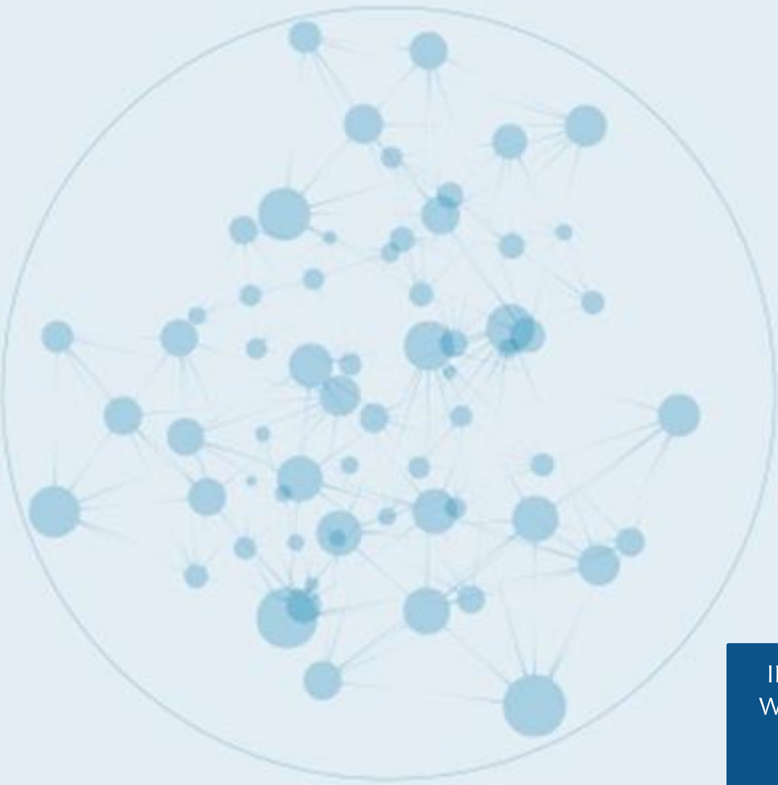
Inquiry: Design of a Sustainable Financial System

UNEP

SUSTAINABLE FINANCE?

A Critical Analysis of the Regulation, Policies, Strategies, Implementation and Reporting on Sustainability in International Finance



INQUIRY WORKING PAPER

16/03

February 2016

The UNEP Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance policy options to improve the financial system's effectiveness in mobilizing capital towards a green and inclusive economy—in other words, sustainable development. Established in January 2014, it published its final report, The Financial System We Need, in October 2015.

More information on the Inquiry is at: *www.unep.org/inquiry* or from: Ms. Mahenau Agha, Director of Outreach *mahenau.agha@unep.org*.

The Centre for International Governance Innovation (CIGI)

CIGI is an independent, non-partisan think tank on international governance. Led by experienced practitioners and distinguished academics, CIGI supports research, forms networks, advances policy debate and generates ideas for multilateral governance improvements. Conducting an active agenda of research, events and publications, CIGI's interdisciplinary work includes collaboration with policy, business and academic communities around the world.

For more information, please visit *www.cigionline.org.details*.

About this report

This working paper results from a workshop the UNEP Inquiry and CIGI held on 2-3 December 2014 in Waterloo, Canada to discuss options for a sustainable global financial system. The workshop included participants from a range of academic and research institutions from the Waterloo region and abroad, including the University of Waterloo, the University of London, Harvard University, and the University of Gothenburg.

Comments are welcome and should be sent to *simon.zadek@unep.org*.

Author(s): Thomas Clarke and Martijn Boersma, University of Technology Sydney, Australia, Centre for Corporate Governance

Copyright © United Nations Environment Programme, 2016

Disclaimer: The designations employed and the presentation of the material in this publication do not imply the expression of any opinion whatsoever on the part of the United Nations Environment Programme concerning the legal status of any country, territory, city or area or of its authorities, or concerning delimitation of its frontiers or boundaries. Moreover, the views expressed do not necessarily represent the decision or the stated policy of the United Nations Environment Programme, nor does citing of trade names or commercial processes constitute endorsement.

Contents

Introduction

The international banking sector increasingly adopts a sophisticated approach to sustainability policy: the question is the extent to which this impacts upon business models, strategies and practices. This paper will seek to assess how the international banking community is building sustainability into corporate strategies; how effectively these strategies are being implemented; how sustainability is being embedded into key business processes and decisions; and how sustainability principles are reflected in reporting.

