CHAPTER 6

UNEP Perspectives

Paul Clements-Hunt[*]

1 Introduction

This chapter describes how, since the mid-1980s, a slow-burning, push-and-pull dynamic between public policy and public sentiment regarding environment and sustainability is succeeding in changing the basis upon which our capital markets and financial institutions view the financial materiality of environmental, social and governance (ESG) issues. It shows that the manner in which the financial services sector and the broader investment chain integrate natural and social value at risk into their risk considerations is changing, albeit slowly, across the mainstream. In time, these changes mean that the risks and market opportunities associated with, amongst others, climate change, resource depletion, the destruction of ecosystems, social challenges and human rights issues, may be more fully integrated into financial, investment and capital market considerations.

The "maybe" is an important element. After several years of intense activity concerning ESG issues across different facets of the financial services sector, the financial crisis of 2007–2009 has created a fork in the road. The destruction of value, cost cutting and job losses across the financial services sector may prompt a demotion of ESG issues to a marginal add-on, as the thinkers within sustainability and business units are squeezed into a short term "results, results, results" focus. Alternatively, the sector has the opportunity to take the "road less travelled" and embed ESG considerations into their policy-making, their business practice and, critically, the culture of finance and investment, in a manner that delivers results which are aligned with shifting public policy and public sentiment. Notably, the "G" of ESG, given the systemic and institutional governance debacles of the financial and economic collapse, demands attention. Despite the "green-tech, clean-tech, low- carbon" thrust of the over USD 3 trillion global public stimulus packages, there is no guarantee that mainstream finance and investment will opt for this path ahead of the next asset bubble forming.

Finally, this chapter shows how the unfolding financial and economic crisis of 2007–2009 has posed some fundamental questions for the concepts of sustainable finance and responsible investment (SFRI). Given the near-breakdown of our fi-

[*] Head, UNEP Finance Initiative.

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nancial system in the final quarter of 2008 and the loss of some "too big to fail" institutions, the reality of SFRI, quite rightly, should come under intense forensic examination. To date, this examination has not been undertaken to a sufficient degree by the SFRI community.

2 The Friday Before Doomsday 2008

On 12 September, 2008, the Friday before Lehman Brothers collapsed and at least one money market fund "broke the buck" for the first time in 14 years, a group of financial executives, climate change campaigners and lawyers met in a HSBC meeting room 28 floors above Canary Wharf in the revamped heart of London's Old Docklands. Despite the gathering gloom associated with the unfolding financial meltdown that had been gaining pace since August 2007, the energy and focus on next steps for finance and investment in the climate change arena remained robust. The meeting at HSBC had been called to foster stronger links between the different facets of financial services on the road to the United Nation's annual climate change summits, held in Poznan, Poland, in December 2008, and then a year later in Copenhagen, Denmark.

At the heart of the discussions in Canary Wharf was the idea that climate change has the potential to bring devastating economic and financial losses while offering the prospect of new markets for financial services. In June 2007, a group of 23 CEOs of financial institutions brought together by UNEP Finance Initiative (FI) warned the Heads of State at the G8 meeting that "Unless action is taken now to set in motion a worldwide transition to a low carbon economy, some scenarios suggest that by 2040, the world could experience annual economic losses as high as USD 1 trillion; and grave social and environmental harm from climate-related disasters."[1]

Earlier in 2002, a landmark UNEP FI study predicted that economic losses from climate change and natural disasters would reach USD 150 billion a year by 2012. The figure was reached seven years early in 2005 and, once again, in 2008 the economic loss figure according to UNEP FI member company Munich Reinsurance Group has topped USD 200 billion, with insured losses rising to USD 45 billion. Announcing the 2008 figures, the Munich Re Group stated: "Driven by high losses from weather-related natural catastrophes, 2008 was – on the basis of figures adjusted for inflation – the third most expensive year on record … Climate change has already started and is very probably contributing to increasingly frequent weather extremes and ensuing natural catastrophes." The scale of the economic and financial risks associated with climate change, which are capable of impacting whole economies and global industries, cannot be ignored by forward-looking institutions that take their fiduciary responsibility seriously and seek to

[1] Extract from the "Declaration on Climate Change by the Financial Services Sector", 5 June, 2007, UNEP FI Statement for the G8 Heads of State meeting in Germany.

grow and protect their clients' assets over the long-term. The participants at the 12 September meeting in London clearly recognized this fact.

