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Environment and Finance

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Towards green banking practices in the South[1]

The discussion around environmental management in financial institutions has until now largely taken place in industrialised countries. However, in view of the financial globalisation and ever increasing environmental regulations, many financial institutions operating in developing and emerging countries are pressed to better manage risks arising from environmental liabilities. Besides credit and market risks, damage to an institution's reputation often represents an important driver for international banks. Domestic players – including microfinance institutions – may have different incentives, among others to contribute to local development, but they play an equally important role.

Once thought to be only a privilege of rich nations, environmental protection is becoming a mainstream issue in the South, too. In many developing countries, the costs of the current environmental degradation have been estimated at 4-8% of GDP annually, according to the World Bank[2]. Today, about 200 financial institutions have committed to integrate environmental factors into their operations by signing the UN Environment Programme's (UNEP) Financial Institutions Initiative. Among them, more than a fourth (55) are based in developing and emerging countries[3].

How do environmental issues affect financial institutions operating in these regions? As other economic players, banks consume natural resources. In developing countries, this type of environmental impact can potentially be very high in view of the insufficient availability of clean sources of energy or the limited infrastructure for the environmentally friendly disposal of products. Banco Itaú, one of the largest banks in Brazil, recycles 2,200 tons of shredded paper annually[4].

However, a bank's financial products do not pollute, but it is now widely recognised that the *indirect* ecological impact of funding enterprises and projects is the most relevant issue. By integrating environmental factors in their decision criteria and pricing, financial institutions can better manage risks while positively affecting the environmental impact of a large number of economic players.

Addressing environmental issues in financial operations is part of a sound risk management

In the past, it was sometimes argued that environmental regulations in developing countries are either non-existing or lack enforcement. Nowadays, environmental liabilities are starting to represent real economic risks. Environmental legislation in many developing countries is rapidly converging, following the path of industrialised countries, while the prospects for enforcement seem to loom larger. In 2000, the Brazilian oil company Petrobras was fined US$ 28 million and US$ 118 million after two oil spills from its refineries, some of the highest fines ever recorded in Latin America[5].

Environmental liabilities are one reason why lenders are exposed to credit risk, should the borrower have difficulties repaying. In fact, many different types of costs can arise as a result of pollution or compliance with environmental laws. Properties assigned as collateral for loans also risk depreciation if they are exposed to pollution. In Columbia, Banco de Colombia was held responsible for cleaning up a site received from the National Federation of Cotton Growers in payment of a loan[6]. The property was contaminated with agrochemicals.

[1] This article was originally published under the title "*Environmental Management Systems and risk reduction in developing economies*" in Sustainable Business Investor – Worldwide (SBI), Issue 2-2002
[2] World Bank (2001)
[3] United Nations Environment Programme (UNEP) Finance Initiatives (2002)
[4] Banco Itaú S.A. (2001)
[5] Source: Gracer J. B. (2000)
[6] Gracer J. B., Ibid.

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Box 1 – Environmental policies in lending in developing and emerging countries

Region / Institution	Central and South America	Africa	Central and Eastern Europe	Asia
International development banks				
Subsidiaries of international banks				
Domestic banks				
MFI (microfinance institutions)				

Scale: the colour of each cell indicates the estimated average application (low, moderate or high) of environmental policies in lending operations in each type of financial institution. The shading shows the degree of confidence about the results (positive or limited evidence):

	low	moderate	high
Positive evidence			
Limited evidence			

This table is based on estimates. Differences within each region can be significant.
Source: Ecofact AG, 2002, own research

Even in the absence of the enforcement of environmental regulations, market risks matter. According to a World Bank study[7] in Argentina, Chile, Mexico and the Philippines, stock markets react negatively to citizens' protests reported by the economic press. Also, stock prices reward the announcement of superior environmental performance such as greater pollution control or the adoption of cleaner technologies.

For many financial institutions however, credit and market risks have not been the primary motivation for adopting an environmental programme. As Herman Mulder, Senior Executive Vice-President for group risk management at ABN AMRO, puts it: "*I believe that environmental damage is primarily a risk to our reputation rather than a credit risk*"[8]. As a result of NGO accusations concerning damage to forests in Indonesia, the bank adopted in 2001 a forestry policy promoting sustainable practices. This year, it developed a mining policy, while a document on the financing of oil extraction is on its way.

[7] World Bank (1998)
[8] ABN AMRO (2001)

Given the globalisation of economic activities, tracing indirect credit and reputation risks raises some unsolvable questions. Lenders may withdraw from sensitive projects in the South and find themselves financing the same projects through financial intermediaries. Or their client companies may use credit lines to buy from incriminated suppliers.