Theoretically and methodologically, the paper will address the interface between regulatory policy and corporate strategy in terms of impact upon financial institutions behaviour and practices: it applies and informs regulatory theory and policy by examining the effects of mandatory regulation and voluntary self-regulation. The paper focuses on the complex relationship between regulation, institutions and cultural change, and informs the issue of regulatory effectiveness. It presents an assessment of the sustainability performance of banks using a range of frequently used indicators, while also scrutinizing the indicators by examining the extent to which they effectively measure the performance and commitments of banks. While many banks achieve high scores on these indicators, there is evidence that there are significant flaws which are not adequately addressed.

It is argued that flaws that contributed to the global financial crisis – misaligned incentives, information asymmetry, financial innovation and levels of risk – also pose risks from a broader environmental, social and governance perspective. A schism exists between symbolic and substantive efforts towards sustainability, which is indicative of sustainability not being integrated in overarching business strategies. Furthermore, precautionary responsibilities require more attention, as current sustainability efforts are driven by economic and reputation incentives, and are often used to offset unsustainable activities.

The research concludes by arguing in favour of increased convergence of corporate social responsibility and corporate governance, which would embed sustainability into authoritative frameworks, make environmental, social and governance matters more enforceable, and firms increasingly accountable. Yet, these advantages will likely only manifest when self-regulation is reinforced by mandatory regulation in critical areas. The reality is that the finance sector, and the international banks that populate it, are systemically important to economies and societies, and while it is vital that self-regulation is maintained by financial institutions, a framework of mandatory regulation is required to ensure self-regulation is operational and effective, and responsibility is exercised.

1 Reconceiving the Responsibilities of Financial Institutions

The global financial crisis (GFC) and its aftermath consisted of compounding failures in financial markets, institutions, regulation and governance. The "animal spirits" unleashed in unfettered securities markets, massive incentivization of risk-taking and leverage, and the abandonment of effective governance and ethical commitments occurred in a regulatory vacuum. Governments were convinced that lightening the burden of regulation was the means to promote dynamic financial markets and business development. Realizing the consequences of unchecked systemic risks has prompted national governments and international agencies into a major series of regulatory reforms and interventions in financial markets and institutions, the effect of which remains to be discerned.[1]

Research considering the causes of the GFC often quotes a number of flaws: misaligned incentives, information asymmetry, financial innovation and levels of risk.[2,3] Some causes such as information asymmetry[4] and misaligned incentives[5] were catalysts of earlier financial crises. Other elements of the GFC were more specific, namely financial innovation and associated levels of risk.[6] During the GFC, risk exposure was much greater than banks anticipated. As such, it makes sense for banks to monitor risk more closely and reduce risk appetite. It must be appreciated that voluntary efforts in these areas, from the perspective of banks, decreases competitiveness. The question remains whether a trade-off between risk and profits is truly unavoidable and manageable.

Risk does not only concern financial activity and results, it also has impacts on society and the environment. Modernity has brought about the *risk society*, which is "a society increasingly preoccupied with the future (and also with safety), which generates the notion of risk."[7] In this sense, risk is defined as "a systematic way of dealing with hazards and insecurities induced and introduced by modernization itself".[8] If financial risk-taking can bring the global financial and economic system to the brink of collapse, it does not require a great deal of imagination to picture the devastating consequences of excessive social and environmental risk-taking. Civil society groups have argued for risk to be increasingly defined in a social and environmental sense, in addition to financial risk.[9]

This paper will distinguish between two kinds of business responsibilities vis-à-vis society. First, precautionary responsibilities, which entail avoiding negative impacts through business activities. This view corresponds with Immanuel Kant's teachings on morality, which dictate that a person is moral when acting in good will. Secondly, active responsibilities, when businesses undertake activities beneficial to society. This view correlates with the philosophy of John Stuart Mill, which states that the morality of an activity depends on the extent to which it contributes to happiness.

We accept as a projection of a sustainable financial system the working definition of the UNEP Inquiry into the Design of a Sustainable Financial System: "Sustainable development requires changes in the deployment and relative value of financial assets and their relationship to the creation, stewardship and productivity of real wealth. A sustainable financial system is, therefore, one that creates, values, and transacts financial assets, in ways that shape real wealth to serve the longterm needs of an inclusive, environmentally sustainable economy."[10]

The UNEP Inquiry core finding is that a "quiet revolution" towards sustainable finance is under way; this paper seeks to examine some of the dimensions of the policy and practical changes towards sustainability that are currently occurring in the largest financial institutions internationally.

