ISIS

A Benchmarking Study:

Environmental Credit Risk Factors in the Pan-European Banking Sector

September 2002

BARCLAYS

The Royal Bank of Scotland Group

CREDIT SUISSE GROUP

SOCIETE GENERALE

HSBC

Standard Chartered

ING

Santander Central Hispano

Lloyds TSB

UniCredito Italiano

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- **ISIS Asset Management: Engagement with the Banking Sector**
  ISIS is a leading European investment manager with €100 billion under management. It manages its equity portfolio according to the Responsible Engagement Overlay (*reo*®) approach. With *reo*®, ISIS engages in dialogue with the companies in which it invests in order to assess how they manage social, environmental and ethical risk factors.

  This study is designed to benchmark the credit risk assessment procedures of a sample of ten banks held in ISIS's Pan-European portfolios, insofar as they specifically address environmental risk factors. The purpose is to enable ISIS to evaluate the potential impact of such practices on profitability and ultimately shareholder value. Whilst the study focuses on environmental risk factors, ISIS recognises that credit risk assessment of banks' social impacts is an area that has received less attention in the past, and therefore benefits from less well-developed internal procedures. This is clearly an area that merits further study.

  All the banks selected for this study have their headquarters in Western Europe, i.e. France, Italy, the Netherlands, Spain, Switzerland and the United Kingdom. However, many of these banks have substantial overseas operations, and the study addresses credit risk assessment procedures in both their home countries and overseas locations. (See introduction for full list of participant banks).

- **Benchmarking ECRA**
  The leadership qualities of participants in the study are judged according to both their written policy on Environmental Credit Risk Assessment (hereinafter "ECRA") and the degree to which such policies have been operationalised.

  The banks' interest in ECRA is evidenced by their willingness to participate in this study and actively engage with both their shareholders and fellow banking colleagues on this issue. The study does reveal, however, that the approach and degree of experience regarding this question differ significantly across the sample.

  Based on the results of the investigation, the ten banks can be grouped into three categories, according to the level of experience they have exhibited and the thoroughness and sophistication of their procedures. These have been labelled as follows:

- **"On the Starting Grid"**
  Santander Central Hispano, Société Générale and UniCredito Italiano

  In this group, the three banks have recognised the relevance of ECRA and begun to review their options, but have yet to articulate a full set of policies, much less implement detailed operational procedures.

- **"The Chasing Pack"**
  HSBC, ING Group, Royal Bank of Scotland and Standard Chartered

  These institutions have engaged in a serious review of ECRA, have established internal policies and apply operating procedures in selected product categories in their home countries.

- **"The Race Leaders"**

  Barclays, Credit Suisse Group and Lloyds TSB

  These banks are the most advanced, having begun to experiment with ECRA policies and operational questions in the early 1990s. They can point to relatively mature and detailed review procedures, training systems and communications.

It is noteworthy that there is no clear leader among the participating banks. Moreover, although the range of practices covers a remarkably wide spectrum, there appears to be still much room for improvement, by the admission of even the most experienced participants. This was particularly noted in relation to their plans for harmonising practices on an international scale.

Overview of Key Findings

- **Does ECRA impact shareholder value and operating performance?**
  All ten banks in the study have embraced ECRA and believe that environmental risks can directly impact bank profitability. ECRA is therefore seen as a traditional question of risk versus financial return. A primary motive for ECRA, recognised by nearly every participant bank, is its role in reducing liability (bad debt and security) exposure. Banks cite multiple instances where the absence of, or past failures in, ECRA have resulted in financial loss, due either to loan repayment difficulties, or worse, to the unexpected cost of repossessing contaminated property charged as security. Indeed, in such instances, the value of the loss is independent of, but can extend well beyond, the monetary value of the underlying loan facility. Losses of this kind have reportedly influenced past operating results and, by implication, shareholder value.

- **How does ECRA affect pricing and other terms?**
  While respondents believe that environmental risk can theoretically influence loan pricing, they have no definitive means of either measuring its impact on pricing or other contract terms. This reflects the difficulty of distinguishing the influence of environmental risk from that of financial risk. In practice, most lenders stop short of assigning a value or margin to environmental risk and rely on "experience as the best guide".

- **Does ECRA enhance the top line?**
  Some banks believe that ECRA can help grow revenues, thanks to improved customer satisfaction, loyalty and market share. In addition, six of the ten sample banks offer specialist "green" or "environmental" credit products, which are marketed on their environmental credentials. These form a minor part of overall portfolios, suggesting that their contribution to income is modest and raising questions about their future commercial viability.

- **Where is there room for improvement?**
  Most, if not all, banks in the sample could benefit from improvements in the areas of performance measurement, training, reporting and stakeholder engagement. In the case of performance indicators, which are the subject of active debate, the dearth of clear numerical measures make ECRA management, objective-setting and reporting very difficult. This is especially problematic in cases where banks find themselves the target of challenges from external stakeholders, such as environmental activist groups, who accuse them of financing environmentally controversial clients or projects. Such scrutiny has caused banks to become increasingly sensitive to "reputation risk," a factor less connected to default or cash flow concerns than it is to other, more top-line sensitive factors. Reputation risk can harm brand value, employee morale, ability to recruit and in some cases, ability to write business – especially in the retail market where boycotts have occasionally erupted over particularly high-profile client relationships[1].

  In such cases, stakeholders, including a growing number of shareholders, can be expected to seek assurances regarding exposure levels and risk management practices. Yet internal tracking mechanisms are often found wanting and policies and practices are, in many cases, not clearly articulated. This is often a consequence of a bank's concern over potential competitive implications, which precludes internal working papers addressing policies and practices from being publicly disseminated. Furthermore, banks cite client confidentiality as an additional barrier to fully disclosed practices.

The Way Forward

- **Will European regulation play a role?**
  If implemented in its current form, the New Basel Capital Accord (2001) will force banks across Europe to disclose and assess their processes for managing operational risk (including environmental risk), and the capital that should be set aside to cover this risk. This level of assessment will however, only apply to those banks undertaking the advanced credit risk assessment process – a means for them to achieve lower capital adequacy requirements. Due to take effect towards the end of 2006 the Accord is currently in the process of bank consultation. The banks in this study have followed the evolution of the Accord, but are generally sceptical of the feasibility of its overall aspiration to quantify environmental issues in the valuation of charged property. This is an issue on which further debate will surely take place.

1 Note the Morgan Stanley Dean Witter and Citigroup consumer boycotts that developed over these banks' association with funding the China Development Bank, financing arm of the Three Gorges Dam.

- **What are the expectations of shareholders?**
While all banks can agree that ECRA impacts the bottom line, none can say categorically that share prices will reflect ECRA practices, much as any single risk factor rarely determines stock price valuations. Nevertheless, ECRA practices have the potential to materially impact the bottom line, and there is a clear presumption that, all other things being equal (which they of course never are), bottom line performance affects share prices.

  Moreover, under the influence of pension fund disclosure legislation[2] and rising public awareness of environmental and broader sustainability issues, shareholders are increasingly focusing on aspects of environmental risk that might potentially affect business results. Although this study goes a long way to clarifying both the risk factors and management challenges that banks must confront, it is fair to expect that banks will increasingly come under the microscope for their association with environmentally controversial clients and projects. Their ability to provide the necessary assurances to their shareholders, to document their exposure and management practices, and to engage pro-actively with a range of stakeholders, will surely reflect positively on them, and benefit themselves and their investors alike.

The Shareholder's Perspective

Why did ISIS Asset Management commission this study?

- Specific incidents of concern have focused public attention on the issue.
- Whereas in the past environmental issues have mainly been a focus for industrial companies, increasingly the financial sector's responsibility in funding environmentally-sensitive projects has been called into question.
- Although there is growing consensus that environmental issues can negatively impact a bank's reputation, ISIS was also keen to understand the underlying factors that can impact financial performance.

Were the results of the study unexpected and if so, why?

- Yes and No. Several banks that are generally recognised to have strong overall management and control systems also did relatively well in the study. However there were some unexpected results, including banks with traditionally robust risk management practices that were found to have weaker ECRA policies than their overall policies would suggest.
- The study recognises that some banks face greater challenges than others when trying to apply ECRA across all of their products and locations. There is a non-level playing field, which, on the one hand, implies that banks faced with lesser challenges would outshine their peers, but on the other hand, also implies that banks faced with the riskier portfolios would be more motivated to actively manage them. The mixed outcome reflects these competing drivers.

How will ISIS use the results of the study?

- The study will be integrated into ISIS' overall investment analysis to enhance the effectiveness of its analytical process.
- The analysis will enable fund managers to achieve a deeper awareness and understanding of each bank's risk management controls and systems and the quality of its management team.
- Successful ECRA is recognised as a key element of bad debt avoidance. Bad debt can make or break a bank's profitability throughout the economic cycle and therefore, any moves a bank takes to pro-actively address the issue can only be interpreted as beneficial for shareholder value.

2 Disclosure legislation requiring a statement as to whether pension funds take account of social, environmental and ethical concerns in the retention and selection of shares and voting are in effect in the UK, Germany, Australia, Canada and elsewhere.

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What does ISIS consider to be the “next steps”?

- This study forms part of ISIS’ ongoing engagement programme (*reo*®) focusing on environmental management and reporting.
- ISIS will use this study as a platform to address ECRA with other non-participant banks in its portfolios.
- In benchmarking the way banks address so-called “non-financial” risks and integrating this analysis into its standard analytical process, this study opens the way for further study beyond the relatively narrow range of environmental issues that were addressed here. ISIS expects to focus on certain areas related to social and human rights factors, as shareholders, customers and borrowers increasingly become aware of the implications of sustainable finance.
- In order to remain focused and produce usable results, this study deliberately covered a limited “slice” of the financial services sector. The next obvious step consists of broadening the lessons learned to the wider financial sector i.e. investment banking, insurance.

Introduction

- **ISIS Asset Management and Engagement**
  ISIS Asset Management is a leading European specialist investment manager with €100 billion of assets under management. It manages its entire equity portfolio according to the Responsible Engagement Overlay (*reo*®) approach. Under *reo*®, ISIS engages with companies drawn from its equity portfolio, with a view to assessing risk management practices related to social, environmental or governance factors, and, where appropriate, to encourage adoption of better practices where this can favour shareholders.

  ISIS is currently interested in understanding how the banks held in its Pan-European portfolios address the potential risks associated with environmental factors. Initial exploratory discussions between ISIS and several of its holdings led to the conclusion that an in-depth academic study to benchmark the practices of a representative sample of major Pan-European banks would be the appropriate means for collecting disparate information and forming a thorough understanding of good practice.

  The result is **A Benchmarking Study: Environmental Credit Risk Factors in the Pan-European Banking Sector** conducted by Dr Andrea Coulson from the University of Strathclyde, and ISIS Asset Management, between August 2001 and Summer 2002, with ten banks drawn from the European portfolios of ISIS.

- **Objectives of study**
  The primary objective of the study is to engage in discussions with banks in which ISIS holds shares and gain a detailed understanding of the role of environmental factors in the banks' credit risk assessment processes. The study aims to enhance the ISIS analytical process and improve the quality of its financial assessments.

  In addition to aiding ISIS's understanding of environmental credit risk management, it is hoped that the study will allow participating banks to benchmark themselves against their peers and identify areas of strength as well as possible improvements.

- **Scope of study**
  The study focuses on benchmarking the role of environmental factors in credit risk assessment in a representative selection of European banks held in ISIS/client portfolios. Ten banks participated in the study:

Barclays	**Royal Bank of Scotland**
Credit Suisse Group	**Santander Central Hispano**
HSBC	**Société Générale**
ING Group	**Standard Chartered**
Lloyds TSB	**UniCredito Italiano**

Bank selection was based on considerations of the representative weight within the banking sector, geographic balance, the relative size of ISIS shareholdings, and the willingness of participant banks. Of the eleven banks invited to participate, only one (Deutsche Bank) declined, citing commercial confidentiality.

The study has been designed to consider the existing credit risk assessment processes of participating banks insofar as they address environmental factors. The study took the form of a benchmarking exercise to the extent that it:

- Considers the potential influence of key industry trend-setters and related parties, and environmental/socio-economic conditions on environmental credit risk assessment
- Identifies the institutions perceived to be best-positioned to protect and enhance shareholder value, and those potentially vulnerable to problems arising from under-managed environmental risks
- Identifies "good practice" for the integration of environmental factors in credit risk assessment at a Pan-European level.

It is important to recognise that credit risk assessment processes vary considerably from bank to bank. This reflects their different product mix, geographic exposure, sector exposure, and to some degree, cultural antecedents. It is often procedural differences that contribute to a bank's competitive advantage and drive its desire to maintain the confidentiality of its processes. With this in mind, the final scope and method of study was defined in consultation with bank participants and the British Bankers' Association.

