



BACKGROUND-PAPER

TITLE Parallel Session VII: Tuesday, 30 April 2002, 14:00 – 15:30

INVESTING IN SUSTAINABILITY?

*Authors: Ari Huhtala and Elena Ciccozzi
UNEP DTIE*

OBJECTIVE The objective of this paper is to convey to the participants that:

- Despite increasing awareness of business decision makers and asset managers of the importance of socially responsible investment, understanding of the economic merits of preventive approaches and efficient resource management remains limited;
- Cleaner production (CP) ¹ is a part of the development agenda for the business community, not an item of overhead;
- There are examples of initiatives and mechanisms to overcome barriers to financing CP investments;
- Mainstreaming and integrating CP into decision making processes makes business sense;
- CP helps increase companies' Shareholder Value (or companies' value);
- CP fosters the development of new knowledge that applies to the whole product/service process life cycle as well as value chains; and
- As CP triggers the creation of knowledge, it indirectly contributes to job creation, enhanced competitiveness and, to some extent, innovation.

INTRODUCTION

Prevention is a better business than allowing production cycle inefficiencies to create losses. The cleaner production (CP) community knows and believes in this. Indeed, CP has made tremendous headway in the engineering community in the last ten years. However, most providers of investment and financing remain unaware, or unconvinced. As a result, financing is still seen as one of the main constraints for wider pollution prevention practice.

This does not mean that there has not been a flurry of activity and progress in this field. Research initiatives in issues related to sustainable finance have multiplied, donor agencies have launched demonstration projects, and special CP financial mechanisms continue to emerge in a number of countries in the last few years.

At the same time, financial markets are becoming more sensitive to issues related to sustainability, particularly environment. Sustainability issues influence both risk and return. Recent evidence shows that also institutional investors are increasingly supporting sustainability.

The key challenge is to mainstream and integrate preventive approaches and efficient resource management into the investment decision making process in

¹ For the purpose of this paper, Cleaner Production, Preventive Approach, Efficient Resource Management and Eco-Efficiency are used as parallel concepts.

government policy, company practice and financial institutions' due diligence process.

UNEP/DTIE has been implementing the project 'Strategies and mechanisms for promoting cleaner production investments in developing countries'² since 1999. The lessons learned in the five project demonstration countries and through the greatly intensified global debate on this topic, form the basis of the issues in this background paper for the session on investing in sustainability at CP7. The paper summarises these lessons and the main deliverables available from the project to global application and use, including training modules and checklists. It also attempts to highlight the most recent trends in the global debate related to CP financing and their relevance to the financial community.

STAKEHOLDERS

The number of stakeholders in activities related to the promotion of CP investment financing has expanded considerably during the last few years. Some stakeholders have an important role in raising awareness, providing technical advice, disseminating information, training etc. Some others provide a policy and regulatory framework and financial resources. Potential stakeholders include:

- International Financial Institutions (private and public);
- Multilateral Financial Institutions (World Bank, IFC, regional development banks, national development finance institutions in OECD countries, etc.);
- Export Credit Agencies;
- Foundations;
- Ministries of Economy and Finance;
- Chambers of Industry and other representatives of the business community;
- CP service providers; and
- Academic and educational institutions specialised in finance, business planning and administration, accounting and engineering
- Media.

UNEP PROJECT OUTPUTS

The immediate objective of the UNEP/DTIE project (see Introduction above) was to facilitate the financing of cleaner production investments in developing countries (Guatemala, Nicaragua, Tanzania, Vietnam and Zimbabwe) by:

1. Demonstrating how to initiate and facilitate the financing of cleaner production investments through the case of the five developing countries
2. Developing financing instruments for effectively promoting cleaner production investments in developing countries and designing enabling strategies for supporting public and private financial institutions and the industrial community to adopt these financing instruments;
3. Motivating key decision makers in the international community and the public and private financial sectors to pursue cleaner production investments in developing countries.

The first activity was a study on past investment practices in eight countries, and the outcome of this study was reviewed in the background paper for the parallel session on financing at CP6 in Montreal in October 2000.

