

The Role of the United Nations Environment Programme (UNEP) and the Financial Services Sector

Work in Progress

Abstract

This article describes the projects and programmes of UNEP in association with the financial services industry, principally through its innovative partnership, the Financial Services Initiative. This is a private and public sector partnership involving some 250 financial institutions, insurers, reinsurers and asset managers within the financial services industry grouped around two separate voluntary codes of conduct. Following a short history of the Initiatives, which started in 1991, the objectives and work programme are described, together with some examples of the way in which this programme has delivered change in the industry.

The article will describe a case of the latest phase of the work programme which is addressing one specific challenge of globalisation: barriers to Cleaner Production (CP) investments in emerging economies. This specific project is examining the past investment practice in five developing economies in order to identify barriers to CP concepts and to provide national policy advice on financial instruments that will enhance investment that brings with it a greater level of environmental protection.

Introduction

UNEP started working with forward-looking organisations in the financial services sector at the beginning of the decade. Since its creation in 1972, UNEP had always had a mandate to encourage economic growth compatible with protection of the environment. But this element of UNEP's role was considerably enhanced by the Earth Summit of world leaders who met in Rio in 1992 and placed great emphasis on promoting development that did not compromise the quality of life of future generations. It was then that the UNEP Financial Institutions Initiative on the Environment was founded when "The Statement by Banks on the Environment and Sustainable Development" was signed by some 30 banks. Now 170 financial institutions with a market capitalisation in excess of US \$ 2 trillion and more than five hundred thousand employees are signatories.

The motivation behind the Initiative

UNEP was convinced that bankers and investors had a valuable contribution to make in protecting the environment while maintaining the health and profitability of their businesses. In 1991 the then Executive Director, Dr Tolba approached a small number of international financial institutions as part of the preparations for the Earth Summit in Rio. His purpose was to enquire of them whether they shared his view that the finance sector could have a role in sustainable development. The banks approached had already publicly demonstrated in a variety of different fashions that they had an awareness of environmental issues. This had generally taken the form of commentary within their financial statements, at that time no bank had published an environment report, although some of their largest customers were beginning to make publish separate environment reports. They responded to the call, working with UNEP to draw up a statement of environmental commitment for the sector.

It was clear that protecting the environment could not be achieved by governments alone. The private sector had a particular perspective on environmental issues and its expertise was needed if a

radical shift in public attitudes about the compatibility of an ecological outlook and ordinary commercial and industrial life was to be achieved. Bankers and investors have crucial links with commercial activity, including activity that degrades the natural environment.

The idea was extended to insurance and reinsurance organisations at the end of 1995 with the launch of the Insurance Industry Initiative on the Environment. The insurers, whilst sharing many of the characteristics and similar concerns of banks had traditionally been managed in a different fashion and grouped themselves as a separate industry. UNEP and the small group of insurers and re-insurers who worked on the engagement of the insurance industry recognised this and took the strategic decision to produce a separate statement to better engage the industry. To date more than 85 insurers and reinsurers have signed the Insurance Industry Statement.

The Statement by Financial Institutions, initially launched as the Banking Statement, was revised in 1997. This was undertaken by a group of signatories in association with UNEP and presented to all signatories on the occasion of the third global roundtable in New York. The revision did not dilute any of the original commitments or aspirations. It did however update the language used to describe the industry and to reflect the changes in the make up of banks since the first drafting in late 1991.

Major banks and insurance groups from around the world have put their name to the statements. A major cornerstone of both is a commitment to sustainable development and support for the precautionary approach to environmental management which attempts to anticipate and prevent environmental degradation. The signatories also undertake to promote public awareness and communication.

The objectives of the Initiatives

The primary objective is to generate a dialogue between commercial banks, venture capitalists, insurance and reinsurance concerns, multilateral development agencies and asset managers, all those involved in economic development and managing risks and environmentalists. A secondary objective is to foster private sector investment in environmentally sound technologies and services.