- **Methodology**

  The study took the form of individual bank case studies involving open-ended, face-to-face/telephone discussions with key bank personnel and, where available, review of bank documentation. Prior to the conducting of primary field study, background details were collected for each bank as a basis for comparison. A common set of key questions (copy included as Appendix I) was provided to each bank to guide case study and facilitate benchmarking. Interviews were conducted in English; however, for all bank meetings a member of the study team was fluent in the local language and able to facilitate translation and debate as necessary. All discussions were tape-recorded, with permission, to allow in-depth analysis and reflection. In some cases, banks provided copies of private and public documentation for scrutiny. Follow-up fact checking was conducted with all banks.

  To encourage the adoption of good practices by participant banks, ISIS Asset Management hosted a workshop to discuss study findings. The workshop also gave participant banks a chance to discuss some of the most challenging issues relating to ECRA, identified by the study. Highlights of these debates entitled “Workshop Feedback” as well as other “Outstanding Issues” have been included in text boxes throughout this document.

  Note on Confidentiality

  It is important to recognise that bank lenders often view their approach to credit risk as a key part of their competitive advantage, and as such, bank requests to maintain confidentiality on specific issues have been upheld. This study includes references to information that bank officials perceive to be sensitive. Permission has been given to include references noted.

SECTION 1: Environmental Credit Risk Assessment Policies

This study focuses on Environmental Credit Risk Assessment (referred to as "ECRA"). This is essentially the method adopted by banks to include environmental considerations within their lending processes. The first section explores Environmental Credit Risk Assessment (ECRA) Policy, Drivers, Historical Origins, Definitions, Scope and Organisational Structure.

1.1 How do Banks Approach Policy-Making?

Basic definitions
Bank policy tends to operate on two levels:

(i) *Overarching or Cross Functional* policies: these apply to all bank activities, including both internal housekeeping (i.e. "office ecology" or "direct operational impacts") and core products and services (i.e. "indirect" impacts). They are applicable across all of the bank's activities or functions, and may be publicly promoted by the bank as an example of its core values. e.g. an environmental policy.

(ii) *Functional policies:* primarily product-specific (e.g. personal lending, commercial lending), these are a second tier of policies that tailor the application of overarching policies to individual bank activities. These can include lending (or credit) policies, by providing details of assessment criteria for loan products and services.

As "functional" policies are closely related to practice, they are normally commercially sensitive and tend to remain confidential. Further tiers of policy may also exist to offer more detailed guidance on bank practice. In many cases, the boundaries between policy and guidance begin to blur.

Lenders typically outline how and why things are done according to an overall bank policy, then embed it within a practical guidance manual. However, this study suggests that the level of specificity of the policy statement varies from one institution to the next, making inter-bank comparisons of limited value unless the companion guidance materials are also considered.

Outstanding Issues

The communication conundrum: providing assurance while protecting commercial interests

This would suggest that for purposes of communicating to shareholders and other external stakeholders, while avoiding the disclosure of commercially sensitive procedural guidelines, banks would be well-advised to articulate a fairly detailed policy that stops short of offering practical operational information.

- **Organisational structure – an indicator of organisation commitment: Where does ECRA sit in the bank's overall policy framework?**
  Environmental credit risk assessment (ECRA) is part of the credit "function" of a bank. As such, it tends to lodge within the standard credit risk management architecture, yet it also straddles a specialist function: environmental management. How do the banks in this study manage this overlap? For the most part, policy detail is based on traditional credit principles prescriptions for evaluation of financial risk versus return.

Eight banks (Barclays, Credit Suisse Group, HSBC, ING, Lloyds TSB, Royal Bank of Scotland, Société Générale and Standard Chartered), out of the total ten participants in this study, had developed an ECRA clause or sub-policy that rested within their credit policy.

At **UniCredito Italiano,** ECRA remains governed by the bank's "environmental" policy. In this particular case, the bank has a clause in its environmental policy that commits it to include ECRA in lending decisions. However, as no reference is made to ECRA within the bank's lending policy, lending officers lack detailed direction on the priorities and methodology of ECRA. As a first step towards making an organizational commitment to environmental best practice, banks have tended to include such a clause in their environmental policies (they appear in a similar form to the statement of commitment to the United Nations Environment Programme Finance Initiative "UNEP FI" principles – see Appendix II). However, the more advanced participant banks, have embedded this policy commitment by inserting ECRA details in their lending policy.

Executives from **Santander Central Hispano** noted that their lending officers consider environmental risk factors according to sector and individual companies, and on an ad hoc basis in project finance. Such delegation of authority (i.e. reactive analysis versus practice management), to the lending officer, for decision-making occurs within all participant banks. The degree of discretion that a lender is delegated depends on their experience and thus relative position in the bank. At **Santander Central Hispano,** where no formal written ECRA policy or guidance procedures exist, if such bottom-up practice does occur, assessment relies on the expertise and judgement of the lending officer concerned and the risk committee that will ultimately approve the transaction.

- **Risk management: direct versus indirect environmental risk**
  Inherent in this study is the recognition that the environmental considerations of lenders are driven by a desire to manage risk. ECRA policies, like generic risk management policies, are concerned with minimizing both direct and indirect classes of risk. The majority of participant banks used the terms "direct" and "indirect" when defining the types of risks that banks are exposed to.

  Direct risks include those risks over which a bank may be held directly liable or responsible. In the case of environmental risk, this may include potential responsibility for the clean-up of contaminated land taken as security on a loan. There has also been concern expressed that liability for the environment may be extended to lenders who "knowingly permit" an act of pollution by borrowers. For example, the British Bankers' Association (BBA) pursued the clarification of the terms "knowingly permit" in the U.K. Environment Bill 1995. Clarification was pursued on the basis that *"lenders are not environmental experts and it is important that attempts to assess the quality of a borrower's management …should not make banks liable for the obligations of their borrowers" .* The BBA noted that an exception to this position was one where *"banks actually exercise effective control"* over a borrower's business. This situation, which is also termed "shadow directorship," confers on banks a level of risk that must be identified and either avoided, or properly managed and priced.

  In comparison to the shadow directorship mentioned above, a more common scenario is one where a bank takes possession of a going concern business that is also a polluting business. In this instance, categorised as an *indirect risk,* the bank is liable for any associated fines to the polluting business, up to the value of the loan extended. These indirect risks rest with the borrower, but nevertheless may impact its ability to repay loans to the lending bank or it may materially affect the value of the collateral. This would also fall within default risk. Banks acknowledge that any borrower penalty for non-compliance with environmental legislation, or subsequent loss of market position, is a risk to repayment.

- **Historical development of ECRA policy**
  The first written ECRA policies emerged during the early 1990s. However, a number of these original policies suffered implementation problems, and most policies have subsequently been extended or rewritten during the last few years. The most obvious operational basis for policy revision is a change in a bank's organizational structure, change in key personnel, and/or merger and acquisition activity.

  Other adjustments have included the extension of ECRA issues to explicitly include what has come to be called "reputation" risk. The risk to a bank's reputation from its association with a "dirty borrower" has recently gained greater prominence. As a result, an environmentally-aware company in need of a credit, may choose one bank over another depending on each bank's awareness of environmental credit risk. Lenders generally categorise risk to reputation as an "indirect" risk, or elevate it into a separate risk category.

2 See BBA (1995) The Environment Bill: Lender Liability. March, p. 2. BBA:London.

Reputation risk has become a key policy driver, and was cited by Barclays, Credit Suisse Group, Lloyds TSB, Royal Bank of Scotland, Santander Central Hispano, Société Générale and Standard Chartered as the justification for policy development and the expansion of the scope of ECRA.

When reviewing a bank's position on ECRA, it is essential to look at the original policy at the time of establishment, as well as review procedures, policy progression and revisions. In many banks, policy development is an on-going process involving annual refinements. Figure 1 illustrates the major ECRA policy developments in the ten participant banks in this study.

Figure 1. ECRA Policy development

Bank	BAR	CSG	HSBC	ING	LTSB	RBS	SAN	SOCG	STCH	UNI
Year adopted	1992	1992	1990s	1995	1993	1993	N/A[iv]	2001	1994	N/A[iv]
Year amended	1995/ 1997[i]	Progres-sive	2001[ii]	N/A	1996/ 2010	1994/ 2001[iii]	N/A	N/A	2000[v]	N/A

(i) Subject to ongoing review
(ii) Including reputation risk
(iii) Renewed ongoing commitment
(iv) Internal circulars only, no formal ECRA in lending policy to date/ see details of environmental policy in figure 3
(v) Including social considerations

1.2 Influences and Drivers of ECRA Policy Development

All of the banks participating in this study reported being aware of environmental credit risks. However, as evidenced by the details disclosed by all ten banks, the participants varied considerably in terms of policy development and implementation of ECRA. The following paragraphs consider the major drivers behind the origination and development of environmental credit risk assessment, which include Events, Geographic Influences, Regulation, External and Internal Networking and Broader Trends.

- **Events**
  In analysing the motives for conducting ECRA, we discovered that two types of "events" had stimulated institutions to take action. The first "event" or trigger was the experience of repossessing contaminated land held as security, and consequently suffering financial loss, sometimes well in excess of the value of the loan. The second trigger was the awareness of high-profile pollution incidents.

Contaminated Land

One of the first major influences on ECRA policy development was bank experience of financial loss in the late 1980s and early 1990s. The losses amounting in some cases to millions of Euros equivalent resulted primarily from clean-up costs relating to contaminated land taken as security. In addition, loan repayments to banks were delayed or lost when borrower's limited cash flows were spent paying fines and penalties for non-compliance with environmental legislation.

Lenders from six banks **(Barclays, Credit Suisse Group, ING, Royal Bank of Scotland, Standard Chartered and UniCredito Italiano)** quoted examples of financial loss. One specific example cited by participant **UniCredito Italiano,** involved the financing of a real estate developer by a U.S. syndicate of banks. The real estate developer filed for bankruptcy as a result of asbestos-related claims, and although the participant bank was not the lead syndicate manager, the whole syndicate suffered financial loss amounting to several million dollars. This raises the question of mutual reliance on the syndicate leader for due diligence, in so far as environmental risk factors may be material. Syndication issues are considered in more detail later on in this section.

> As far back as the 1980s, high-profile pollution incidents had a similar influence on policy development by virtue of banks being associated with "dirty" companies through their banking relationship.

Pollution "incidents" were recognised as posing a risk to corporate reputation. Interestingly, lessons were learned by many banks, even in cases where they themselves were not associated with these transactions. Two banks, **ING** and **Credit Suisse Group,** cited examples including the Exxon Valdez oil spill, and the Sandoz "Schweizerhalle" contamination of the Rhine, as raising awareness among ECRA policy makers. In addition, one bank noted its involvement in the high profile clean-up of Hong Kong harbour as a significant factor affecting its position on ECRA overseas.

Of particular note is that these incidents are also viewed as influencing the development of legislation and industry regulation affecting some of the banks' major borrowers, and raising general awareness of potential environmental impacts. For example as quoted by **ING,** in light of the Valdez oil spill, the U.S. introduced stricter shipping controls in and around ports, in an attempt to avoid future oil spills. As a result of the incident and ensuing legislation, lenders perceived that their borrowers in the petrochemical industry could no longer ignore environmental management issues. To the extent that environmental reputations vary geographically as a result of localised incidents, the nature and location of a bank's market clearly affect the extent to which incidents of this kind will ultimately impact its business.

- **Geographic influences**

  A bank's domestic market location in Europe was found to have a considerable influence on its position on ECRA. **ING** and **Credit Suisse Group** in particular, view domestic government policy on environmental management as positively contributing to both their own, and the environmental performance of their borrowers. These countries have tax incentives/penalties in place to encourage higher environmental standards, and their stakeholders were more environmentally aware. As a result, banks perceived that both their borrowers and shareholders expected them to conduct ECRA as good corporate citizens, rather than because it paid off. The question of profitability as a driver for ECRA was therefore not always evident.

  For other banks, local conditions have had a remarkably negating influence on the development of ECRA in domestic markets. For example, two banks felt that national government policy tolerated the sacrifice of the natural environment in favour of economic and social gain. Lack of regulation was one obvious gap which appeared to preclude the emergence of ECRA. Yet this also raises the question as to whether profitability and default rates are driven purely by regulatory factors, or whether poor environmental standards in themselves prove costly to borrowers and their lenders.

  Several banks also felt some resistance to a proactive environmental approach from local borrowers and other domestic banks and to this end, reported actively encouraging more government action on environmental protection.

  Some banks headquartered in the more industrialised, and apparently environmentally progressive, countries, nevertheless recognised that the political process often gives more weight to social imperatives than environmental ones, all the more so in developing economies. As a result, they tended to apply their ECRA policies more strenuously in their home market, where the regulatory and public support exists, than overseas, where they tended to "go local". In this context, the role of international networking, both within and between banks, is of special interest. (see later paragraph).