Core teams of national experts (financial analysts and CP promoters) have been built in the five demonstration countries, with new skills to assist the industrial community in improving the demand for CP investments (e.g. preparation of bankable loan applications) and the financial sector to assess the merits of

² Shortly referred to as "CP Financing Project"

these proposals.

Portfolios of CP loan applications have been prepared in each country with selected local industries³, amounting to some 50 projects with investment unitary value ranging from USD5,000 to USD4million. These investment proposals have also served as valuable cases for local capacity building and the teams of national experts have promoted them among potential sources of financing. So far five have been financed and implemented (in Zimbabwe).

Based on the results of training need assessments conducted in the five countries, and in partnership with several international institutions, the UNEP project has developed a menu of four **training courses**:

CP1 – Introduction to CP concept and practice (1-day awareness course)

CP2 – Introduction to capital budgeting and financing of capital projects (1-day awareness course)

CP3 – Profiting from CP (2-day skill course)

CP4 – Funding CP projects (2-day skill course)

These were adapted to local conditions and implemented in all the five demonstration countries (in English, Spanish and Vietnamese). By March 2002 nearly 100 courses had been delivered with nearly 2,000 participants. The target audiences have included political decision makers in national and local government authorities, company managers, engineers and accountants, bank loan assessors, academia, and the media. As a result, active CP promotion networks have emerged in some of the countries with a much broader range of stakeholders than before. Many of the partner institutions hosting the courses are in the process of adapting some of the material to their own curricula, thus contributing to mainstreaming CP into courses on business management, accounting and financial analysis.

Components of these courses have also been used in global and regional training events for the benefit of e.g. the Directors of UNEP/UNIDO National Cleaner Production Centres (NCPCs) and bankers from developing countries and economies in transition.

As a result of the project field experience and based on the recommendations of an Expert Group Meeting on UNEP Capacity Building Material to Promote CP Investments (held in Paris 27-28 November 2001), UNEP/DTIE intends to publish the following in June 2002:

- Brochure 'Profiting from cleaner production – Journey to efficient resource management' for senior and middle management in government, finance and business
- Executive awareness slide presentations 'Profiting from CP' for industry, financiers and government
- Checklists to facilitate decision making related to CP investments
- Generic version of training modules (see four courses above)
- Trainer's guide

In addition to training, the project has also carried out missions and organised workshops on **innovative financing schemes** in all five demonstration countries. In the long run, CP investments normally should not need subsidised financing. They can have incremental effects on the cash flow and net income of enterprises, but often do not provide much in respect of collateral. Following fact finding missions, concrete proposals for a CP dedicated financial mechanism

³ Most of these cases come from the textile, pulp and paper, metal mechanics, food-processing and tannery sectors.

have been made for the consideration of the government (policies and regulations), local financial community (financing) and potential donors (support to promotional projects) in each demonstration country.

LESSONS LEARNED

Work carried out under the UNEP/DTIE project, particularly through workshops and contribution to various regional CP Roundtables and draft articles compiled by UNEP/DTIE for the special issue on financing of the Journal of Cleaner Production have resulted in a number of conclusions and recommendations which will be here outlined under several subheadings. To put these various elements into a functional context, we should first recall a number of **basic facts concerning cleaner production**. Commonly held misconceptions have often prevented the adoption of useful preventive measures in the past:

First – Cleaner production is frequently an investment with a return. Spending money on repairs or on environment control is more properly a capital cost. This makes CP an opportunity, part of the development agenda, not an item of cost.

Second – Prevention of loss – whether of materials, products or money – is a matter for mainstream business managers, including financial controllers. Cleaner production, as a loss prevention approach, often justifies the extra expenditure by the increased productivity and business security it creates.

Third – Cleaner production has an eye on long-term profitability. Current financial policy, particularly in developing countries, is often short-term. CP financing is trying to overcome this barrier.

Fourth – Cleaner production is a strategy that requires a change in attitude and behaviour to be broadly spread. It cuts across the entire spectrum of stakeholders from production engineers to accountants, financial analysts and managers, government policy makers and academia.

MAINSTREAMING – COMPANY PERSPECTIVE

CP requires thinking about the life cycle assessment of consumption, production and distribution, using the results of the analysis in design and operation. This behaviour of looking beyond the immediate necessities of a project must be promoted as an element of good management, risk reduction, social responsibility and competitive advantage.