How have we come to the point where the CEOs of the world's largest financial institutions are warning policymakers, in clear economic and financial terms, of the coming environmentally- triggered threat to our communities, ecosystems, markets and institutions? Is this merely a blip driven by the spotlight focused on climate change in recent years or is there something deeper?

To understand these changes we have to cast our attention back to 1987 and remember the hope and optimism that came with the vision in the report "Our Common Future" presented by the Brundtland Commission. That report, which captured the work of the United Nations World Commission on Environment and Development, set in place the political context that has enabled environment and development to be discussed as one issue. This global discussion over the past twenty years, while complex and at times glacial and often infuriating, has yielded a way of thinking and a set of disciplines that are now infecting markets like a virus. The most forward-thinking segments of mainstream finance and investment are responding. The end result of this way of thinking fuses the ethical and ESG dimensions of business with the business case. It does this in a manner that can help bridge the gap between those who demand an ethical and ESG foundation to underpin all business activity with those who demand a business case based on financial materiality.

What do I mean? The Brundtland Commission emboldened governments to undertake the 1992 Rio Earth Summit, which itself delivered international agreements – frameworks in fact – dealing with climate change, biodiversity and desertification. The landmark gathering of world leaders in Brazil also yielded Agenda 21 and the Rio Declaration, and saw the creation of the UN Commission for Sustainable Development. In 2000, the Millennium Development Goals were unveiled by former UN Secretary General Kofi Annan and the UN Global Compact was established. In 2002, when the World Summit for Sustainable Development gathered in Johannesburg and in December 2007 – on the mystical isle of Bali – the global community finally seemed to jointly "get it" on global warming. The people and bodies involved in this 20-year process were, to say the very least, often a long way removed from the worlds of high finance and capital markets.

However, the community that has delivered the concept, mechanisms and tools to foster sustainable development has now captured both the attention and creative imagination of the finance and investment community. If one were to fast forward the tape from Brundtland in 1987 to today, one would trace a period when – quite rightly – the role and responsibilities of the markets and business have been forensically dissected as never before. That dissection continues anew today as amid the wreckage of the latest market implosion. Through a twenty two-year period of unimaginable political, social and economic change, the issues around the ethical, environmental, governance and social responsibilities of business have remained a constant, nagging and unresolved series of complex questions. The context set by "Our Common Future" and carried on through Rio de Janeiro, Johannesburg and

Bali drove a process that demanded new thinking from business and, more recently, has demanded new thinking from the mainstream finance and investment community.

The responses by the business and financial services community have yielded a myriad of initiatives and activities – at the global, national and sectoral levels – that have set the stage for a fundamental change in the way we do business, secure finance and make investments in the decades to come. Whether through the World Business Council for Sustainable Development (WBCSD) in the early 1990s, the emergence of UNEP Finance Initiative in 1992, the evolution of the United Nations Global Compact (UNGC) since 1999, or the Principles for Responsible Investment in 2006, the business community and, latterly, the financial services and investment community, have been encouraged to focus on the financial materiality of the questions raised by the Brundtland Commission. Greater granularity was added to these questions through subsequent international, regional and national agreements covering climate, biodiversity, water, waste and chemicals management, amongst other issues.

3 ESG and Risk as It Really Is

For our capital markets, for the financial services sector and for the businesses and companies they invest in, the ESG threats identified and classified over these 20 plus years of public policy debate, discussion and implementation need to be understood and, ideally, they need to be quantified as risks understandable to the full range of market actors. The ability to understand and quantify risks sets modern developed society apart from the past and, only now – in a faltering and imperfect manner – is this thinking to the planet itself and the systems and resources that underpin all human development. Ironically, the past two years have seen the markets' financial risk management rule book – built on the altars of efficient market theory, modern portfolio theory and sophisticated financial modelling – thrown out of the window.

Up until August 2007, it appeared that the global financial services sector had managed, finally, to tame the gene of risk as finance traditionally had seen it, through the evolution of complex financial models, the deployment of structured finance and the emergence of derivatives to spread risk more effectively across the system. The concepts of Value at Risk and financial materiality appeared to have anchored a system that enabled more adventurous financial engineering that freed up credit markets. Post crisis, the different actors in the financial services system – asset owners, asset managers, banks and insurers – will have to work hard to reconfigure their understanding of the best way to assess, manage, transfer and contain risk at both the institutional and financial system levels This will take place as the political, policy and regulatory disciplines that govern our financial and capital market systems and institutions are themselves fundamentally overhauled.