Workshop Feedback: International Operations

- **How far should home country standards extend overseas?**
- **How to operationalize?**
- **How to address local competition in a non-level playing field?**
- **What is the role of international networks?**

General consensus among participants indicated their wish to comply with international standards, rather than local legislation, in their overseas operations. In other words, they are keen to abide by the "highest common denominator". However, such an approach is hard to enact in practice as differing legislative environments obstruct consistent global standards and lead to a bank's global policies being implemented differently in each operating country. Possible solutions that were highlighted included a consistent and continuous approach to ECRA awareness-raising in international operations, ensuring that local lenders are equipped accordingly, and encouraging international managers to rotate regularly around international locations in order to share, encourage and integrate best practice.

In addition, the banks recognised that support from international governments, in the form of tax break "rewards", and from international companies, collaborating with financial institutions to encourage environmental best practice, also facilitated the development of ECRA in the international marketplace.

Interestingly however, all participant banks conducting ECRA claimed to be doing so according to international guidelines produced with reference to World Bank standards. As noted by Ganzi et. al. (1998) in Leverage for the Environment, "World Bank guidelines exercise indirect influence on commercial banking activity overseas. Although these guidelines are not mandated or imposed upon transactions not involving the World Bank, they have become a default standard of environmental assessment from which banks may model a minimal standard of their own"[4].

This raises questions concerning the gap between principles and practice, particularly where local competition may dictate a deviation from the global standards developed at head office. Such competition represents a further influence on the extent to which environmental management standards can be expected of indigenous businesses. One bank pointed out that the application of unrealistically high environmental criteria, in isolation of its competitors, the market and the regulators, would leave it "out of the game", denying it any opportunity to act as an agent for change. Incremental changes in local environmental awareness were instead more likely to prove constructive in promoting progress.

- **Regulation**

  Most participant banks recognised that European banking requirements were helping to harmonise European banking practice, including ECRA. One particular example cited was the Basel Committee's Consultative Document: *The New Basel Capital Accord (January 2001).* The Committee has proposed that banks disclose and assess their processes for managing operational risk (including environmental risk), and the capital that should be set aside to cover this risk. This level of assessment will however, only apply to those banks undertaking the advanced credit risk assessment process – a means for them to achieve lower capital adequacy requirements.

  It is noteworthy that the timetable for consultation and development of the Capital Accord has been extended by two years to 2004, with implementation by the end of 2006. Unfortunately, due to extensions in the consultation timetable, and scepticism over the feasibility of its overall aspiration to quantify environmental issues in the valuation of charged property, some lenders doubt its potential influence. One lender noted that this is *"not so much of an issue now…the issue has decreased in terms of current priorities"* **(Royal Bank of Scotland).**

4 Ganzi, J, Seymour, F. and S. Buffett (1998) Leverage for the Environment. International Financial Flows and the Environment Project. World Resource Institute. See Commercial Banking page 3.

- **External networking**

UNEP

The involvement of key bank personnel in industry forums, such as the UNEP Financial Institutions Initiative, provides lenders, at a minimum, with what one termed a risk "radar" **(Royal Bank of Scotland)**. Nine of the participant banks are UNEP signatories and a number were involved in the initial development of these UNEP guidelines, aimed at engaging financial institutions in dialogue on sustainable development, in 1992[5]. However, signatory status is not necessarily an indicator of well-developed ECRA best practice, but rather of a high-level commitment to develop a policy and systems.

Figure 2. UNEP Signatory Status and Policy Adoption

Bank	BAR	CSG	HSBC	ING	LTSB	RBS	SAN	SOCG	STCH	UNI
UNEP 1992	Y (1992)	Y (1992)	Y (1992)	N	Y (1992)	Y (1992)	Y (1990s)	Y (2001)	Y	Y (1998)
ECRA Policy	1992	1992	1990s	1995	1993	1993	N[i]	2001	1994	N[i]

(i) Internal circulars only, no formal ECRA policy to date

Banks in the "chasing pack" and those on the "starting grid" tended to value more highly the contribution of external networking in terms of helping them establish new ECRA priorities. For example, a number of lenders who are only just starting to consider ECRA have reviewed the ECRA model developed by UNEP in conjunction with the Swiss Bank Association (OBU).

EBRD

The development of ECRA policy at one of the banks on the "starting grid" (UniCredito Italiano), is based on the European Bank for Reconstruction and Development's (EBRD) environmental risk management manual. In addition, a subsidiary of this bank has set up a joint venture with the EBRD in order to undertake a joint review of ECRA.

Internal networking

Personal Experience: How a banker's outside directorship raised environmental awareness

One of the banks relayed an incident involving a Senior Director, who also held a board seat in another major industrial company. This company was the subject of a high-profile environmental pollution incident. The industrial company suffered huge adverse publicity and a downturn in public sentiment which all board directors, including Non-Executives witnessed, up front. As a result, the senior director determined that the Bank should not allow itself to fall victim to such reputational damage, even if only indirectly through its client relationships. This event triggered the development of the bank's ECRA policy.

Investment Banking Experience

Commercial lenders noted that they share experience of bank policy, and of ECRA, both within commercial banking activities, and also between commercial banking and other bank services such as investment banking.

International Experience

– Experience in one country can be used to develop preventive policies and systems throughout a bank's international network of operations. One case in point concerns the U.S. experience with contaminated land, which generated improvements in ECRA in other regions, as detailed in the following case study:

5 The "UNEP Statement by Financial Institutions on the Environment & Sustainable Development" is included as Appendix II

U.S. experience of lender liability

Some of the first environmental risk concerns publicised by bank lenders were in response to potential lender liability for environmental damage under the US Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) 1980, a remedial legislation requiring clean-up of contaminated sites. Under CERCLA, lenders could be held strictly liable for site clean-up as owner or operator of property taken as security. According to principles of strict liability, it is necessary to prove only a causal connection between a polluting act and the resultant environmental damage. Therefore, the absence of prior knowledge of, or direct responsibility for causing the pollution, is no defence against liability. This standard places a very heavy burden on banks to ensure that they have fully traced the historical land uses of any property taken as collateral. In effect, this legislation resulted in many banks refusing to lend to certain industries or regions.

As governments have debated the development of strict liability principles across Europe, U.S. lenders' experience of strict liability has undoubtedly led to preventive measures being implemented across participant bank groups. However, the debate in Europe has not, as of yet, resulted in the introduction of legislation comparable to that in effect in the U.S. In turn, European banks have not matched their U.S. peers in terms of addressing this issue within their ECRA.

– Sharing best practice: in the group of "leading" banks **(Barclays, Credit Suisse Group and Lloyds TSB)** and in some of the "chasing group" **(Royal Bank of Scotland and Standard Chartered),** key personnel with environmental responsibility have spent time reviewing ECRA priorities across their organisations. They have formed international teams of lending officers who share experience of best practice, and develop ECRA policy. For example, **Lloyds TSB,** discussed the translation of U.K. ECRA guidelines to fit the bank's Australasian market.

- **Broader influential issues**

Climate Change

During the last decade, climate change has become a subject of considerable debate. Despite a growing consensus regarding the threat of global warming, and an acknowledgement by an increasing number of industry players (e.g. insurance industry and the oil and gas sector) of its relevance, surprisingly only four out of ten participant banks recognised global warming as an issue worthy of consideration. These four banks – including the three in the "leading pack," and one other from the "chasing pack" **(Barclays, Credit Suisse Group, Lloyds TSB and Royal Bank of Scotland)** – specifically cited the importance of devoting management attention to the climate change agenda. In particular, they all noted that key bank personnel are working with industry forums on specific climate issues such as the United Nations work on the Clean Development Mechanism, and Financial Institutions Initiatives. **(Barclays, Credit Suisse Group and Lloyds TSB).**

Corporate Governance

Corporate governance is another issue that has gained considerable prominence over the last few years. Six of the ten participant banks recognised that customer and investor expectations mean that ECRA has also come to be regarded as an element of good corporate governance (highlighted by **Barclays, Credit Suisse Group, HSBC, Lloyds TSB, Royal Bank of Scotland and Standard Chartered).** As the focus of corporate governance shifts to the management of all material risk factors, including social and environmental, a bank's ability to adopt an integrated approach within its central risk control systems is increasingly valued.

Workshop Feedback: Climate Change

- **How relevant is Climate Change to the global banking sector?**
- **How should ECRA take account of it, if at all?**
- **How effective are the existing networks and institutions in getting member banks to develop and enact policy changes?**
- **What role should the sector play in the development of financial instruments aimed at facilitating the use of voluntary mechanisms to reduce emissions?**

Carbon emissions and the current levy on emissions, as well as the long-term environmental consequences of climate change, such as flood plains, were acknowledged as being the major factors impacting the banking sector. However, all participants admitted that Climate Change is a very broad topic that is not really being actively addressed by the banking sector at the moment, not least in ECRA. Although there is a current BBA working group on flood risk, very little else is currently being done at an industry level to address Climate Change issues.[6]

This general inactivity is being compounded by a lack of borrower sensitivity and a overriding feeling that the potential consequences of Climate Change are too far in the future for banks to take immediate action. In addition, several banks expressed the view that the contributors to, and victims of, climate change, are frequently not one and the same. Therefore it is impractical to fully capture the risks posed by carbon emitters in credit analysis.

One practical example of where the banking sector does face a direct risk from Climate Change is the question of making property loans in flood plain areas. Participants observed that mortgages are extended conditional on the existence of flood insurance. However, flood insurance policies are renewable on an annual basis and can be withdrawn to suit the insurers updated risk assessment. In as much as mortgages extend far longer than one year, banks are effectively left to shoulder the flood plain risk in a way that insurance companies are not.

1.3 Organisational Structure and Lines of Accountability for ECRA

In eight participant banks, i.e. all those with developed ECRA policies (**Barclays, Credit Suisse Group, HSBC, ING, Lloyds TSB, Royal Bank of Scotland, Société Générale and Standard Chartered),** responsibility for ECRA rests with the Executive Board of Directors. The executives concerned are responsible for risk management across the bank, and the implementation of an overarching risk management policy, of which ECRA policy is a part. In addition to ultimate board responsibility for ECRA, individuals heading credit risk teams are held accountable for the practical implementation of ECRA.

In these eight banks with ECRA policies, senior executives reporting directly to the board, currently conduct an annual review of ECRA policy and procedure. **Standard Chartered,** however, highlighted that such reviews of its procedures are carried out more regularly than reviews of its longer-standing policies. **Société Générale,** after starting the process in 2001, indicated that it is about to undertake such a review process as part of its overall risk management. Although the two other participant banks, **Santander Central Hispano** and **UniCredito Italiano,** do not have formal, developed ECRA policies, ultimate responsibility for ECRA similarly remains with their Executive Board, and according to **UniCredito Italiano,** "is one of its strategic priorities."

6 This stands in contrast to the recently issued London Principles of Sustainable Finance that state that: "Providing access to commercial finance for the developers of the new key technologies in energy, water, waste and other areas is perhaps the most vital role of the financial system. Reducing the environmental damage from existing technologies is important, but the transition to a sustainable economy will only come through innovation and the financing of clean technologies."
(www.forumforthefuture.org.uk)

Figure 3. ECRA Policy and Review

Bank	BAR	CSG	HSBC	ING	LTSB	RBS	SAN	SOCG	STCH	UNI
ECRA Policy (year adopted)	1992	1992	1990s	1995	1993	1993	N/A[iii]	2001	1994	N/A[iii]
Board responsibility	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Executive review	Risk	Risk	Risk	Risk	Risk	Risk Env[ii]	Risk	Risk	Risk	Risk
Env policy	Y	Y	Y	N	Y	Y	Y	Y	Y	Y
Year reviewed	P/a	P/a[i]	P/a	P/a	P/a	P/a	N/A	2002[iv]	P/a[v]	2001[vi]

(i) Detailed business unit reviews every 3 years
(ii) By both risk and environmental committees
(iii) Internal circulars only, no formal ECRA policy to date
(iv) Planned for 2002
(v) Significant reviews in 1998 and 2000
(vi) Only implemented in 2001, no details of review

1.4 The Scope of ECRA Policies

- **Geographic scope**
  In all ten participant banks, lending policy, including environmental credit risk assessment, is organization-wide, encompassing these banks' domestic and international lending operations.

Figure 4. Global ECRA Commitments

Bank	BAR	STCH	ING	RBS	SOCG	UNI	CSG	SAN	HSBC	LTSB
Global	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y

For practical reasons, domestic ECRA practices have been implemented ahead of their introduction in overseas markets, with one exception where one foreign subsidiary actually appears to be ahead of the rest of the bank. Whilst all banks with an ECRA policy aimed to achieve international coverage, the quality of the assessments varied with the stage and success of policy implementation. It is apparent that even in the "leading" banks, local implementation of ECRA in developing/under developed economies is still seen to face many challenges. This has implications for profiling a bank's ability to manage environmental risks: Do banks that predominantly do business in developing economies face the greatest potential risks, or is it that heightened awareness of environmental factors in developed markets has created a higher-risk environment?