In order to fulfil its primary objective UNEP has convened meetings of bankers, insurers and other interested groups in all regions of the world. These have ranged from the very first meeting in Geneva in September 1994, attended by some 50 bankers, to the Third International Roundtable in New York which attracted some 350 participants. The agenda for these meetings has changed very little in the intervening years. There is still a very great concern about the impact of environmental risk on clients financial performance and the knock on effect that this might have on the banks' own results. But there is also an increasing awareness of the opportunities created by a conscious approach to environmental opportunities. Financial institutions are big businesses in their own right and taking an eco-efficient approach to their own business operations is some times the first sensitizing to environmental issues. This improved environmental performance generally brings with it an improved financial performance and a willingness to consider this area more pro-actively. In our experience the awareness raising is best done at a regional or national level rather than at a global level. Also it is important to have practitioners talking to their peers as a further demonstration of the business centred focus of this activity. Some years ago the phrase '*environmental sense makes business sense*' was first used and since then it has been a key theme in convening meetings around this subject.

The common theme in all of these gatherings has been that it is industry practitioners who are addressing these subjects and that they are addressing them from the perspective of being inside their business looking out rather than an outsider looking in. The persuasive arguments employed by a banker talking to his peers are very different to those that would be employed by a different constituency and have a different set of results.

Initially UNEP's role was an educational and information giving role in partnership with a few banks. Now it is very much as a catalyst as the sector has started to educate itself on the importance of addressing these issues for the long term, as key survival issues for the sector. UNEP acts as a guide in this unique partnership and facilitates change amongst informed banks within the sector. It has a clear leadership role as the environmental voice of the United Nations and it is one that is increasingly listened to by the private sector. For example, in fulfillment of its secondary objective UNEP has, as part of its assessment of the level of implementation of the Statement, collected examples of innovative products and services that have been created by signatories and promulgated such information amongst the industry. At the time of the last review in 1999 almost 60% of signatories had introduced specific products or services that have an environmental as well as financial dimension. By far the most common was a discounted loan facility for an environmental improvement or a 'green' savings product but did also include environmental consultancy, bio-degradable credit cards and a green garbage waste disposal business. In addition it has involved signatories in other areas of UNEP's work, and with other UN agencies either as participants or advisors in a number of work programmes. In 1998 a number of signatories acted as peer reviewers of a training manual - Accounting and Financial Reporting for Environmental Liabilities and Costs, which was then used to train national standard setters, regulators and others involved in this area of the financial services industry. A direct result of this programme, which is still on-going, is that a major bank who hosted one of the workshops has introduced a rating system using this information and is planning two sector specific seminars. As well as this other institutions have used the material to inform their own internal risk training programmes.

This is the background to the latest phase of UNEP's work with the financial services sector and may well serve as a model for its future work with the sector. This involves a wide range of financial institutions and other interested sectors in addressing one of the most critical issues in the current financial services sector and environment debate - the promotion of environmentally sound technologies through the supply of innovative products and services leading to the promotion of environmentally superior technology. A virtuous circle bringing with it environmental and financial benefits for all involved local communities, suppliers, customers, and of course the environment as well as the more traditional parties of owner, worker and financier.

UNEP'S involvement in Cleaner Production (CP): a case description

Introduction

A concrete example of a UNEP technical co-operation project in promoting win-win technology options in industrial investment is the project "Strategies and mechanisms for promoting CP investments in developing countries", which was launched by UNEP in 1998 and has been funded by the government of Norway. The project aims to demonstrate how investments in CP can be stimulated by helping financial institutions to understand its benefits, and by training national experts to develop creditworthy CP investments proposals. Demonstration activities are being organised in

Guatemala, Nicaragua, Tanzania, Vietnam and Zimbabwe. UNIDO/UNEP National Cleaner Production Centres (NCPCs) support the initiative in all these countries.