At the same time, and as the economic perils of climate change, resource depletion and ecosystems destruction become more apparent, there is an accelerating

need for our capital markets and financial institutions to understand how natural and social value at risk will impact their business within both short- and long-term horizons. This need and its implications for our economies give rise to a series of complex questions for the broader business community and, most notably, for the financial services sector. These questions are crucial for those parts of the system, such as the pensions and investment sector, which need to protect and grow assets over the long-term. The questions under consideration include:

- How do we value and price systems that support life and enable economic and social development?
- How do we place a future value and price on these planetary support systems?
- In effect, how do we value our options for a secure economic, social and environmental future?

These are questions of great complexity and, most certainly, our economists will at a global level play a role in addressing them. However, it is essential that our financial institutions, lead by the investment community, ask these questions and seek answers if they are to deepen their understanding of the impacts of natural and social value at risk. This is also crucial to enable financial institutions to identify early those new vibrant global markets and investment opportunities associated with sustainable development.

At a global level, what are these emerging risks to our planet and the economies and societies it supports? In October 2007, the United Nations Environment Programme released its fourth Global Environment Outlook report, known as GEO-4. Every four years this planetary assessment is updated as UNEP explores the state of the world. GEO-4 made for disturbing reading; it is worth highlighting a number of its key findings that are particularly relevant for the global investment community:

- First, environmental exposures now cause almost 25% of all diseases, including respiratory diseases, cancers and emerging animal-to-human disease transfers;
- Second, around the globe more than two million people die prematurely because of air pollution;
- Third, two billion people are likely to suffer absolute water scarcity by 2025;
- Fourth, only one in ten of the world's major rivers reaches the sea all year round;
- Fifth, all species, including animals and plants, are becoming extinct at rates 100 times faster than those derived from fossil records;
- Finally, fish stocks, a key protein source for several billion people, are in crisis. Some 30% of global fish stocks are classed as collapsed and 40% as over exploited.

In summary, the GEO-4 report warned that the world's current population of 6.75 billion people has reached a stage where "the amount of resources needed to sustain it exceeds what is available." Indeed, GEO-4 was a haunting wake up call for all of the earth's inhabitants, and it outlines clear dangers for future generations. Yet within this detailing of threats and risks there exists for the financial services sector the seeds of future opportunity. For each economic, social and environmental risk highlighted above there exists investment opportunities, potential innovative insurance products and bankable projects. The markets that will provide the most explosive commercial opportunities and the index-beating returns of coming decades are already emerging. The brightest and most forward-thinking investors are preparing to benefit from the markets, asset classes and investments that will define the 21st century. I would like to highlight a few of these new opportunities:

- First, global carbon markets stood at USD 126 billion[2] in 2008 and clean energy markets are expected to approach or surpass USD one trillion by 2020 given a supportive policy environment. Whatever questions of political uncertainty exist around the future of carbon markets post 2012, it is clear that the most forward-thinking business leaders understand that the future is carbon-constrained. These leaders are working to re-engineer their products and services to serve and profit from this new economic context. The world's largest investors are also looking at a whole new range of opportunities associated with the emergence of the "green, carbon-proofed" economy. In the seven months from September 2006 to March 2007, carbon funds jumped to USD 11.8 billion, an increase in value of approximately 50%, or USD 4.7 billion. Investment capital flowing into renewable energy jumped from USD 80 billion in 2005 to USD 100 billion in 2006 – and then to USD 148 billion in 2007.[3] Despite the severe economic downturn, the capital flowing into renewable energy in 2008 was close to the 2007 figure. In February 2008, a group of nearly 50 institutional investors, building on the work of the Investor Network on Climate Risk and managing over USD 1.75 trillion in assets, backed a climate change action plan, "… that will boost investments in energy efficiency and clean energy technologies and require tougher scrutiny of carbon-intensive investments that may pose long-term financial risks."

- Second, for the first time in 2006 more than 50% of humanity lived in cities. Many of these are mega cities in developing countries, where life for the poorest citizens – often for environmental reasons – is brutally hard. The markets for environmental utilities and new integrated approaches to old urban challenges – such as water supply, flood control, urban and in-

[2] "State and Trends of the Carbon Markets," World Bank, 2009.