- **Product coverage**
  Lending products considered in this study fall into three categories: personal, small and medium sized business (SMEs), and commercial/large corporate (including project finance). Investment banking, institutional asset management and brokerage services are outside the scope of the study.

  In all of the participant banks, ECRA is applied to retail and commercial lending products.

Figure 5. Products Including Environmental Assessment

Bank	BAR	CSG	HSBC	ING	LTSB	RBS	SAN	SOCG	STCH	UNI
Retail/SMEs	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Commercial	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Personal Banking	N (M)	Y (S&E)	N	Y (S)	N	Y	Y	N	N	Y

S = Savings Accounts; E = Equity Investments; M = Mortgage Services

In addition, five banks operate personal banking services that take environmental factors into account, e.g. savings accounts and equity investments, credit and debit cards and mutual funds. Although one further bank does not in general include environmental assessment in its personal banking operations, it does provide mortgage services that include a review of energy efficiency as part of the approvals procedure. ECRA policies do not apply to these products. These are covered by separate policies, and they are not analysed further in this study.

In all participant banks ECRA policies are applied across the entirety of the lending portfolios. This includes secured and unsecured loans, and recourse and non-recourse project finance. Given the breadth of environmental risk considerations, ECRA is generally considered from the start of the application process through to the lending decision and subsequent monitoring of the facility extended to a borrower.

- **Syndication**
  ECRA is applied to all syndicated loan transactions, irrespective of the existence of a third party guarantee underwriting debt repayment (for example, provided by an export-credit guarantee agency). This is due to the banks' desire to manage exposure to both repayment risks and reputation risk.

  The application of ECRA in syndicated transactions is widely viewed as a matter of credibility between syndicate members. One lender cited it as "part of assessing the integrity of the lead bank" (Royal Bank of Scotland). The "leading" banks stressed that as ECRA is conducted in most banks, it would be unlikely for a lead bank not to conduct an environmental assessment. If, however, the lead manager failed to conduct ECRA, or assessment procedures were found to be inadequate the credibility of the lead bank would be in doubt. In such circumstances, several banks indicated they would request that ECRA be included in the financial appraisal process. However, it was also noted that as the lead manager only invites partner banks into the underwriting syndicate once most of the appraisal work has been done, their ability to influence the lead was limited. The alternative course of action for syndicate members was for them to withdraw.

  Participant banks emphasised that ECRA conducted in a syndicate was likely to match 'best' practice among the syndicate membership. In fact, our review of ECRA revealed that the most advanced "leading pack" banks, were often the lead managers in a syndicate.

Workshop Feedback: ECRA Standards in Loan Syndicates

- **How effective is a syndicate member's ability to assess the ECRA standards of the lead bank?**
- **Should new safeguards be introduced?**
- **Can widespread recognition by peers of leading-edge ECRA policies translate into favoured position as syndicate lead?**

All participant banks highlighted the reputation of the lead bank as a key factor in determining their involvement in a syndicate. However, the ability to assess the ECRA standards of the lead tends to be hindered by the challenge of consistently "rating" lead banks across a vast range of highly varied deals. In most syndicate cases therefore, the banks rely more on the lead's general reputation than on its specific ECRA standards. Once a member of a syndicate, participants admitted that it is challenging for non-lead banks to impose additional conditions on loan appraisals, if they are dissatisfied with existing ECRA. In instances where ECRA has been conducted, it was cited as helping lead banks to "sell" the debt that they were underwriting, as an awareness of "green" issues was considered a "selling point".

The banks agreed that the borrower often has a significant impact on a syndicate, in terms of environmental assessment. In some cases, borrowers were cited as being the primary drivers of environmental awareness in a syndicate but in other cases borrowers demonstrated a complete lack of awareness of ECRA.

1.5 Why are ECRA Policies in Place?

Banks were asked to rank the key objectives underlying ECRA, ranging from minimising default risk, to complying with regulation, growing top line revenue, and protecting their corporate reputation. Answers reflected both strong agreement on the main driver (default risk), and remarkable divergences on the secondary motivations.

- **Direct bottom-line impact**

Default Avoidance

All ten banks **(Barclays, Credit Suisse Group, HSBC, ING, Lloyds TSB, Royal Bank of Scotland, Santander Central Hispano, Société Générale, Standard Chartered and UniCredito Italiano),** citing the fundamental principle of pricing debt as a function of risk to maximise return, recognised default risk minimisation as the key factor for establishing and implementing ECRA.

Figure 6. Key reasons why ECRA policies are in place
(ranked in order of importance: 1 being the most important)

Bank	BAR	CSG	HSBC	ING	LTSB	RBS	SAN	SOCG	STCH	UNI
Default risk minimisation	1	1	1	1	1	1	1	2	1	1
Reputation risk	2	2	3	3	3	4	2	1	1	3
Security value	3	3/4	2	2	2	3	3	–	2	2
Income generation	4	3/4	4	5	4	2	–	–	2	–
Regulation	–	5	5	4	–	5	4	3	–	–

Repayment Ability and Security Value

Banks manage default risk firstly by focusing on repayment ability, and secondly by mitigating risk to security. Repayment ability is predominantly determined according to a potential borrower's perceived business viability, at the centre of which is the issue of cash flow. Taking security (collateral) is considered more of an insurance policy (especially **Royal Bank of Scotland**). Consequently, there is generally more interest in a borrower's cash flow and ability to repay on time, than in the value of a borrower's assets.

ECRA as part of credit risk management is no different. A number of participant banks indicated that the protection of security, and thus asset value, has become a secondary issue for them. Previous ECRA experience has indicated that less contaminated land exists than originally anticipated when ECRA policies were written, and clean-up legislation based on strict liability principles has so far not been introduced. However, ECRA remains an important issue for two reasons. Firstly, the existence of contaminated property remains a risk to security (albeit a reduced one). Secondly, the existence of contaminated land indicates a lack of attention to environmental management. Banks are increasingly viewing this as a sign of poor overall management and thus a potential risk to business viability and repayment.

Reputation concerns

All banks recognised the strategic importance of managing risks to reputation. Lenders in six of the participant banks **(Barclays, Credit Suisse Group, HSBC Royal Bank of Scotland, Santander Central Hispano and Standard Chartered)** stressed however, that reputation risk was not exclusively a credit risk. Reputation risk in non-OECD countries and emerging markets was a particular point of discussion. One bank noted that pressure group activity in the U.S. and Europe had made companies more sensitive to reputation risk (i.e. persuaded them to manage risk). This had not historically been the case outside of these regions, however the reaction of banks to more recent pressure group activity in Asia, by Friends of the Earth, shall be considered later in section 4.

The relative importance of reputation was a subject of disagreement: whilst it was singled out by two banks as the main driver of ECRA **(Société Générale and Standard Chartered)**, others gave it less importance. This may reflect a belief that banks can only have limited influence over how major corporate borrowers manage risks to their reputation. Their reticence to apply pressure reflected a recognition that they operate in a competitive market in which many of their peers are seen to consider neither environmental nor reputation risk. One lender **(Barclays)** noted that: *"A way to determine how aware a borrower is of risk to their reputation is to question/assess what communications are in place to manage potential risk to reputation, including environmental management procedures."*

Best Practice: How to Approach Policy-Making?

- **ECRA policy sits within overall risk management, rather than communications or other non-core functions.**
- **Responsibility rests with Board of Directors.**
- **Policy and procedures are developed centrally, but a mechanism exists to learn from local experience and spread global best practice. Local differences are, however, reflected in practice.**
- **Active membership in global industry networks is one important means of learning best practice and influencing regulatory standards.**
- **Risk management policies take account of both direct and indirect (e.g. reputation) risk factors**
- **Product coverage is gradually being extended to include retail, small business as well as large corporate lending.**
- **ECRA is applied consistently regardless of whether products are recourse on non-recourse, secured or unsecured – although land contamination carries a disproportionately significant environmental risk.**

Observations:

- **The integrity of the ECRA procedures of the lead bank in cases of syndicated loans is a significant weak link.**
- **Default minimisation is the fundamental objective of ECRA**
- **Although cash flow is a much greater factor than security value in determining lending terms, the incidence of land contamination is seen as an important indicator of overall management quality, a factor that, in turn, determines repayment ability.**
- **The importance given to managing reputation risk varied, possibly reflecting variations in environmental awareness from one geographic area to another.**

SECTION 2: Policy Implementation and the Environmental Credit Risk Assessment Process

Section 1 reviewed ECRA policies. The following section considers the measures taken by participant banks to actually implement ECRA in their lending decisions.

2.1 Translation of ECRA Policy into Practical Guidelines

- **Implementation tools**
  This study revealed that the mere existence of an ECRA policy, regardless of when it was introduced, was no automatic sign of successful implementation. In the case of all banks, credit risk assessment is ultimately the responsibility of individual lending officers. These officers have the authority to lend up to specific lending limits, based on their lending experience and expertise. This system reflects the unique nature of lending decisions, and the practical need for lenders to consider the details of each case on its individual merits. In the absence of strict procedural controls, lending policies can, at best, be described as "guidance" policies with the implementation of ECRA often left to individual decisions.

  Nevertheless, in all banks, the implementation of ECRA policy is guided by a series of more or less detailed practical guidance "tools". Some examples of guidance tools include:

(1) Flowcharts: these outline the ECRA process; supported by a checklist of questions to be considered by the lending officer

(2) Borrower questionnaires: these list questions that the lender should pose to the borrower to identify the existence of environmental risks (this is often a prompt for the lender, and is not shown to the borrower)

(3) Risk matrices: these guide lending officers through ECRA. (Often used instead of a flowchart, but the guiding principle is the same in both cases.)

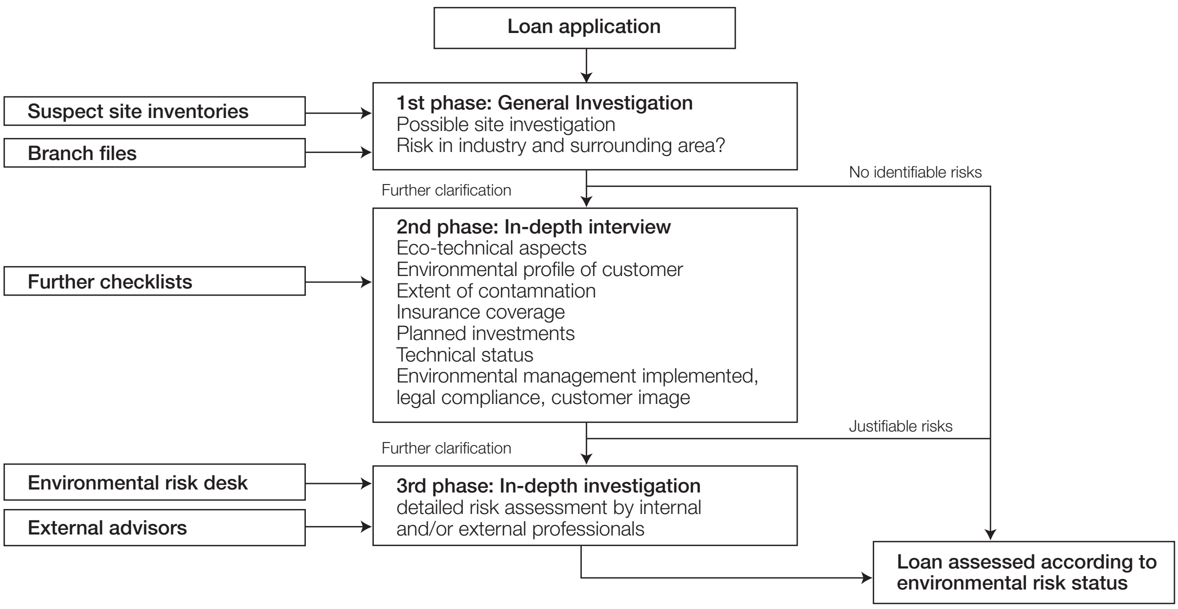
Flowchart Example

The Swiss Bankers' Association ("OBU") and the United Nations Environment Programme (UNEP) have benchmarked the environmental assessment procedures of their members and represented them in the flowchart illustrated in Figure 7. This provides a framework for borrowers and other interested parties to follow in order to *"check out environmental risks according to banking reference methods"*[8].

Outstanding Issues

To what extent does the flowchart provide a satisfactory representation of the way that banks, in general, approach ECRA?

Figure 7. Flowchart



Source: UNEP and Swiss Bank Association (OBU) guidelines

8 For further details see web site: http:www.unep.ch/eteu/envr-fin.htm

Banks may use one or more of these tools to guide a lending officer through a three "phased" (see diagram) or "staged" process of ECRA. The tools work by first posing questions, or raising issues for attention based on policy assessment priorities. A series of prompts then indicate when, and how, a lender should move between assessment stages.

