td>1.01</td>
<td>16.60</td>
<td>16.47</td>
</tr>
<tr>
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<td>BOS / Bank West</td>
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<tr>
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<td>Sumitomo Mitsui</td>
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THE RELATIONSHIP BETWEEN ENVIRONMENTAL IMPACT AND ENVIRONMENTAL RISK

The results illustrate the aggregate environmental impact intensity (in terms of greenhouse emissions and water use) of transactions in which particular institutions participated over a specific 5-year period.

The table does not directly show financial or environmental risk. This is because the environmental impact indicators are related to certain kinds of risk, but are not perfect proxies for environmental risk overall.

For example, a house on the beach might emit almost no greenhouse gases at all (especially if it uses green power), but could nevertheless be highly exposed to climate change-related storms or sea level rise. Environmental impact is low, but environmental risk is high.

In addition, certain activities may be relatively low-impact yet highly dependent on an associated high-impact activity. These relationships do not always emerge in the CSIRO data. For example, operating a toll road falls into the relatively low-impact category of “Services to Transport”, but the economic success of such roads depends on a large number of consumers engaging in the relatively high-impact activity of transporting themselves by personal passenger vehicle. Similarly, financial services have very low direct impact values, yet some finance sector businesses may be dependent on financing high-impact activities.

Further, similar environmental impacts do not carry the same degree of financial risk across different industries and geographic regions. Operating a water-intensive industry in the wet tropics region of Australia might not be as risky in a financial sense as dependence on water in southwest Western Australia, where climate change-driven drought and water scarcity could result in significant price and supply volatility and uncertainty. Similarly, the diffuse emissions of CO\textsubscript{2}-e in the agricultural sector is perhaps financially less risky than the emission of CO\textsubscript{2}-e from the stationary energy sector, since the latter is more likely to be the target of future regulation to limit greenhouse gas emissions.

With those caveats in mind, environmental impact measures are nevertheless likely to be strongly correlated to certain kinds of environmental risk. For example, it is reasonable to expect that, on the whole, greenhouse emissions-intensive industries would be worse affected by future pricing of such emissions than relatively low-emissions industries.

It should also be noted that the analysis covers only syndicated loans, which are only a fraction of any institution’s total portfolio. A complete view of an institution’s total indirect environmental impact would entail analysis of other modes of financing as well, including single-lender transactions, project finance, equity investments, and so forth. Comparable data is not generally available for most of these other investment modes. Further, the analysis shows a profile of environmental intensity of activities over time, but not of any actual investment portfolio at any specific point in time. This is because each institution’s actual portfolio would include transactions entered into before 2000, and may exclude some transactions where subsequent repayment of loans or transfer of debt instruments to other institutions has occurred.
The Australian Conservation Foundation (ACF) is committed to inspiring people to achieve a healthy environment for all Australians. For 40 years we have been a strong voice for the environment, promoting solutions through research, consultation, education and partnerships. We work with the community, business and government to protect, restore and sustain our environment.

ACF is Australia’s leading national not-for profit environment organisation and is funded almost entirely by individual membership and donations. Since 1966, we have focussed on the most important and urgent environmental problems, seeking change with lasting political, economic and social support. ACF has played a key role in increasing protection for some of Australia’s most outstanding natural assets including the Franklin River, Kakadu, the Daintree Rainforest and Great Barrier Reef.

ACF is also engaged to improve the environmental responsibility of Australia’s corporate sector, through corporate law reform, engagement, and corporate monitoring initiatives. For more information about ACF’s corporate environmental responsibility campaign and our other work, visit our website: www.acfonline.org.au