[3] New Energy Finance/ UNEP, 2008.

dustrial wastewater, municipal solid waste management, emission and pollution control, mass rapid transit systems and clean energy – will be some of the most dynamic markets of coming decades. Innovative investment approaches and financial engineering around environmental utilities which align public needs and private capabilities will become an attractive asset class in its own right;

- Third, markets for biodiversity and ecosystems services will become, in time, buoyant areas of commercial and investment activity. The scale of the coming opportunities is captured by the fact that the value of carbon locked in the boreal forests of Canada alone at USD 3.7 trillion falls just short of the annual premiums collected in 2007 by the world's largest industry, namely insurance.

4 Changes in Finance and Investment – Real or Illusionary?

Digging deeper into how these developments at the international level have affected, over more than 20 years, the thinking and working of the capital markets and financial institutions, one is struck by the slow, smouldering and almost unobservable nature of the change. In short, twenty plus years of debate, policy discussions, imperfect policy innovation and an embedding of ESG disciplines in the working of the markets have seen finance and investment wake, not only to the risk management aspects of ESG integration, but more recently to the upside market opportunities that ESG has to offer. This is not to say that finance and investment have been transformed into a paragon of sustainability, but rather that the global financial services community is beginning to see the "value in the business case of values". A quick look at the key developments in various sub-sectors of financial services confirms this.

Whether the investment, banking, or insurance fields, the period 2003–2009 has witnessed a staggering range of new initiatives as institutions, individually and collectively, have focused on their role in SFRI.

5 Investment

In April 2006, the launch of the Principles for Responsible Investment (PRI), now backed by more than 500 institutions representing assets of USD 18 trillion, heralded a significant change for the world's largest institutional investors. This change has profound implications for the way capital markets work, for the financial service organizations that compete in those markets, and for the companies that raise capital on those markets. A month ahead of the July 2009 PRI annual meeting in Sydney, the gathering was already oversubscribed with a sound global representation – despite the travel restrictions and cost-cutting reality so many investment institutions face.

Despite the dynamic nature of the PRI and associated responsible investment initiatives, some observers allege that the work underway is little more than a public relations exercise, at a time when the public, clients and politicians have become increasingly sensitised to environmental issues, notably climate change, and also to scandals in the marketplace as a result of the high profile corporate debacles in the early years of this century. Those sceptical about the upsurge in ESG-focused activities within financial services and capital markets often question the real impact of voluntary initiatives such as UNEP FI, the UNGC and the PRI. Others see that forward-looking financial institutions are re-casting their policies and operations to finance the entrepreneurs, technologies and companies of the future, rather than being seen as institutions and investors associated with the grime of the industrial past. In effect, they are embedding a new ESG-supporting DNA, which plays a role in determining corporate identity, values and activity. Leading institutions are beginning to understand the public policy changes around ESG that have taken place over the past twenty years and the shift in public sentiment: they are adjusting to the dawning of a new reality that resonates at a deeper level than the credit crisis.

Importantly, the emergence of the PRI reflects a growing understanding and appetite amongst the world's largest institutional investors – pension funds, special government reserves and foundations – that a fuller integration of ESG in their investment policy-making and decisions can provide a more effective tool to manage new risks and builds a better understanding of new market opportunities. In time, dynamic implementation of the commitments created by the PRI has the power to align more effectively the entire investment chain with ESG thinking and values. The PRI came about, in part, because the timing in the marketplace was right. That is reconfirmed by the fact that just three years after the former UN Secretary General Kofi Annan launched the PRI at the New York Stock Exchange, nearly USD 18 trillion in assets now backs this voluntary set of principles. The sheer size and influence of the asset-owning institutions backing the PRI, in many cases the largest universal investors owning chunks of entire markets, is driving change within the asset management community: an increasing number of fund managers realize that their biggest clients want to work with money managers that understand ESG. In the marketplace there is growing evidence of how fund managers are reacting to serve this growing ESG demand from the institutional investment community.