Figure 8. Guidance Tools used by Participant Banks

Bank	BAR	CSG	HSBC	ING	LTSB	RBS	SAN	SOCG	STCH	UNI
Questions or checklist	Y	Y	N	Y	Y	Y	Y	N	Y	N
Flowchart	Y	N	N	N	Y	N	N	Y	N	N
Risk matrices	N	Y	N	N	Y	Y	N	N	N	N

(i) Standard Chartered clarified that guidance tools are used differently in various operations as policy development and implementation is country specific with consultation from head office

Participants were questioned on the type of tools that they use to support the implementation of ECRA. Their responses are illustrated in Figure 8. At a minimum we would expect that bank implementation of an ECRA policy would involve the preparation of a set of key questions, or a checklist, to guide initial risk identification. This may be followed by the choice of a flowchart, or risk matrix, to guide a lender through the ECRA process. The relative sophistication and detail of each tool will reflect the relative maturity of the ECRA process.

- **Assessment priorities**
  Each bank conducting ECRA has defined a set of key factors that it believes give a good indication of the potential incidence of environmental risk. These factors determine the priorities for ECRA and translate into practical guidance when conducting the assessment process. While factors differ between banks, one is common to all banks, and appears to have achieved the greatest level of analytical sophistication – Sector Classification. Assessment priorities are considered in detail below.

Sector classification

The industrial activity of a potential borrower, generally classified by industry sector or sub-sector, was highlighted by all banks as the primary trigger for environmental assessment.

Sectors are, in turn, classed into risk categories such as high, medium, and low, with the level of risk dictating the required degree of detailed follow-up assessment. Barclays specifically isolates high-risk sectors in order for them to be referred to centralised environmental credit risk specialists.

Although all banks agreed that the key driver in determining sector-related risk was legal and regulatory factors, the approach to defining "risky" sectors varied considerably amongst participant banks:

- Two banks **(Credit Suisse Group and ING)** claimed to *"screen out, or red-line"* certain sectors from investment. Both of these banks noted the nuclear energy industry as a sector they positively avoided. (The nuclear sector was recognised as a high credit risk sector amongst all participant banks.)

- Two other banks **(Royal Bank of Scotland and Standard Chartered),** noted that they attached strategic investment objectives to certain growth industries (specific details of these sectors withheld for competitive reasons) and claimed *"to avoid investment in sectors in which they lacked specialist knowledge."*

- Three banks **(Barclays, HSBC and Lloyds TSB),** adopted yet a third approach: they encouraged their lending officers to work with potential borrowers to improve their environmental performance. **Lloyds TSB** suggested that there is a reluctance to *"red-line"* particular sectors in case circumstances such as technological advances or government policy changes resulted in a subsequent reduction in industry risk. A bank actually working with such a borrower is arguably better placed to foresee such changes. For example, the risk of lending to the nuclear energy sector could be considerably reduced if the government decides to underwrite decommissioning.

As mentioned in section 1, lending products subject to ECRA primarily fall into two categories: small business lending/SME, and commercial/large corporate lending (including project finance but excluding investment banking[9]). When a loan is designated as commercial/ corporate (standard cut-off of €1.5 million plus facility), it is the responsibility of a specialist sector adviser in the bank. Similarly, project finance is also the domain of a sector specialist.

Small business loans, with the exception of some in the agricultural sector, are less likely to be subject to such specialist sector oversight. However, in all eight banks where ECRA policy applies **(Barclays, Credit Suisse Group, HSBC, ING, Lloyds TSB, Royal Bank of Scotland, Société Générale and Standard Chartered),** and in **Santander Central Hispano,** (where no formal ECRA policy exists), SME loans are generally also categorised by sector or sub-sector. At this scale of lending, individual officers are left to their own discretion rather than refer to centralised support.

Other priorities

There are a number of other factors that banks cited as triggering environmental assessments:

- Physical geographic location of borrower:
  - Past land use e.g. land contamination **(Barclays and Lloyds TSB)**
  - Flood plains **(Lloyds TSB and Royal Bank of Scotland)**

- Country risk:
  - Influence of legislation
  - Political risk)

- Supply chain responsibilities:
  - One particular bank noted that when lending to small businesses overseas, it is becoming increasingly important to consider the environmental reputation of the "big" businesses to whom they supply goods and services. It is perceived that if the "big" business is the target of a consumer boycott campaign (e.g. McDonalds) its suppliers may be the ones forced out of business, while the bigger company has the resources to weather the storm of a possible downturn in sales.
  - In a growing number of cases large companies are also requiring their suppliers to become ISO accredited.

Notwithstanding the growing awareness of climate change, air pollution was generally not viewed as influencing ECRA at a practical level. This is because air quality was still felt to be a largely unregulated issue. Interestingly however, the mention of flood plains by two banks indicates an awareness of the consequences of climate change, even though the elements of industrial or commercial behaviour that engender climate change do not, as yet, trigger any preventative action in terms of assessing funding risks.

Outstanding Issues

Are there opportunities – within the existing framework for sector-based risk measures – for the use of flood plains as risk indicators, to introduce an integrated approach to address climate change-related risk?

9 Bank boundaries between corporate banking and investment banking varied. For the purpose of this study, corporate finance should be taken to exclude investment banking as noted earlier.

2.2 The Environmental Credit Risk Assessment Process

The Three-Staged Approach to ECRA

- **Stage 1: General investigation**

Desktop review

The first stage of assessment involves a "desktop" review of a borrower's activity. This enables the lending officer to gain an initial impression of potential risks, and whether there is need for additional assessment. In the case of some participant banks, the desktop review remains a manual process guided by ECRA support documentation. For those banks with more established ECRA processes, the desktop review is guided by a computerised reference system built into standard credit assessment procedures.

The three "leading" banks **(Barclays, Credit Suisse Group and Lloyds TSB),** one "chasing pack bank" **(Royal Bank of Scotland),** and one bank "on the starting grid" **(Santander Central Hispano),** have developed and implemented detailed computerized risk databases that refer to sector-specific issues and interface with standard credit assessment procedures. One other bank **(UniCredito Italiano),** stated that it intends to implement similar procedures in the future. Once lending officers have entered the sector details of the borrower, they are required to answer a number of basic questions aimed at bringing out further potential concerns. It is at this point that factors, such as location, are generally considered.

Site visits

As it sits within the routine credit risk process, ECRA will generally carry through to the site visit, which takes place during the initial application phase of a loan.

> Site visits may be conducted to assess the capability of local management, or to check the existence and quality of equipment, and applies equally to small business loans and project finance.

It is a general observation that the larger the size of the borrower organisation, the harder it is to gain a true impression of management capability from a site visit alone. However, all lenders noted that site visits were particularly important in the evaluation of management in overseas markets, even for large facilities.

- **Stages 2 and 3: In-depth interview and investigation**

The second stage of assessment generally includes more detailed follow-up of the issues flagged in the initial review or "general investigation." The flowchart in Figure 7 highlights the likely issues to be pursued in this phase.

Where necessary, a third stage of assessment can be carried out. This typically involves an in-depth site investigation, and will reflect the input of the central environmental credit units (the environmental risk desk) and/or external advisors, depending on the referral structure of the bank. (Further details of this referral process are explained in Section 3).

A site investigation generally involves the commissioning of external consultants, such as environmental experts, surveyors or lawyers to pursue specialist risk assessment. This may involve basic survey work, or more intrusive scientific site exploration, and testing of pollution levels and migration patterns. Only two banks in the study **(Barclays and Credit Suisse Group)** have specialist environmental experts within their organisations, who are able to undertake a preliminary site review. However, even these two banks use external experts, with for example, access to laboratory testing facilities, for full site investigations. The cost of such investigations is most likely to be borne by the borrower. Consequently, the cost and benefit of such an exercise, particularly for a small loan, will need to be carefully considered by both the lender and the borrower involved.

Participant banks noted that an in-depth site investigation is not a common procedure. Such an investigation is only undertaken in the most 'high-risk' situations, is costly, and, clearly, can result in a loan being rejected after costly investigations. Lenders noted that it is becoming increasingly common for borrowers to undertake or commission their own investigation. In such circumstances, the lender would assess the nature of the investigation, and the credibility and reputation of the specialists undertaking the work, before deciding whether to rely on it.

- **Assessment summary**
The standard method used by banks to reach their final lending decision varies from the application of numerical credit scoring systems (i.e.1 to 8), to statements of risk exposure (i.e. low to high risk).[10] Both methods include file notes as a permanent record evidencing the decision. All of the banks conducting ECRA **(Barclays, Credit Suisse Group, HSBC, ING, Lloyds TSB, Royal Bank of Scotland, Santander Central Hispano, Société Générale, Standard Chartered and UniCredito Italiano)** apply one of these methods. The degree of influence of ECRA on the credit scoring process is generally indicative of the level of integration of ECRA within the overall lending process. Clearly, in cases where numerical scoring is used, it is easier to measure the influence of ECRA on the overall risk decision, relative to more qualitative systems.

  Six of the participant banks **(Barclays, Credit Suisse Group, HSBC, ING Royal Bank of Scotland and Santander Central Hispano)** noted that ECRA could have an influence on the credit ratings they applied as standard to all loans. In three of these banks **(Barclays, Credit Suisse Group and Royal Bank of Scotland),** the results of ECRA were integrated into the scoring system along with other lending criteria. In the two other banks **(HSBC and ING),** a credit score is calculated (without environmental criteria) and then compared to ECRA results to see if an adjustment is required.

  All lenders, irrespective of credit scoring preferences, felt that specific measurement of environmental credit risk within a loan application, or within their lending portfolio, was problematic. This was due to difficulties identifying and separating the influence of environmental performance from overall business performance. For example, one lender noted that potential environmental risk could be the root cause of a default, yet initially give rise to cash flow problems or a lack of technological investment, thereby not being recognised as a material cause of financial loss.

  To estimate their portfolio's exposure to environmental risk, lending officers review the total financing extended to so-called "dirty" or "high risk" sectors. Banks often used the term "rules of thumb" when discussing measurement of environmental risk in the bank's portfolio. They acknowledge that a blanket consideration of sectors as "dirty" was only a crude representation of risk.

All participant banks undertaking ECRA recognised that the level of environmental risk could extend beyond the actual monetary value of a given loan.

  For example, in a case where ECRA had failed, land that had been taken as security could require extensive clean-up prior to sale. In addition, such an incident could result in a bank's reputation being tarnished, if it was exposed to public scrutiny. Alternatively, high-risk sectors may be risk-aware and an excellent example of environmental management, thus posing little credit risk.

- **Pricing and terms of financing**
In general, there is no definitive structure for pricing environmental credit risk or defining terms of financing. Participant banks cited experience as being the best guide to reconciling the two. This was due to difficulties identifying and separating the influence of environmental performance from overall business performance noted previously.

- **Pricing**

All participant banks stated that environmental credit risk could influence the pricing of loans. However, all agreed that it was very difficult to particularly distinguish and separate the impact of environmental performance on overall financial performance.

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10 Credit rating is an extremely sensitive issue and thus no further details on those conducting standard rating procedures can be provided.

As a result, most lenders felt uncomfortable trying to put a value, or margin, on the influence of environmental risk on price. In general, lenders perceived the influence of environmental factors on the pricing of loans as minimal: a company with a good environmental performance generally reflects a company with good management and strong financials.

Many participants noted that there are a number of transitional and developing economies where environmental risk is generally not recognised by the market. These banks recognised that pricing environmental risk into bank products in such markets posed both opportunities and threats. The opportunities included reduced risk and retained business with good environmental performers, but on the down-side, some business could be lost to competitors who did not conduct ECRA. Pricing risk and return in overseas markets was therefore considered to be a fine balancing act.

Terms of financing

Five of the participant banks expressed a preference to work with potential borrowers in order to improve their environmental performance **(Barclays, Credit Suisse Group, ING, Lloyds TSB and Royal Bank of Scotland),** rather than deny financing or raise pricing. This could mean a bank alerting a borrower to potential environmental risks during the loan application process, and requiring the borrower to undertake certain measures to reduce the risk before financing is provided. Such steps could include the installation of environmental protection equipment or site remediation. In comparison, two banks **(Société Générale and Standard Chartered)** would not engage in such negotiation and instead expressed a preference to keep dealings with borrowers at arms length, particularly in overseas markets. **Standard Chartered** explained its preference for a totally non-prescriptive relationship with its borrowers.

Once financing has been agreed, it is standard procedure for participant banks with more developed ECRA processes to add a "suite" of environmental covenants and waivers to loan contracts, along with standard financial terms. For example, all borrowers are required to report any regulatory breaches, including environmental offences. In other participant banks, environmental covenants and waivers are applied on a case-by-case basis depending on its merits.