Constraints to CP investments

Investments in CP can have attractive economics due to the reduction of costs for input materials, energy and water, and expenditures on waste treatment and disposal, as well as increase of production and better output quality. Their payback period may, however, be longer than is customary in a typical EIA for a new investment. Small and medium sized industries have a particularly hard time making CP investments for a variety of reasons, ranging from the cost of capital to the absence of appropriate funding mechanisms. Furthermore, CP is less likely to be economically attractive in countries with few and lax environmental regulations, under-priced or free natural resources and no green consumer movement. The table below summarizes the major problems of funding CP investments from the perspective of the financial sector

Problems to be Addressed	Underlying Causes
1. Inability of financial institutions and industrial authorities to assess the technical and financial merits of CP investment proposals.	<ul style="list-style-type: none"> · Impact of CP on profitability of investments and creditworthiness of borrowers not understood by credit providers. · Inability of credit providers to assess the CP content of investment proposals.
2. Lack of credit schemes customised to Cleaner Production investments.	<ul style="list-style-type: none"> · Limited development stage of banking system, reflected in focus on traditional collateral value (land and buildings), short repayment periods and provision of working capital only. · High interest rates, (largely) caused by macro-economic and financial instability.
3. Inability of to develop creditworthy CP investment proposals.	<ul style="list-style-type: none"> · Lack of CP assessment capacity, and CP assessments undertaken not directed to result in creditworthy investment proposals (including business plans).
4. High cost of implementation of Cleaner Production.	<ul style="list-style-type: none"> · Limited local availability of CP adapted technology and devices and engineering and installation services. · Perceptions regarding high technology risks associated with CP investments.
5. Lack of enabling environment for Cleaner Production.	<ul style="list-style-type: none"> · Lack of conducive policy environment for Cleaner Production. · Lack of demand for CP from industrial community.

Even in the cases where the management of a company has the intention to invest in CP, the implementation of such a proposal can still be hindered by a lack of financial resources. The appraisal of a loan application from a commercial bank depends not only on the way financial costs and benefits are identified and quantified but also on the existing relationship between the bank and the company and on the firm's overall creditworthiness.

Possible solutions

The following considerations may help banks to orient their lending towards CP: management competence (CP as an integral part of Total Quality Management), cash flow (CP reducing costs of environmental compliance), and long-term competitiveness. In most financial institutions by far the greatest level of attention is paid to past costs, including regulatory costs. It is not common for future potential costs to receive the same level of assessment in a loan application as past financial costs. Yet the weight of regulation is getting heavier, not just in developed countries but in developing countries and those countries with economies in transition. This does mean that a true assessment of risk must factor in the future costs of operation as well as the past performance.

In terms of equity financing, companies must comply with reporting standards of markets for stock exchanges to generate capital through the issuance of shares. As environmental awareness increases, shareholders may consider ecological aspects in their investment behaviour. This has led to the emergence of green investment funds and, for instance, the Swiss bank UBS AG offers the possibility to invest in “ecological leaders” or “innovators” with a significant window for CP opportunities. Another alternative source of financing is leasing which can be geared towards facilitating the financing of CP investments.

The success of environmental funds depends on the extent to which they manage to attract capital. Such funds can encompass various financial structures, including restricted accounts, lines of credit, revolving loans and guaranty funds with special emphasis on CP. For instance, the Nordic Environment Financing Corporation (NEFCO) launched in 1997 a revolving facility for CP investments in Lithuania and Northwest Russia. Development assistance presents a specific form of special-purpose funds which are often provided through financial intermediaries in developing countries. An example of such a facility is a credit line for CP financing in China.

UNEP's project

The expected results of the project at the country level are:

- More effective interaction between financial and manufacturing sectors;
- Improved ability of public and private financial institutions to assess investment proposals and provide preferential treatment to CP;
- Improved ability of technical assistance and CP assessors to develop creditworthy CP investment proposals and mediate in obtaining funding for their implementation; and
- An increase in CP investment in participating countries particularly in selected priority sectors¹.