6 Banking

Few of the world's leading global banks do not now understand the need to set in place policies and procedures that set out their position with respect to sustainable finance. The challenge of driving this thinking and approach through the core business lines of massive institutions, often with tens if not hundreds of thousands of employees, is a formidable one that will continue into the next decade. In many

instances, there remains significant internal resistance to change amongst banking business units, where the mantra of "results, results, results" has often undervalued or ignored ESG issues. What is changing rapidly amongst an influential group of the most senior banking executives, however, is the understanding that good ESG practice often helps deliver sustainable results for the institution. A notable example is governance: the early lessons of the sub-prime experience and the credit crisis are confirming the importance of honest risk assessment that takes into account a full range of risks, traditional and otherwise. At the same time, and as the "war for talent" intensifies, it is becoming apparent that valued professionals coming into the financial services labour market increasingly want to work for institutions where responsibility is part of the fabric of the organization, rather than just part of the public relations department. The crisis of 2008–9 has intensified this sentiment as markets pick up and financial institutions start to hire the next crop of bankers to serve the post-crisis markets. A combination of this evolving top-down philosophy of the most senior management and the bottom-up desire from bank staff to work for organisations that understand both value and values will drive and accelerate change within the largest of the institutions.

Ranging from climate change, water and ecosystems services to human rights issues, as well as the responsibility of financial service organisations in regions of conflict, the sustainability and responsibility agendas for the banking sector have grown exponentially since 2003. At the same time, the basic tools for analysing, reporting and measuring the impact of the various policy and practice approaches have evolved. For example, the Global Reporting Initiative (GRI) initiated a process during 2004–6 that saw a group of major banks, cooperating with insurers, asset managers and a multi-stakeholder group, develop a financial services sector reporting protocol. The GRI Financial Services Sector Supplement was piloted by a group of banks during the 2006–7 sustainability and Corporate Social Responsibility reporting cycle, and it was then launched in October of that year. Critically, the GRI reporting protocol was based on the need to report indirect impacts of financial service organisation operations, thereby extending the reporting requirement to the impact of the institutions' products and services

Taking examples from two contrasting areas of activity, project finance and private banking, gives a sense of how very different arms of banking are striving to understand complex issues and build them into their operations, products and services.

For banks involved in project finance, the emergence in 2003 of the Equator Principles, based on International Finance Corporation (IFC) guidelines, has been a revelation. By June 2009, nearly 70 banks and financial institutions representing more than 85% of global project finance volume had signed the ten principles that cover environmental and social issues related to projects with a total capital cost above USD 10 million. The original principles were revised and strengthened in 2006. A 2007 memo from the law firm LeBoeuf, Lamb and Greene & MacRae, co-authored by international environmental law expert, Paul Q. Watchman, states: "Though the EP are non-binding, they have become an extremely important factor

in the project finance market. There are no sanctions for breach of the EP but given their prevalence, the importance attached to compliance with the EP by leading bankers and the ever-increasing scrutiny of projects by civil society, it can be said that there is strong pressure to adopt the EP."

Separately, the private banking community that serves the rich and super rich, as well as institutional clients, are waking to the growing demand for responsible investment products from their clients. By 2012, the expectation is that global assets of High Net Worth Individuals (HNWI) will reach close to USD 60 trillion. By the end of 2008, some 10 million people worldwide were considered to have high net worth, with the average wealth of this category surpassing USD 4 million for the first time and total assets reaching USD 40.7 trillion. In 2007–8 the Middle East, Eastern Europe and Latin America advanced more rapidly than the other regions. Market analysis indicates that 32% of the HNWI community finds ESG investment concepts attractive, yet to date just 4–5% of HNWI assets integrate ESG factors in any way. Increasingly, innovative private banking institutions are seeing ESG-inclusive investment as a business opportunity and source of competitive advantage.

7 Insurance

The insurance industry is a strong lever for implementing sustainability due to its size, the extent of its reach into communities and the significant role it plays in the global economy. In 2007, the worldwide premium volume exceeded USD 4 trillion, making insurance the largest industry in the global economy, while its global assets under management stood at USD 19.9 trillion.

The insurance and reinsurance community were amongst the first financial service organisations to engage and explain the long-term economic risks posed by climate change. A group of the largest financial companies now agree that a USD 1 trillion loss in a given year by 2040 is a viable scenario. The Stern Report, commissioned by the UK Government, underpinned work undertaken in recent years by insurers and re-insurers highlighting the potentially catastrophic global economic costs of no or low climate action.