Workshop Feedback: Pricing of Financing

- **Defining non-price loan terms: how engaged with borrowers should banks be in setting terms and conditions aimed at encouraging environmental best practice?**
- **Does engagement confer a joint responsibility to the bank for its clients' behaviour?**
- **How have banks responded to this? Is pricing a legitimate tool for addressing heightened environmental risk?**

All banks agreed that there is limited scope for one individual area of risk (i.e. ECRA) to influence the pricing of a loan. Loan pricing is more widely determined by the overall quality and competency of a company's management and its ability to recognise and respond to changing market expectations (e.g. taking environmental factors into account). ECRA is more likely to influence the setting of the terms of a loan, which may for example, result in conditions obliging the borrower to comply with future legislation or react to changing market conditions. One bank illustrated this point with an example of an SME borrower specialising in PVC packaging. The bank was aware that one of the U.K.'s major retailers was planning to phase out PVC packaging, and chose to warn its client of this impending threat to its business model.

Participants also highlighted the need to carefully manage the extent to which they engage with their borrowers. Whilst they recognised that banks can be a force for positive environmental change in their customers, they also acknowledged that a bank asking too many questions could be competitively disadvantaged. Banks have to ensure that they strike the appropriate risk balance in their engagement, enabling them to fully understand their customer, but at the same time present themselves as a constructive and understanding partner while avoiding the introduction of unnecessary hurdles.

Best Practice: Implementing ECRA Policies

- Practical guidance tools for lending officers include flow charts and/or risk matrices to guide assessment; and lender checklist/ borrower questionnaires

- Priority given to industrial sector assessments with sectors being graded by level of risk

- Additional risk assessment criteria:

  (1) Physical geographic location of borrower
  (2) Country risk
  (3) Supply chain responsibilities

- Three-Stage Loan Assessment Process:

  (1) General investigation including desk-top reviews and site visits
  (2) In-depth interview
  (3) In-depth investigation with advice of external advisors and site assessments

- Guidelines on loan pricing and terms of financing

Observations:

- Consensus on priority of industrial sector assessments but divergent opinions on additional risk assessment criteria

- Divergence on whether a bank should engage with a borrower on environmental concerns

SECTION 3: Managing and Monitoring ECRA policies

3.1 Operational Guidelines

- **Basic definitions**
  As highlighted in the two previous sections, bank lending procedures including ECRA policies at best provide a common "guidance" framework for lending officers reviewing a broad range of lending scenarios. Although the level of procedural guidance offered by each participant bank varied considerably, in general the banks followed a three "phased/staged" approach to assessment (General Investigation, In-depth Interview, In-depth Investigation).

  This section analyses the extent, and the ways in which banks are able to manage and monitor their environmental credit risk assessment process. Broadly speaking, the day-to-day management of ECRA is controlled by the referral of processed loan applications to senior lending officers for approval, and then where one exists, to a credit committee.

- **Auditing**

All of the participant banks in this study conduct internal audits to ensure that policy guidelines are being implemented.

In some banks quarterly audits are carried out, and in others, time frames are extended to annual reviews. In the "leading pack" banks with well-established ECRA procedures **(Barclays, Credit Suisse Group and Lloyds TSB),** it is standard practice for internal audits to include a review of general working documents for evidence of ECRA. For banks "on the starting grid," audit for ECRA is yet to become standard procedure.

In all banks, any non-compliance that is highlighted during the audit process is reported by exception, and followed up with supervising officers. A number of banks noted that as ECRA policies had only been introduced relatively recently in their organizations, a lender's failure to conduct appropriate ECRA, was at this early stage, unlikely to lead to strict penalties. Instead, the oversight would most likely be rectified by a lending officer trained in the conduct of ECRA, and the individual concerned would be closely monitored by a senior officer.

One particular participant **(HSBC)**, gave details of a staff appraisal system which includes an assessment of credit policy awareness, including the conduct of **ECRA.** The system also requires lending staff to read current lending guidelines at least once a year.

- **Support services**
  All three "leading pack" banks, have a centralised environmental credit risk support service, tasked with providing help and advice on ECRA policy implementation. This support group is, in addition, often responsible for measuring environmental performance. These "leading" banks are the largest banks in the participating group, and have greater resources to operate a centralised department/unit of ECRA experts.

  In the other participating banks, ECRA policy is deployed by a key executive, responsible for co-ordinating functional risk management activities, with the support of a team of local credit experts (in both national and international operations). (e.g. **HSBC and ING**). Any queries regarding ECRA policy implementation are directed to the risk co-ordinator and/or the credit expert team. At **UniCredito Italiano,** ECRA policy deployment remains the responsibility of autonomous credit departments, operating under Head Office guidance, and the risk committee, in the case of more sizeable loans.

Figure 9. Central Support Services

Bank	BAR	CSG	HSBC	ING	LTSB	RBS	SAN	SOCG	STCH	UNI
Environment Department/ units	Y	Y	N	N	Y	Y	N	N	N	N
Advisory Teams	Y	Y	Y	Y	Y	Y	N	Y	Y	N

- **External consultants**
  Nine of the banks conducting ECRA **(Barclays, Credit Suisse Group, HSBC, ING, Lloyds TSB, Royal Bank of Scotland, Santander Central Hispano, Société Générale and Standard Chartered,)** rely on external consultants to help inform their environmental assessment process. **UniCredito Italiano** stated that it might rely on consulting support in the future. These consultants include environmental experts, land surveyors and legal advisers. Due to familiarity with local legislation in their domestic markets banks tend to rely most heavily on specialist environmental advisers in their domestic market and legal advisers in their overseas markets. In many cases, banks have what they commonly refer to as a trusted "panel of consultants," with whom they have established specific terms of reference. A number of consultants provide banks with a free help line (or help desk) service in their domestic markets.

  As part of its professional valuation procedure, **Barclays** requires its valuer to complete a Land Use Questionnaire. Once completed, this questionnaire is reviewed by the bank's central environmental credit risk team to determine whether there are any environmental issues to be investigated regarding either the site itself, or potentially, the activities on the site.

  In addition, two of the "leading" banks **(Barclays and Credit Suisse Group),** have environmental consultants working, on secondment from one of the U.K.'s leading environmental consultancies, in their central environmental credit risk support service. By assuming a "turnover" of these staff of approximately two years, up-to-date technical knowledge is maintained, as the secondee is rarely more than two years out of the field. Furthermore, one of the banks in the "chasing pack" **(Royal Bank of Scotland)** has five dedicated environmental specialists working in its U.S. operations.

Workshop Feedback:

- **What is the optimal balance of internal and external expertise?**

Participants recognised the value and benefit of both internal and external expertise. On the one hand, internal expertise ensures a thorough knowledge and understanding of in-house environmental issues; however, external expertise offers professional indemnity and an up-to-date knowledge that is constantly refreshed though close field contact. In some instances, however, the selection (and payment) of consultants is not determined by the bank but is instead in the hands of the borrower.

The results of this study indicate that training in ECRA is generally an area of weakness for the banks involved. Even in the banks where ECRA policies are relatively mature, training remains in the formative stages.

For the purpose of this research, a distinction will be made between "general awareness-raising" (for example, the circulation of case studies highlighting incidents where environmental factors have resulted in financial loss) and actual "training." This distinction is important because during this research study, the boundaries between awareness raising and training were not always clear. There is thus a risk that a bank mistakenly perceives "awareness-raising" activities to be adequate "training".

As a means of raising the general awareness of environmental issues, a number of banks **(Barclays, Credit Suisse Group, Lloyds TSB and Royal Bank of Scotland)** publish regular environmental newsletters and/or bulletins. These include for example, references to regulatory reforms such as *European Commission's Paper on Environmental Liability* and lending case studies. A number of banks also offer e-newsletters focusing on environmental issues, in addition to dedicated environmental Intranet sites. These environmental publications are generally available to non-credit staff as well as lending officers.

Domestic training in ECRA

A comprehensive series of annual domestic training sessions/workshops in ECRA is only conducted in two participant banks in this study **(Credit Suisse Group and Lloyds TSB).** At **Credit Suisse Group,** attendance at training sessions is an introductory requirement at each stage of an employee's career progression. At Lloyds TSB, regional training workshops are attended by employees of each grade, in each office location. In three other banks **(Barclays, ING and Royal Bank of Scotland),** isolated introductory training sessions were provided for lending officers when ECRA policies were first introduced. However, no specific follow-up ECRA training sessions have taken place. **Barclays** has taken steps to integrate elements of ECRA into its standard internal training packages on relevant bank procedures and practices (e.g. in Securities training), so ECRA can be seen to be part of "business as usual". Similarly, **Royal Bank of Scotland** has reinforced this initial training within the credit policy, procedures and underpinning guidance held on its Intranet site.

Where annual ECRA training sessions are organised, training is often computer-based, and conducted on-line or via interactive CD-ROM training packages **(Credit Suisse Group and Lloyds TSB).** These programmes include case studies of hypothetical and/or real lending cases and are used during workshops, as well as during subsequent desktop practice sessions. In addition, one "leading" bank **(Lloyds TSB),** had developed a training video which included analysis of a site review.

International training in ECRA

There is only limited evidence of ECRA training in the international operations of the participant banks. In four banks **(Barclays, Credit Suisse Group, Lloyds TSB and Royal Bank of Scotland),** central environmental risk co-ordinators have chaired one or two international ECRA workshops overseas. These workshops have typically involved getting key lending representatives from local offices together with risk co-ordinators to discuss local ECRA implementation issues. Such events often follow ECRA policy launches and/or revisions. Alternatively, **HSBC,** has employed an external training consultant to deliver courses on ECRA to key lending officers working outside of Europe; and **Standard Chartered** is in the process of developing a training programme to meet the needs of all its employees working overseas.

- **Performance measurement**

Of the nine banks conducting ECRA, only four banks, the "leading banks" and a "chasing" bank **(Barclays, Credit Suisse Group, Lloyds TSB and Royal Bank of Scotland),** formally track their performance with respect to ECRA.

The limited existence of ECRA performance measurement indicators is in part due to the inherent difficulty of isolating the impact of environmental performance from the financial performance of a loan portfolio as a whole. A bank's only real means of gauging the success of its ECRA policies and procedures, is according to the level of financial losses that can be attributed, at least in part, to environmental risks. Consequently, ECRA performance measurement indicators tend to focus on the extent of ECRA being conducted, rather than the impact that ECRA has on a loan portfolio. For example:

- **Monetary performance indicators:**
  These indicators are used to monitor the expenditure required to maintain ECRA policies and are, in the majority, internal performance metrics only. Only the three "leading" banks **(Barclays, Credit Suisse Group and Lloyds TSB)** provide details of their annual expenditure on ECRA, and this measurement is restricted to the expenditure on centralised environmental credit risk support services.

  Details of expenditure items include internal salary payments and expenses; and payments made to external consultants.

- **Non-monetary performance indicators:**
  All three leading banks and a further "chasing pack" bank **(Barclays, Credit Suisse Group, Lloyds TSB and Royal Bank of Scotland),** also use non-monetary indicators to help establish levels of ECRA, and justify budgeted expenditure as appropriate.

  For example, annual calculations include: the number and nature of ECRA case referrals to central credit risk support services and external consultants, and the number of help-line enquiries relating to ECRA. Two banks **(Barclays and Lloyds TSB),** publish this information in their environmental reports (see boxes below and also later discussion of reporting of ECRA in section 4).

- **ISO accreditation:**
  In the absence of any recognised benchmarking of the ECRA process for the banking sector, **Credit Suisse Group,** opted to pursue ISO 14001 certification as a measure of its environmental performance. It has achieved ISO 14001 certification across all of its global banking locations.

Performance Indicators

Barclays Bank

This extract from Barclays Social and Environmental Report 2001 (page 24), provides an example of the ECRA performance indicators (or "Facts and Figures" as they are entitled here) used by the bank. The example shows comparative figures detailing the number of ECRA cases referred to the bank's central environmental risk management unit for detailed assessment of land valuation during 1999 and 2000. Figures are split according to U.K. land valuation and additional cases from outside the U.K. (global). U.K. figures are further analysed to show the percentage of cases subject to further enquiry (for example, referral to external consultants for scientific site surveys).

Extract from the Environment: Facts and figures (on performance)[11]

	2001	**2000**	**1999**
UK land valuation cases reviewed (by ERMU)	6,180	6,138	5,830
% subjected to further enquiry	32%	25%	26%
Additional case referrals (global, non-U.K.)	430	457	550

Performance Targets

Lloyds TSB

Lloyds TSB is the only bank that has taken the first steps to track its ECRA implementation activities by establishing general objectives for the forthcoming year, publicly disclosing them in their environmental report, and then reporting their performance against these targets.

The Community and our Business, Environment Report 2000

Lending and the environment (p 6)

Objective for 2000: Launch and distribute the customer advice leaflet
A booklet providing practical advice for small businesses a better environment for business success was distributed to all of our business banking offices in 2000. The booklet can also be requested via our internet site **www.lloydstsb.com.** In addition to the initial distribution we have had almost 900 direct requests for the booklet from small business customers.