2 Corporate Governance and Corporate Social Responsibility

Self-regulation by business is embodied in corporate governance and corporate social responsibility (CSR), two areas that are increasingly overlapping.[11] Corporate governance is the system through which companies are directed and controlled, aimed at ensuring that duties are exercised according to laws, regulation and codes of conduct.[12] CSR can be defined as the policies and practices included in business operations aimed at maximizing positive impacts on society, and which eliminate or minimize any negative consequences for the society or environment.

Narrow views on corporate governance emphasize legal and accounting compliance, with a focus on shareholder returns. Broader views of corporate governance include environmental, social and governance (ESG) issues, as well as responsibilities to wider stakeholders groups.[13] CSR transparency is more effectively achieved through improving the quality of corporate governance, rather than mandating specific disclosures.[14] It is here that corporate governance converges with CSR, and the legal and moral liability of managers and directors come together.[15]

For many observers, the main concern of responsible business is no longer how to mitigate negative externalities of business practices, but rather how to find ways in which businesses can anticipate and prevent negative impact in the first place. This precautionary turn means a significant step towards increased responsibility of firms, which goes beyond symbolic efforts and implies a major change to the overarching business model.[16]

Given their nature as financial intermediaries, responsible enterprise takes on a specific form for banks. The impact of banks is not only measured through direct operations in offices and branches, but also through investments, which can lead to involvement in unsustainable practices. As banks often provide the majority of external finance to companies, they can require firms to embrace sustainable business models. Bank lending potentially has more impact on sustainable business practices compared to the stock market.[17]

3 Methodological Approach

The present analysis builds on earlier research on banking sustainability. Jeucken developed a way to rate the sustainability performance of banks by looking at indicators such as sustainable banking products, services and environmental risk management.[18]

Scholtens enhanced this framework by adding indicators and categorizing them into four groups: (1) codes of ethics, sustainability reporting and environmental management systems; (2) environmental management; (3) responsible financial products; and (4) social conduct.[19]

In their study of the governance of corporate sustainability, Klettner, Clarke and Boersma explore how corporate governance processes and structures are used to develop, lead and implement corporate social responsibility strategies.[20] The study by Klettner *et al.* is supplementary to the research by Jeucken and Scholtens, as it looks at board and management approaches to sustainability.

For the purpose of this paper the approaches of these studies have been combined. Updating and combining the groups of sustainability indicators offers an extensive methodology for the assessment of self-regulation and reporting of the world's largest banks. In the updated framework, 41 indicators in four different categories are examined**:** (1) Voluntary reporting, initiatives and principles; (2) Responsible finance; (3) Stakeholder engagement; and (4) Governance (see appendix B1).

4 Survey

Both Jeucken and Scholtens surveyed significant numbers of financial institutions, however these were largely European. This current survey for UNEP is more global in orientation surveying the largest banks (with the possibility later of surveying the insurance companies, investment companies and pension funds sustainability policies and practices). It intends to be international and comparative and includes the largest international banks by market capitalization and assets.

The largest 20 banks by market capitalization include banks from the US (5), China (4), UK (2), Australia (3), Spain (1), Ireland (1), France (1), Canada (2), and Japan (1). This gives a useful comparison of Anglo American, European and Asian banks. The largest 20 banks by assets include banks from China (4), Japan (4), US (3), France (4), UK (3), Germany (1) and Spain (1) (see Appendices A1 and A2). While these are the largest financial institutions measured by market capitalization or assets under management, they may well not be all among the most advanced institutions in their policy development and commitments around sustainability.

While some will become more sophisticated in their policies (for example BlackRock, the world's largest institutional investor with $4.6 trillion of assets under management as of 31 December 2015, has been acquiring significant expertise in this field in recent years) other major international financial institutions, particularly those located in the developing world may prove at a more rudimentary stage. However assessing the rate of shifting of the international financial institutions towards corporate responsibility and sustainability will be a useful task.

Because the framework adopted is binary (1 = yes, 0 = no) there is no nuance in assessing the banks. For example, having an ambitious environmental policy or setting an impressive reduction target is rated the same as having an environmental policy that is unambitious and has unimpressive targets. These matters demand a qualitative examination of banks' specific policies and practices. This survey conducts a quantitative analysis of the extensive range of indicators included in the assessment, but will also reinforce this with a qualitative assessment of the processes of leadership and implementation of sustainability policy and practice.

预览已结束，完整报告链接和二维码如下：
https://www.yunbaogao.cn/report/index/report?reportId=5_15948