Apart from climate change, the insurance industry is now starting to explore the commercial viability of conceiving, developing and rolling out new products and services that address global sustainability issues. The industry is beginning to realize the macro potential of microinsurance – insurance for the poor – as both a prime business opportunity and a powerful tool for sustainable development. Products and services that address environmental impairment liability, aging populations and lifelong income, modern day health risks, and weather insurance for farmers are coming to the fore. Potential new markets include insurance for emerging man-made risks and the protection of natural resources, in particular, biodiversity, ecosystems and water. The insurance industry is also awakening to the fact that acting sustainably, as in the cases of internal resource efficiency and the recycling of damaged assets, save money and are concrete ways of leading by

example. Beyond their raison d'être of managing and carrying risks, insurers are major institutional investors and increasingly recognise that responsible investment is a critical component of the overall sustainable insurance agenda. A group of insurers convened by UNEP FI is developing the Principles for Sustainable Insurance (PSI) for the global industry. This effort will provide a responsibility framework that mirrors the PRI conceived for the investment community. As part of UNEP FI's efforts to support the evolution of PSI, a global survey of insurers and re-insurers has been undertaken during late 2008–9. The survey obtained more than 250 respondents across the insurance value chain and other stakeholders from over 50 countries representing the regions Africa, Asia-Pacific, Europe, Latin America and the Caribbean, and North America. The results of the survey and a comprehensive analytical report were released at UNEP FI's 2009 Global Roundtable, "Financing change, Changing finance" that took place in Cape Town, South Africa from 22–23 October 2009.

8 The United Nations Promoting ESG

During this time, different arms of the United Nations were actively pushing the ESG agenda amongst the global finance and investment communities in order to prompt sustainability and ESG-focused initiatives at the sectoral and institutional levels. Uniting these efforts was the underlying question: how do financial institutions, investors and the capital markets deal with ESG issues? These activities gave real momentum to the emergence of the PRI. Within weeks of the publication of the first UNGC and UNEP FI reports focused on responsible investment in June 2004, the UN launched an initiative to create a responsible investment framework for pension funds and other large institutional investors. In time, this framework would become the PRI. On 16 July 2004, The Financial Times reported: "The United Nations has launched a campaign with leading pension funds and other large asset managers to develop a set of guiding principles for responsible investing."[4] Three of the United Nation's key efforts in this area are outlined below.

9 The UNGC Who Cares Wins Series and Stock Exchange Engagement

The "Who Cares Wins" report series was a joint initiative of leading financial institutions invited by then UN Secretary-General Kofi Annan. The research process leading to the first Who Cares Wins report, which was initiated in late 2003, involved some of the investment world's most innovative thinkers in the field of responsible investment. The research, forged through a collaboration of leading

[4] Extra-Financial Concerns: "UN to develop responsible investing guideline", Financial Times, 16 July, 2008.

asset management companies, enhanced clarity on the respective roles of different actors in the financial market – from companies, regulators, stock exchanges and investors, to asset managers, brokers, analysts, accountants, financial advisers and consultants – and outlined recommendations on how ESG issues can be better integrated into financial analysis, asset management and securities brokerage. The UN Global Compact launched the first report, "Who Cares Wins – Connecting Financial Markets to a Changing World" at the UNGC Business Leaders Summit, which was held at the UN Headquarters in New York in June 2004. The report, endorsed by the CEOs of more than twenty leading firms in the financial industry, articulated the growing consensus, supported by an increasing body of evidence, that good management of ESG issues enhance company value. It provided a critical impetus to embed ESG issues in mainstream investment practices to achieve the long-term goals of stronger and more resilient financial markets and, accordingly, more sustainable societies. The report also provided one of the cornerstones that supported the process leading to the PRI. The meeting of the minds that generated the in-depth report underscored that collaborative action among stakeholders is imperative in order to realize significant progress. In June 2004, the UN Global Compact also established a bridge to an integral component of the capital markets – stock exchanges. The UN Global compact issued a statement, endorsed by ten of the world's stock exchanges, that these exchanges would explore collaborative initiatives to advance the tenets of good corporate citizenship and trust-building in society. This laid the foundation for the UN Global Compact's work with the World Federation of Exchanges, the international umbrella organisation comprising the world's leading markets. This has propelled an even broader engagement with public companies to which the unequivocal message of responsible investment is fundamental.