CP investments can strengthen the financial situation of a banker's client and reduce risks of loan default caused by fines, or non-compliance, clean-up costs, etc. The challenge ahead is to create added value by integrating preventive approaches and efficient resource management into the strategic and management processes of a company. It is the Chief Executive Officer who has the prime responsibility for environmental management of an enterprise, not the environmental engineer.

ROLE OF COST ACCOUNTING

There is a need for increased emphasis on costing and on environmental management accounting (EMA) as tools to promote CP and improve cash generating capacity at the enterprise level. 'What you can measure, you can manage'. Several institutions promoting CP are currently also involved in the UN-led Expert Working Group on 'Improving the role of government in the promotion of EMA'. The UNEP/DTIE project on CP financing has forged close links with the Working Group and EMA, and costing is a key component in one of the two skill

courses (CP3 'Profiting from cleaner production') developed under the project.

There are several examples in developing countries and economies in transition. The current National Cleaner Production Centre in Zimbabwe (SIRDC-ERSI) has used demonstration companies from the recent DANIDA-funded CP project to illustrate the concept of EMA to the Trust Bank, as well as the economic benefits accrued by the company implementing CP. As a result, the bank's credit line for export-oriented SMEs promotes investments with an environmental management component. In the Philippines, EMA is a key instrument in promoting the CP concept among the business community. The CPCs in Hungary and the Slovak Republic are active participants in the global UN-led dialogue to advance EMA. The recent UN-DESA publication 'Environmental Management Accounting Procedures and Principles' was introduced to the Directors of the UNEP/UNIDO NCPCs at their latest annual meeting in Seoul in November 2001.

**ROLE OF PUBLIC
POLICIES**

Transparent and effective governance is crucial in mobilising domestic resources and avert investment flight. Government commitment is equally essential in creating a market reality that will interest financial institutions in preventive approaches. Stable macroeconomic conditions and specific policy measures aimed at creating or fostering an effective institutional framework (e.g. removal of trade and investment barriers, tax concessions, loan guarantees, realistic pricing of utilities) together with an efficient enforcement system, are all conducive to sustainable investment patterns. In this sense, more institutional support to governments of less developed countries would be necessary to enable them develop an effective legislation, market based policies and instruments for sustained investments, particularly private ones.

**ASSET
MANAGERS'
PERSPECTIVE**

The Institute of Environmental Management and Business Administration at the European Business School (Johannes Schmidt) has carried out research on sustainability and shareholder value. The summary includes:

- The market for environmental and sustainable investment can be an important driver for the promotion of sustainable development.
- Transparency about criteria, methods and products is a basic precondition for the further development of the market, especially for the so-called best-in-class funds.
- By exploiting the potential for economisation in the gathering and processing of information, efficiency can be enhanced and transaction costs reduced.
- Among the 'top-five' environmental criteria for value drive from the sustainability analysts' point of view, three relate directly to cleaner production: 'reduction of resource input in processes', 'reduction of resource input in products' and 'minimising the probability of accidents'. The other two are: 'environmental standards' and 'risk management systems'.

**INNOVATIVE
FINANCING
SCHEMES**

Although regular commercial sources should be the main ways of financing new and retrofit CP investments, revolving funds, energy efficiency windows, loan guarantee schemes for SMEs and innovative schemes, have proven to be useful in jump-starting the process and introducing the concept to banks and industries, particularly in developing countries and economies in transition.

There are several examples of this. The revolving fund for CP investments for the Baltic States and North-West Russia by NEFCO is now well established and very successful. Similar donor-sponsored initiatives have emerged in various regions, for instance, the Asian Development Bank, KfW and the EBRD

operated schemes. Perhaps less known are initiatives driven by private sector banks. The Trust Bank in Zimbabwe has concluded an alliance with the new NCPC (SIRDC-ERSI) for bringing various industrial clients and the bank together to continue to promote CP financing. Under the UNEP/DTIE project, a CP Credit Programme has been proposed for consideration by several countries in Latin America. The scheme foresees that funds providers (e.g. international green funds), channel resources to a local commercial bank or financial institution (including microfinanciers) for the benefit of particularly small and medium-sized entrepreneurs. Local business providers (most notably the local Cleaner Production Centre) will be the key link between companies and fund providers, assisting the borrowers in performing investment analysis and preparing loan applications