At the global level, the project aims at developing new instruments and project initiatives (including credit lines, trust funds, policy changes, training, etc.) to foster additional CP. The project is supported by national co-ordinators and advisory boards. An international Advisory Board provides overall guidance and ensures that there is no overlap of activities between countries or regions. It will use the accumulated experience gained with UNEP's Cleaner Production Programme and the UNEP Financial Institutions Initiative which promotes the integration of environmental considerations into the financial sector's operations and services.

Project implementation has started in spring 1999 with a major study on past investment practices. It became clear at an early stage that there is a wealth of knowledge outside the selected countries and these resources are also being tapped. Parallel activities are currently identifying the existing tools used by investors, appraisers and project developers to integrate CP into project assessment. Additionally the same expert group is developing what could be the elements of an ideal assessment tool. It is hoped to bring this to the market in the form of trial project assessments in the first half of next year. The project is scheduled to be completed in 2002 and is working in close co-operation with partner agencies such as UNIDO, ICC, IFC, World Bank, OECD, selected bilateral programmes and commercial banks, and UNDP.

¹ Three-four subsectors have been selected in each demonstration country, representing most important industries, for example food processing, textiles, tanneries and small-scale mining in Tanzania. This will provide an opportunity to formulate draft benchmarks to for use by authorities and financial institutions at the country level.

Conclusion: the big challenge

Since its beginnings in the early 1990's the financial institutions initiative has grown from an initiative addressing one aspect of the financial services sector, the private sector, and within that just commercial banks, through to a broad based initiative addressing the whole range of financial institutions in the market place today. In part this has been due to the growth of understanding, amongst both financial service providers and UNEP and partly due to the growth in private sector financial investment. Capital investments in developing countries have multiplied during the 1990s. International financing institutions such as the World Bank and regional development banks have played an important role in this development, but the most spectacular growth has taken place in private sector investments. This flow has mostly been for investments similar to what had been the pattern during the industrialisation period of OECD countries. Such investments, whilst necessary, often lead to increased pollution loads and use of energy and natural resources. The awareness of this potentially double cost, firstly to industrialise and secondly to upgrade to cleaner production processes has been a strong motivator in driving this programme forward.

Globalisation also presents a major challenge to developing countries in their attempts to promote economically viable domestic and international investments, and to financial institutions who are looking for new and emerging markets. Ecological considerations often relate to environmental impact assessments (EIA) and/or emission standards only without any linking between social, environmental and economic performance. The challenge is to achieve sustained income growth for these economies by raising investment rates, strengthening technological capacities and skills, and improving the competitiveness of products and services in world markets; distributing the benefits of growth equitably by creating more and better employment opportunities and protecting and conserving the physical environment for future generations. That is why the CP Investments project and the CP Programme generally is so critically important for developed and developing countries alike. The CP project is only working, directly, in five countries yet the results will have an impact in a large number of economies. Already the number of countries actively engaged has more than doubled with further enquiries from most regions of the globe. It is clear that there is an interest and an enthusiasm to know more. It is also clear that there is a lot to be done and very few institutions working in this area. The challenge will be to use the multiplier effect of the demonstration projects to best advantage so that the legacy of this project is not a series of reports but rather a series of manufacturing businesses demonstrating that sustainable development works. The reports will be important in pointing the way for others to follow these pioneers of industry.

UNEP will face a number of challenges in making this vision a reality. No one underestimates the difficulties facing these economies and the changing shape of the financial services sector adds to the problems. UNEP has to change the way it addresses the market in response to such changes and has to do this with very limited resources. Whilst it is unlikely that any new Statements will be created to face the sector there have been changes in the way engagement is addressed. Broader consultation, participation of a number of stakeholders, National Governments, NGOs, and academics, never enough but always more than before helps to bring these issues to the top of the agenda. This is how UNEP will continue to work; raising difficult issues in an atmosphere of dialogue and openness and continuing to push the agenda so that complacency is never an option.

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