10 The UNEP FI Materiality Series

In late 2003, UNEP FI's Asset Management working group, at the time a group of 14 asset managers collectively representing USD 1.7 trillion in assets under management, asked whether the materiality of a range of ESG issues traditionally overlooked or undervalued by many investment approaches should be reconsidered. To move the exercise forward, the UNEP FI Asset Management working group invited a group of the world's leading investment research companies to explore the financial materiality of ESG issues in a range of business and industry sectors. At the heart of the exercise stood the challenge of understanding how different ESG issues in various sectors impacted the value of securities. The resulting studies yielded more than 1,000 pages of research contained in 11 analytical reports undertaken by 10 research companies. Participating institutions included Deutsche Bank, Dresdner Kleinwort Wasserstein, Goldman Sachs, HSBC and UBS. The research was synthesized into a 52-page UNEP FI summary report entitled "The Materiality of Social, Environmental and Governance Issues to Equity

Pricing". The report was published in June 2004. The robust conclusions of the "Mat 1" project, as it became known, UNEP FI launched a meeting of Europe's largest pension funds in Paris in June 2004, during which the results of the research were presented. The Paris meeting heard, for the first time, the suggestion that there should be a responsible investment framework for institutional investors that in time would be realized through the PRI. The success of UNEP FI's Mat I exercise persuaded the UNEP FI Asset Management working group to launch a second call to sell-side researchers to produce further ESG-inclusive research. The resulting "Mat II" study broadened the work on financial materiality to look at additional sectors and methodologies. Institutions participating in the Mat II research included ABN AMRO, Deutsche Bank, Goldman Sachs, JPMorgan, Merrill Lynch, Morgan Stanley and UBS. The resulting summary report, entitled "Show Me The Money: Linking Environmental, Social and Governance Issues to Company Value", found a striking increased sophistication of the work undertaken by analysts compared with the original work. In short, the sell-side's ability to integrate and analyse ESG issues had improved a great deal in a very short time. The reports submitted for the Mat II process describe an emerging taxonomy of ESG risk categories. While not all the reports use the same language, many acknowledge similar factors. Additionally, there are issues that are uniquely important to certain industries or sectors. The findings of Mat II reconfirmed that company valuation is not complete unless it includes a consideration of ESG issues. Regarding the UNEP FI materiality series, the UNEP FI partnership will launch the "Mat III" report, which will explicitly examine the materiality of climate change issues across various business and industry sectors.

11 The UNEP FI Freshfields Report and Fiduciary II – The Legal Underpinning

In parallel to the work undertaken to conceive, frame and launch the PRI, a discussion was started in late 2004 between members of UNEP FI's Asset Management working group with one of the largest law firms in the world, Freshfields Bruckhaus Deringer. The asset managers wanted to understand the legal implications and realities of integrating ESG issues into investment processes within the major capital market jurisdictions worldwide. Paul Q. Watchman, at the time a partner of Freshfields and lead author of the legal interpretation that became known as the Freshfields Report, wrote: "Despite the evidence that ESG issues often have a material impact on the financial performance of investments, many institutional investors still insist that their legal duties prevent them from taking such issues into account. In short, institutional investors who hide behind profit maximisation and the limits supposedly placed by their legal duties do so at their own peril. There is no legal bar to the integration of ESG considerations into decision making (provided the focus is always on the beneficiaries)."

Clearly, much progress has been made since the publication of the original Freshfields Report, but more can and must be done. In July 2009, UNEP FI has launched a follow on to the original Freshfields report, with the working title "Fiduciary II". This report will serve as a sequel to the original report in both scope and spirit. The purpose of the report is to provide a roadmap for fiduciaries looking for concrete steps to operationalise their commitment to responsible investment.

Specifically, the report offers guidance on the following areas:

- Legal commentary on fiduciary duty and the implementation of ESG in investment mandates, including sample ESG language for investment management contracts to legally require asset managers to provide ESG integration services;
- Best practices being developed by investment consultants on ESG integration, including the assessment of asset managers' competencies in providing ESG-inclusive investment strategies and approaches;
- Practical developments on ESG integration, which provide insights into the extent to which institutional investors have adopted, and can adopt, longer-term and more sustainable investment approaches; and a review of legal developments on fiduciary duty and ESG issues since and including the Freshfields Report.