Outstanding Issues: Performance Measurement

- **Which numerical performance indicators are most relevant to ECRA measurement**
- **How meaningful can numerical indicators be in tracking progress and setting objectives?**
- **What qualitative performance indicators would be useful?**
- **Does ISO 14001 provide an attractive framework for benchmarking ECRA performance?**

Workshop participants voiced their strong concerns about this issue but stated very clearly that it was "a can of worms." ECRA performance measurement has been widely, but largely unsuccessfully discussed by a number of financial industry associations, including both the BBA and UNEP FI. Given limited time at the Workshop, a decision was taken to focus on issues where more instructive discussions could be accomplished.

11 Extract subject to slight modification for presentational purposes. Figures representative of Barclays Business Banking.

Best Practice: Managing and Monitoring ECRA policies

- ECRA policy is reviewed as part of a bank's internal audit procedure
- A centralised environmental credit risk support service (a team of ECRA experts) advise on ECRA policy implementation
- Terms of reference are established with external consultants to add specialist knowledge to the environmental assessment process
- Regular ECRA training sessions/workshops are required for lending officers in the banks domestic and international markets
- ECRA training is an integral part of an employees career progression and performance monitoring
- ECRA policy and procedural guidance is made available on bank Intranet
- Performance measures are developed for ECRA:

  – targets are set for ECRA implementation
  – targets are monitored
  – performance is reported
  – performance is reviewed

Observations:

- ECRA training was a key differentiator between "leading pack" banks and those "on the starting grid"
- Specific training of lending officers in ECRA remains limited, especially in a bank's international markets
- Performance measurement indicators for ECRA focus on the extent to which ECRA is implemented, rather than the impact that ECRA has on a bank's business. It is difficult to justify involvement in ECRA as its bottom-line impact cannot be clearly isolated and defined
- As yet there is no evidence of detailed reporting on performance indicators in the preceding year, relative to the current year and future targets

SECTION 4: Communication and Reporting of ECRA

The following section examines external communication and reporting of ECRA, from the standpoint of both formal annual reporting, and the ad hoc disclosure that accompanies consultation exercises and engagement with external stakeholders – this research project being one obvious example.

- **Formal reporting**
  The history of 'external' environmental reporting by banks dates back to the 1990s. More recent developments in reporting include reference to social as well as environmental considerations. Eight out of the ten participants publish a stand-alone environmental/society report of some kind. Three banks were first time reporters in 2001/2.

Figure 10. Environmental Reporting

Bank	BAR	CSG	HSBC	ING	LTSB	RBS	SAN	SOCG	STCH	UNI
Stand-alone report	Y	Y	Y	Y	Y	Y	N	N	Y	Y
ECRA Ref.	Y	Y	Y	Y	Y	N	N	N	Y	N
Performance Measurement Indicators	N	Y	N	N	Y	Y	N	N	N	N

Included within all environmental reports is reference to ECRA by the bank. However, the quantity and quality of information reported varies between banks. In most banks, disclosure includes an acknowledgement of the banks' ECRA policy and brief details of its implementation. The example below illustrates a typical statement. Further information disclosed by **ING,** includes details of its banking objectives, limiting lending liabilities and guidelines for dealing with environmentally sensitive industries.

ECRA Disclosure

ING Bank

ING in Society 2000: Risk Management

Environmental Risk Assessment (p39)

In the Netherlands, ING Bank and Westland/Utrecht Hypotheekbank have a long tradition in considering environmental risk when assessing credit. An environmental sub-clause is included in the credit risk analysis in cases that are deemed to be a potential environmental and financial risk. Depending on the nature of the expected risk, an environmental risk inventory is conducted by an internal environmental accountant or external expert. An 'Environmental Checklist' designed by ING is available for account managers to assess environmental risks in credit applications. As part of increasing the knowledge on environmental issues a course on soil contamination is offered to account managers whose business focus is on mortgage products.

Section 3 highlighted the limited role played by ECRA performance measurement indicators; this, in turn, is reflected in the reporting, where reference to performance measurement is very limited. Of the four banks measuring environmental performance, only three **(Barclays, Credit Suisse Group and Lloyds TSB)** publish details of performance indicators in publicly available annual environmental/social reports. Non-reporting banks justified their decision on grounds of both confidentiality, and a concern that quoting performance indicators out of context might be misleading.

Disclosure of Performance Indicators

Lloyds TSB

Environmental report 2000; Contained within Lloyds TSB pack:
The Community and Our Business

Lending and the Environment

Over 1,500 lending officers have attended environmental risk training workshops and all lending officers have access to workbook and video training in their offices. We have an ongoing programme to offer training workshops where specific needs are identified.

We provide ongoing support to our lending officers via a dedicated environmental help-line. During 2000 the help-line has provided advice on 1,648 cases as well as hundreds of general environmental queries.

- **Consultation, Engagement and Disclosure**
  In addition to formal reporting, banks recognise that additional information about their ECRA practices is likely to be disclosed as a result of external consultation and engagement, such as this research study. Other benchmarking exercises, such as the Dow Jones Sustainability Index (DJSI) and Business in the Environment (BiE), were also cited as a basis for industry comparison and an additional source of information made available to their stakeholders.

  Unsurprisingly, lenders generally expressed a reticence to provide any internal documentation to external parties. As part of this study, only one participant bank **(Credit Suisse Group)** offered a comprehensive file of internal bank documentation for review by ISIS Asset Management, though on bank premises only. The bank noted it was house policy to make such documents available as a basis for engagement with shareholders. Going forward, another bank **(Barclays)** has offered to share and discuss various policy papers and supporting documentation with ISIS Asset Management, and other interested stakeholders, again on bank premises only. **Lloyds TSB, Royal Bank of Scotland and Société Générale** voluntarily provided internal bank information, albeit a more limited amount.

  In addition to engaging with shareholders and research organisations, all ten participant banks cited their involvement in networking activities with local bank associations. **ING** and **UniCredito Italiano** also highlighted the importance of more informal local seminars on environmental risk, as a means of engaging on ECRA.

  Often such “engagement” activities would also involve policy makers and non-governmental organisations (NGOs). For example, in the United Kingdom, representatives from the Department of Environment, Food and Rural Affairs (DEFRA), the Environment Agency and Business in the Environment (BiE) have been invited to attend seminars held by the British Bankers' Associations Environmental Issues Advisory Panel. At an international level, UNEP Roundtable events have included representatives from local government bodies and NGOs such as Green Alliance, Greenpeace and Friends of the Earth. Special NGO briefing sessions have been held for UNEP signatories prior to UNEP Roundtable events.

  However, bank engagement with broader stakeholder groups remains limited, with many participant banks quoting the case study highlighted below as a primary example of their engagement activities.

Case Study – Friends of the Earth

The funding activities of many banks (whether debt or equity) have recently been the subject of increased scrutiny. One such instance was a report by Friends of the Earth (FoE May 2001)[12] entitled Paper Tiger, Hidden Dragons which investigated the alleged "responsibility of international financial institutions for Indonesian forest destruction, social conflict and the financial crisis of Asian Pulp & Paper". The report centred on an analysis of the funders of one particular forestry company, Asia Pulp and Paper (APP).

Five of the banks participating in this research study were named by FoE as providing debt finance to APP and consequently supporting their activities. FoE wrote to all of these banks asking them to respond to their accusations that they were responsible for financing forest destruction and social conflict, dating back to bank performance in the early 1990s.

The banks implicated in the APP allegations have responded in different ways to FoE's enquiry. Two banks invited FoE in to discuss their involvement with APP and outline their ECRA procedures and plans for improvement. Another bank chose not to engage with FoE at this point, but may do so in the future. All participant banks, including the five banks implicated by FoE, said that it would be almost impossible to deny potential involvement in such investment (particularly if tracked back in time and based on association with APP's subsidiary).

The FoE report findings highlight the fact that bank accounting systems are not set up to easily evaluate funding exposure to anything other than their primary investment (i.e. related companies are not directly visible from their records). This case study highlights one basic difficulty faced by virtually all banks: that of accurately tracking exact sources of exposure when challenged by external stakeholders, so as to be able to make the necessary disclosures to satisfy public concerns. It also highlights the challenges that banks face in balancing the need to disclose information to satisfy public concerns while maintaining their duty of client confidentiality.

Best Practice: Communication and Reporting of ECRA

Public disclosure of:

- ECRA implementation process and guidelines (not including commercially-sensitive operational procedures)
- Annual ECRA implementation targets
- Annual results against ECRA implementation targets

12 Ed Matthew, and Jan Willem van Gelder (2001) Paper Tiger, Hidden Dragons. May, Friends of the Earth: UK. (http://www.foe.co.uk/resource/reports/paper_tiger_hidden_dragons.pdf)

SECTION 5: Summary of How the Banks Compare

This section aims to summarise the results of the study so far. As referenced in the previous sections, the ten participant banks have been grouped into three categories according to the level of ECRA experience they have exhibited, and the thoroughness and sophistication of their ECRA procedures. Banks have been classified as “on the starting grid”, in the “chasing pack” and the “race leaders” in respect to ECRA.

“On the Starting Grid”:

Santander Central Hispano, Société Générale and UniCredito Italiano

Although welcome steps have recently been taken to develop ECRA in all three of the “starting grid” banks, they have less-developed environmental credit risk assessment procedures than the other participants in this study.

Santander Central Hispano, Société Générale and UniCredito Italiano have all taken the decision to introduce ECRA policy, procedures or guidelines.

Société Générale: *the leader on the starting grid, with a recognisable commitment to ECRA*

- The Board of Directors formally recognised the link between business risks and environmental issues in 2000. New credit “rules” relating to ECRA were written and circulated to all lending officers in 2001.
- Responsibility and accountability for ECRA is currently being discussed at a strategic level. Plans for a training programme and performance measurement are set to follow.
- Discussions about the pursuit of in-house ISO 14001 certification (particularly to support specialist lending units such as forestry) are underway.

UniCredito Italiano: *a recognisable commitment to developing ECRA*

- Has a cross functional environmental policy.
- Broad lending rules on ECRA have been circulated via bank circulars. Consequently senior officials believe that ECRA is informally conducted as part of its lending activities with “dirty sectors”.
- Aims to map its portfolio in order to evaluate it in terms of environmental risk; no details of a timetable have been disclosed.
- Senior executives at the bank believe they are ahead of their domestic competitors in relation to ECRA (there is no apparent evidence to the contrary). UniCredito is keen to lead other local banks and businesses by example.

Santander Central Hispano: *a recognisable commitment to developing ECRA*

- Aware of the environmental risks recognised by lenders in other banks; plans for formal ECRA policy development; no details of a timetable have been disclosed.
- Lending officers may address environmental risk factors (both sector and company-specific) as they are included in the Bank’s internal ratings system.
- Broad lending rules on ECRA have been circulated via internal bank circulars.
- Responsibility for credit risk assessment lies with the individual lending officer and the Risk Committee following guidance from the Bank’s risk criteria and circulars.
- Aside from specific ECRA policies, the bank has made considerable investment in the development and implementation of more general credit risk assessment processes. Evidence suggests that these procedures are of a high quality, particularly in respect to the recognition and measurement of risk.

“The Chasing Pack”

HSBC, ING, Royal Bank of Scotland and Standard Chartered

Banks in “the chasing pack” have established ECRA policies and procedures and are actively managing their environmental credit risk. Whilst instances of good ECRA practice can be found in these banks - particularly at Royal Bank of Scotland they demonstrate relatively few examples of “best practice” when compared to the “leading pack” banks.

ECRA policies are generally applied across the banks’ operations and refer to all retail and commercial products including secured and unsecured lending; recourse and non-recourse project finance; and syndicated loan transactions (including instances where third-party guarantees are provided). ECRA is initially implemented in the banks’ domestic markets and is being applied, to various degrees, across the banks’ international operations.

Highlights:

Common themes amongst the “chasing pack” (also shared by the “race leaders”):

- ***Scope of ECRA:*** ECRA is considered from the start of the loan application process through to the lending decision. Loan facilities extended to a borrower are monitored.
- ***3 phases of ECRA implementation:*** A three-phased approach to ECRA is conducted:
  (I) General investigation including desk-top reviews and site visits
  (2) In-depth interview
  (3) In-depth investigation with advice of external advisors and site assessments
- ***Industry sector classification:*** The industrial activity of a potential borrower, generally classified by industry sector or sub-sector, is highlighted as the primary trigger for environmental assessment.
- ***Reporting:*** Banks reference ECRA in some form of annual, specific-purpose reports such as social, community or environmental publications.