In domestic financial institutions, regardless of their size, environmental management systems have potential

While many commercial banks in industrialised countries have already implemented Environmental Management Systems (EMS), the reality is different for financial institutions operating in the Southern hemisphere (see Box 1). In fact, many have gone no further than signing the UNEP declaration.

With the adoption of an EMS, a bank introduces policies into all its operations aiming at reducing direct as well as indirect environmental impacts[9].

[9] For a definition of Environmental Management Systems (EMS) and the ISO 14001 standard, see the International Organization for Standardization (ISO) (2002)

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In lending operations typically, it means introducing environmental risk and impact assessment procedures. The impetus for EMS in banking came particularly from the World Bank, which adopted Environmental Assessment (EA) procedures as early as 1989. Today, all regional development banks use EA and many international groups apply World Bank standards, with European banks leading the way.

In the South, domestic financial institutions have been under pressure from multilateral agencies. In 1992, when the Development Bank of the Philippines (DBP), a large lender to Filipino industry, received a credit facility from the World Bank, the latter required on-lending institutions to have a policy addressing environmental issues. Then, "*over time, DBP's commitment to [..] sustainable development became more ambitious and was driven less by what a bilateral aid agency desired and more by senior leadership of the bank itself*"[10]. In 1997, the bank initiated efforts to implement an EMS.

Despite a handful of examples, few domestic financial institutions currently use an EMS. The findings of a survey[11] among 76 Latin American banks showed that only 22% have an environmental policy applied to lending. The banks surveyed cited several challenges, including the difficulty of translating environmental impacts into relevant financial terms and the lack of experience.

With the advance of financial globalisation, it is likely that environmental management will spread to domestic banks in developing countries as well. The development of local environmental legislation will be an additional driver. In fact, since the enforcement of laws in enterprises has its failings, targeting the well-regulated institutions that finance them might be considered an attractive policy option by governments.

In small financial institutions however, the implementation of environmental management does take a different shape. The amount of time a loan officer can spend on an environmental assessment depends very much on the size of the project. In low-income countries, where the informal economic sector usually represents 40-80% of the economically active population, many small microfinance institutions play a very important role in financing the economy. Although the standards developed by larger banks cannot be transferred to microbanks, best practices exist. One of the world's largest microfinance institutions, the Grameen Bank in Bangladesh, provides banking facilities to the poor, particularly women. As part of the development mission of the Bank, borrowers need to learn a series of 16 principles. Although this is a simple procedure, more than 2.3 million clients in 40,000 villages have learned the rule "*We shall always keep our children and the environment clean*"[12].

The good news? In the long term, environmental management pays

The reduction of environmental impacts contributes to more sustainable practices, but it also makes good business sense. The Standard Bank Group of South Africa, active in 18 sub-Saharan countries, recognises that "*environmental management is an important area of corporate performance*"[13]. More important than cost reduction, EMS have proved to bring a better risk management which results, over the long term, in higher returns for the lender.

Several studies have also shown the link between environmental management and a company's intangible assets such as reputation, staff commitment, business excellence and competitive advantage. Public pressure is certainly not the only incentive to act. The intangible benefits of involving employees in an environmental protection scheme may actually prove to be higher. In addition, anticipating new regulations represents a market advantage in view of the move towards stricter environmental requirements observed in developing countries.

[10] United States – Asia Environmental Partnership (US-AEP) (undated)
[11] Pratt L., Rojas E. (2001)
[12] Grameen Bank (2001 and 2002)
[13] Standard Bank Group (2002)

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Besides, banks have the opportunity to tap into the growing markets of "green" financial products, among them Socially Responsible Investments (SRI), helping investors to diversify their assets. Of particular relevance to developing countries, greenhouse gas emissions reduction projects are starting to be developed under the framework of the Kyoto Protocol. Since January 2000, six "Carbon Funds" have been issued by the World Bank and other multilateral institutions for a total volume of US$ 1 billion[14].

In the developing world, where social and environmental issues appear more acute, banks may also be more inclined to adopt voluntary commitments such as community programmes as part of their general corporate engagement towards society and the environment. "*Community investment and development are seen primarily as an overhead in developed countries, but in emerging markets they are shown to be important in retaining the 'license to operate' and in reducing risk*", concluded the UK consulting firm SustainAbility[15].

As a result of specific goals and needs in each local context, financial players in the South will pursue different strategies to address environmental issues, each bringing different rewards. The profitability of new environmental products is difficult to assess, but they present attractive long-term perspectives. Above all, the business case for managing environmental risks is growing stronger in developing and emerging countries. At last, the trend towards greener banking practices will also contribute to better living conditions for all.

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Ecofact AG (www.ecofact.ch) is a Swiss-based consultancy advising financial services providers in the area of environmental management, risk management and sustainability. You can reach us at: contact@ecofact.ch

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