12 The Good News and the Bad News

Despite the intense SFRI activity since 2003 across the banking, investment and insurance sectors, where does the financial and investment community stand today? Clearly, the developments in SFRI must be set within the context: once again, capitalism has teetered on the brink through one of its episodic crises. A combination of experimentation in financial engineering, greed and misdeeds in our financial markets has endangered the real economy. From 2007 through 2009, the sub-prime credit crunch wiped trillions of dollars from the market; and this has been followed by a severe global economic downturn. The market's memory is indeed a short one. From the Mexican crises of 1995, through the Asian collapse in 1997, the 1998 demise of Long-term Capital Management that was linked to turbulence in Russian markets, followed by the dot com boom and bust and the governance meltdowns that plagued the markets at the turn of the century, we have become accustomed to these all-too-frequent shivers and shifts in the tectonic plates of the markets. Some would say that such volatility is simply part of the destructive creation that comes with our powerful and increasingly interlinked markets.

The nine months following the 12 September climate meeting at Canary Wharf saw hundreds of thousands of job cuts globally across the financial sector and intense pressure levied inside institutions to cut costs to the bone. There is no question that sustainability units within banks, insurers and asset management companies

have suffered losses; nascent teams carefully assembled during the boom years to service emerging environmental markets (climate, water, biodiversity, infrastructure, microfinance) have been emasculated.

In these crises, which atomise value and jeopardize the economic well-being of communities and families worldwide, ethical and governance issues are often unearthed as causes and drivers of value destruction. As public policy shifts to reflect deepening concern for our planetary challenges, resource constraints, and social tensions based on inequality and environmental threats, the liabilities associated with environmental and social factors will contribute increasingly to these intermittent processes of value destruction. Must the investment community, ranging from the world's largest institutional investors to the "mom and pop" retail savers seeking a reasonable return on their retirement investments,, accept the occasional ethical, environmental, social or governance landmine, as they invest in the future? In a worst case scenario, these create unimaginable systemic risk for the global financial system. The jury is still out as the financial system and markets seek to remake themselves, and as they are remade by policy-makers and regulators who understand now how close the system came to collapse after the doomsday of Monday, 15 September 2008.

Those involved in promoting SFRI thinking and approaches must also ensure a deep examination to understand how SFRI approaches can be deployed more effectively in years to come. Without an honest and urgent assessment of SFRI's contribution to date, the opportunity presented by the crisis of 2007–9 to accelerate and further embed an SFRI approach in mainstream finance and investment will be lost. This approach should include the integration of ESG issues into the entire investment chain. Broad guiding questions that should be asked include:

- At worst, is SFRI as practiced a public relations fig leaf for financial institutions that, in reality, threw honest risk management to the wind? Institutions that signed up to a range of SFRI-focused codes and disciplines were, over the past decade, driving and benefiting from new exotic markets; the outstanding notional value of over-the-counter (OTC) derivatives contracts approached the staggering figure of USD 600 trillion by the end of 2008.[5] Some 975 commercial banks, a significant number of these professing adherence to various sustainability and corporate social responsibility codes, were holding derivatives by 2008. Is a financial institution's adherence to SFRI incompatible with reckless excesses in the marketplace? What needs to change to see SFRI rolled out cohesively across institutions policies, practices and cultures?

- How have the world's seemingly most conservative institutional investors, which bear serious fiduciary duties that affect the well-being of future generations, faired in the aftermath of the financial crisis? These institutions,

[5] "Let Battle Commence," Financial Times, Wednesday, 20 May 2009.

whether pension funds, sovereign wealth funds, special government reserves or foundations, woke up in 2009 with a titanic credit crisis hangover after having asked very few pertinent governance questions – the "G" of ESG – about the financial institutions whose rising stocks they were investing in during the boom years. Many of these institutions had recently converted to the concept of respsonsible investment. How can SFRI ensure that the institutional investors ask the right questions —ahead of time – next time?

- Were SFRI disciplines and advocacy a simple "nice to have" add-on during the boom years, while the main business units of many financial institutions conceived, developed and rolled out products suited to the Goldilocks economy? Such financial products were in reality built on global imbalances and a tidal wave of cheap money and easy credit that duped regulators and swamped western consumers. How can SFRI be integrated in a pervasive, holistic way in financial institutions?

Developments at the international level over the past twenty years have changed – in ways not yet fully apparent – the political and economic context to the way that our societies, ecosystems, markets and finance interact. The finance and investment community has reached a fundamental fork in the road; the path littered with ethical and environmental, social and governance (ESG) landmines does not have to be followed. The finance and investment community – by better understanding the ethical and ESG dimensions of the market while, importantly, appreciating the need to build the investment business case around the ideas, entrepreneurs, technologies and companies that will define the future – can play a leading role in determining a positive, inclusive future development path.

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