Introducing CP into an enterprises often improves cash flow, but normally does not increase collateral. So, in some countries, promoting CP investment in SMEs would require loan guarantee schemes rather than revolving funds. Combinations of the two may need be considered. Such facilities may provide funds at rates which are slightly below the prevailing commercial ones in the same country. However, the approved investment projects should always meet strict commercial criteria and the fund be administered and channeled through professional financial institutions, preferably local. As the understanding of the economic merits of CP and efficient resource management spreads in the country and the demand for investment increases, such special credit facilities should gradually be accompanied by funding through the regular financial products available in the market.

NEW INVESTMENT AND SMEs

Retrofitting factories will not be sufficient in the long run. The greatest challenge will be influencing new investment, particularly among SMEs, to incorporate CP principles. New approaches must be developed to find and work with intervention points so that investors and designers can learn about CP methods and resources, and be rewarded for their efforts to incorporate CP.

Small and medium enterprises (*SMEs*) play a crucial role in the growth and industrialisation of most developing countries. SMEs that are actively pursuing CP have unusually strong and visionary management that pays attention to all aspects of production. These are good signals for future business performance and should be promoted to financial institutions. Local governments should introduce measures to favour SME investments into CP solutions.

Assuming that business providers of special CP services, such as investment appraisals and expert advice, will be set up in national investment coordination boards or work in cooperation with them, furthering CP should deal with the following issues and provide the following benefits:

1. Minimization of diseconomies of industrial production (e.g. by limiting the demand for public utility services, which are often subsidised).
2. Making sure that long term sustainability is considered also in terms of competitiveness and employment generation.
3. Providing a means of checking officially that investments do not take the form of environmental dumping.
4. Giving relevant investment bodies the authority and capacity to provide certification as the following:

- Certificates stating that planned new investments comply with the standards which may be required by foreign lenders and guarantors, thus increasing the accessibility of foreign financing for new investments or securing such financing at more competitive costs.
- Certificates for individual investments and global agreements with foreign export credit and export credit guarantee agencies to attract their participation.
- Certification of new investments to ensure that these get access to international markets, including such environmentally conscious markets as those related to green procurement etc.

Measures should also be encouraged both by government and industry to integrate CP in the supply chain decision for SMEs. Corporations could play an important role in this. In the same light, more effort should be put into building a group of public and private procurement professionals conversant with CP and eco-efficiency.

**CAPACITY
BUILDING – THE
WAY AHEAD**

Well functioning advisory services are needed to assist companies in preparing project proposals and loan applications, which can also be of great value to financiers in securing solid baselines, supervising project implementation and monitoring project results. CP Centres should focus on catalysing behavioural change in policy and investment decision makers.

The UNEP CP financing project generated a number of checklists and training packages (see ‘UNEP project outputs’ above). There is a clear demand to disseminate this material to countries and regions not covered by the four-year pilot project. In addition, core teams of trainers need to be trained to be able to deliver such knowledge, through business schools and other educational institutions, operating at the national level. UNEP/DTIE has prepared project concepts and started a dialogue on them with a number of potential partners to, i.a.:

- Translate the capacity building material into Chinese, French and Russian and train core groups of experts in those language areas;
- Identify national institutions to host training activities;
- Prepare of loan applications with business;
- Carry out extensive training programmes in selected countries in Asia, Africa, Eastern Europe and Latin America;
- Continue contributing to environmentally related training workshops for financial intermediaries organised by development finance institutions; and
- Integrate preventive principles in the training programmes of the UNEP Financing Initiatives.

- OUTCOMES**
- The session will provide feedback on the statements, conclusions and recommendations presented above.
 - The session will provide “next steps” recommendations for the involved stakeholders (private and public financial institutions, export credit agencies, ministries of economy and finance, chambers of industry and other representatives of the business community, CP service providers, academic and training institutions with curricula on financial analysis, business

planning, accounting or engineering, selected NGOs, as well as media).

- The session will identify concrete activities that participants commit to undertake in the following two years.