Examples of good practice:

- ***ECRA tools:*** **Royal Bank of Scotland** has developed and implemented a detailed computerised risk database outlining sector-specific issues as a basis for ECRA
- ***Training:*** Key risk co-ordinators from both **Standard Chartered and Royal Bank of Scotland** have been involved in group-training events outside of Europe.
- ***Performance measurement indicators:*** Royal Bank of Scotland alone provided examples of performance indicators monitoring the implementation of ECRA procedures.

Examples of good practice:

- ***Training:*** Greater distinctions between “general awareness-raising” initiatives and “training” in the banks’ domestic and international markets. No formal training programme currently exists in overseas operations.
- ***Reporting:*** Increased level of public disclosure through reporting.
- ***ECRA performance measurement:*** Development and publication of information on ECRA performance indicators.

“The Race Leaders”

Barclays, Credit Suisse Group and Lloyds TSB

Whilst there was no clear leader among the participant banks in this study, three of the ten banks (Barclays, Credit Suisse Group and Lloyds TSB), illustrated more examples of ECRA “best practice” than other banks in the group.

The “race leaders” were among the first banks to implement ECRA in the early 1990’s and as such can point to relatively mature and detailed review procedures, training systems and communications. In addition to developing ECRA procedures in-house, these banks have been strategically involved in the development of ECRA at a national and international level. For example, representatives from all three “leading” banks play key roles in the continued development and implementation of the UNEP principles on the Environment and Sustainable Development.

Highlights:

Common examples of best practice:

- ***ECRA tools:*** All three banks have developed and implemented detailed computerised risk databases outlining sector-specific issues which interface with assessment procedures.
- ***Technical support:*** Each bank has a centralised environmental credit risk support service tasked with providing help and advice on policy implementation, and often responsible for environmental performance measurement.
- ***Performance measurement indicators:*** All three participant banks were able to provide evidence of established indicators that they used to track their ECRA performance.
- ***Reporting:*** All three “race leaders” publish examples of ECRA performance measurement in their social/ environmental reports.

Other examples of best practice:

- ***Training:*** **Credit Suisse Group and Lloyds TSB** conduct a comprehensive series of ECRA training sessions/workshops each year. At **Credit Suisse Group,** ECRA training is integrated into the career progression of employees. **Barclays** integrates ECRA training into its mainstream training packages.
- ***Training tools:*** A range of training tools has been developed. Examples drawn from across the three “leading” banks include: on-line case study assessments (including hypothetical and/or real lending cases) and interactive CD-ROM training packages **(Credit Suisse Group and Lloyds TSB).** Lloyds TSB has also developed a training video including a site review.
- ***Performance measurement indicators:*** One bank publishes annual targets for ECRA
- ***Certification:*** One bank has achieved ISO 14001 certification for all of its global banking. locations.

Areas for improvement:

Although the range of practices by the “race leaders” covers a remarkably wide spectrum, by their own admission, there still appears to be much room for improvement. This was particularly noted in relation to their plans for harmonising practices on an international scale and measuring performance of ECRA.

SECTION 6: The Impact of ECRA on Business Performance

This section considers the impact on profitability of environmental credit risk assessment and specialist environmental products, and, in particular, focuses on whether ECRA practices help banks differentiate themselves from their competitors.

All ten participant banks conducting ECRA believe environmental risk has an impact on profitability.

Indeed, this was cited as the fundamental justification for conducting ECRA in the first place. The impact of ECRA on profitability was discussed not only in terms of a reduction of liability exposure, but also, in some cases, as a potential source of additional revenue generation. These distinctions are considered in detail below.

6.1 Where does ECRA most impact bank profitability?

Most banks saw ECRA first and foremost as an issue of traditional financial risk versus return.

For example, two of the more experienced "leading" banks noted that "as a result [of ECRA] we have better quality credit risk management" **(Lloyds TSB),** and "we wouldn't do it if it did not make business sense" **(Credit Suisse Group).** Even one of the less experienced, and apparently more sceptical, banks acknowledged that: *"It is early days…if anything, ECRA is a positive because it reduces negative risk"* **(Standard Chartered).**

ECRA's primary effect was seen as minimising downside rather than boosting upside results. Thus, virtually all participants recognised that ECRA *"minimises loss"* through a reduction in *"bad debt/liability exposure".* Banks readily acknowledged that failures in ECRA in the past had caused financial loss as a result of default on payments and, more specifically, the unexpected cost of taking possession of security. These factors undoubtedly influenced historic profitability. One bank also noted that sound ECRA demonstrates a bank's aim *"to make assets as clean as they could be…ECRA will be tested if the market faces a general downturn"* **(Barclays).**

Two banks highlighted the fact that although the probability of environmental mishap was likely to be low, poor environmental risk assessment could have a disproportionate impact on a company: there is **"a low likelihood of environmental risk could have a disproportionately high impact on profitability " (Credit Suisse Group),** or in the words of another bank, "risk equals what you see, plus what you don't see" **(ING).** Thus, poor information, or a limited understanding of the range of potential business impacts of weak environmental performance, were not in themselves deterrents to applying ECRA, because the business impacts could, in rare cases, be so severe as to easily justify the investment of resources - an approach that is reminiscent of the "precautionary principle" in other contexts.

ECRA was perceived to provide banks with enhanced market intelligence - an additional tool to evaluating the business prospects of their customers. For example, two "starting grid" banks observed that *"environmental risk is a significant issue…a (borrowing) company can go out of business on the basis of environmental risk"* (**UniCredito Italiano).** The robustness of a borrower's environmental management systems was seen as a valid indicator of overall management capabilities, or in the words of one respondent, ECRA will help *"to pick out the best borrowers"* **(Société Générale).**

In some instances, ECRA procedures were cited as leading to a loss of business to competitors not employing ECRA. Two banks noted cases (both in Europe and overseas) where borrowers perceived ECRA as an additional burden and consequently preferred to do business with competitor banks without ECRA processes. However, both felt that the risk-management benefit provided by ECRA, outweighed this lost-opportunity cost, and that in time, borrowers were also likely to recognise the advantages provided by ECRA.

6.2 How can environmental expertise be used to generate revenue?

- **Growing the top line by building stronger, more loyal customers**

A number of "leading" banks noted that ECRA could lead to revenue generation by "adding value".

In particular, by helping customers identify and mitigate environmental risk, they believed that customer satisfaction and loyalty would be enhanced (Barclays and Lloyds TSB). As Royal Bank of Scotland explained, "customers and investors share the same expectations: ECRA is fundamental to sound management and a sound income stream", and therefore helping a customer improve its risk profile through ECRA benefits both borrower and lender.

In addition to the substantive benefits of reducing risk, a bank's association with strong ECRA standards was thought to "have a positive impact on bank reputation and brand value" **(Barclays and Lloyds TSB).**

- **Specialist environmental products**
  Distinct from, but nonetheless related to, ECRA, are the specific lending products that banks develop and market on the basis of environmental considerations. These consist of proprietary "green" loan products, and those eligible for external subsidies and guarantees.

Proprietary "Green" products

Figure 11 illustrates the full range of products offered by participant banks including screening criteria and the benefits advertised by each bank.

All banks offering such products believe they are commercially viable because good environmental performance reduces risks to banks, in addition to leading to improved public relations. One interesting variant is the case of **UniCredito Italiano,** in as much as the development of its environmental product (which has a below-cost philanthropic element see following Case Study) is "*not about screening activities… it is a question of relationship management and raising customer awareness*".

As noted by one bank, most lenders offering specialist environmental products market them on the basis that borrowers receive preferential terms. Do these benefit the customer?

When questioned, most banks acknowledged that *"it is impossible to verify the direct financial benefit gained by the (borrower) in taking up such a specialist product".* This reflects the fact that, due to the inherent difficulty in identifying the contribution environmental practices make to financial out-performance, it is virtually impossible for a bank to document that the reduced interest margin reflects good environmental practices.

Still, regardless of whether customers truly enjoy an additional gain, the question for the banks and their shareholders boils down to whether these specialist products actually enable banks to write additional business, rather than cannibalise existing business. In principle, any marketing practice that pulls in incremental business on profitable terms surely enhances financial performance. Yet the scale of specialist environmental products relative to core products is uniformly tiny across our entire sample. This suggests one of two things: either this represents a nascent product that has yet to achieve maturity, or it is an uneconomic use of resources that is of marginal value to the business.

Figure 11. Environmental Product Characteristics

Bank	Barclays	Credit Suisse Group	ING	RBOS	Santander	Unicredito
Green savings Investment	N/A	Y	Y Post-bank: energy loan	Y Direct Line launched FTSE4Good Tracker Fund In 2002	Y Green debit/credit card Green Mutual funds	Y Savers Scheme
Green mortgage/*	N/A	N/A	Y	N/A	N/A	N/A
Efficiency loan (energy)	Y	Y	Y	N/A	Eco-efficiency	Eco-efficiency
Technology loan (clean)	Y	N/A	N/A	Withdrawn May 2002	Y Aeolian technology park for alternative energy[i]	N/A
Investment Focus	Derelict Land & Buildings[i]	Equity investment	Energy	Brown-field Environmental Services[i]	Land & Buildings[iii]	SMEs Suppliers of multi-nationals[iv]
Other (will put at end when reformat	–	–	–	RBS Mentor Services provides Employment, Health, Safety and Environmental Law Consultancy Service for customers[ii]	–	–
Pricing	Cash Back 1.25% loan	Risk-adjusted pricing	Linked to Dutch tax breaks	Reduced fees 0.5-1% Disc. interest margin	–	Rate set: Euribor +0.125/0.5%

(i) EIB Products
(ii) The environmental service is at early stages of development
(iii) Project Boadilla: land and buildings for bank use
(iv) EMS Certification

EIB loan guarantee scheme

In three of the six banks **(Barclays, ING and Santander Central Hispano)** offering specialist environmental products, these are supported by the European Investment Bank's (EIB) small loan guarantee scheme (also referred to as the European Investment Fund or EIF). Under the EIB initiative, a bank agrees to offer a "green" product to small and medium-sized enterprises and the EIB underwrites the loan repayment. The aim of the initiative is to encourage small businesses to become environmentally friendly. For loans supported by the EIB initiative, "screening" criteria, to define eligible investments, are established according to terms set down by the EIB, in association with participant banks.

Two banks however, **(Lloyds TSB and RBOS [NatWest])** have recently withdrawn their EIB-related loans, and other banks have expressed problems in generating loan volumes under the scheme, due to lack of demand. In the case of Lloyds TSB, low volumes led to a lack of perceived benefit to the bank. Lloyds TSB felt that the EIB conditions were "too restrictive" to allow the product to be commercially viable and essentially, the cost of the additional administration relating to the product was not being met by additional loan sales. In a similar situation, RBOS discontinued its EIF, Growth & Environment initiative and its original NatWest discounted loan schemes in May 2002, due to operating restrictions and general lack of customer demand in the UK. Instead, RBOS is funding clean technology and other efficiency improvements via tailored traditional banking products.

Figure 12. Summary of Specialist Environmental Products

Bank	BAR	CSG	HSBC	ING	LTSB	RBS	SAN	SOCG	STCH	UNI
Proprietary green loans	**N**	**Y**	**N**	**Y**	**N**	**N**[i]	**N**	**N**	**N**	**Y**
EIB-backed green loans	**N**	**N**	**N**	**Y**	**N**[i]	**N**[i]	**Y**	**N**	**N**	**N**

(i) LTSB and RBOS used to operate products under the scheme but they were withdrawn due to lack of commercial viability.

A business seeking to obtain an EIB-backed loan (from **Barclays, ING or Santander Central Hispano**) would undergo the same ECRA process as any other potential borrower. Once the bank has made a decision to lend to the borrower, it will evaluate whether or not the screening criteria laid down by the bank, in conjunction with the EIB, have been successfully met.

By contrast, a borrower applying to **UniCredito Italiano** will go through a process of ECRA that is unique to its environmental product. The process is considered in the box below.

Case Study – UniCredito Italiano[13]

UniCredito offers an alternative form of environmental product that was unique amongst the sample of banks surveyed. The bank has developed a specialist environmental loan product that is backed by a pool of funds collected in so-called "Green Bonds", which are sold to large Italian companies.

The product has been designed specifically to encourage small businesses – many of whom are suppliers of to the very Italian companies to whom UniCredito markets the Green Bonds – to develop a certified environmental management system (EMS). Rather than make EMS certification a condition of doing business with them, large Italian companies prefer to encourage their suppliers to be environmentally responsible by steering them towards the UniCredito green loan product. Thus, the bank plays an intermediary role in the process, offering small businesses preferential rates on investment in EMS.

The bank developed the product in consultation with potential bondholders and borrowers, and also offers an advisory service to support EMS development. Green Bondholders accept a slightly below-market return on their investment, on the basis that their deposit is used solely for the purpose of EMS development. In exchange for this lost interest income, these large companies benefit from having their suppliers become aligned with their own business objectives of environmental best practice.

The business benefit for UniCredito consists of developing a pipeline of small business clients whose ability to supply large customers with exacting procurement standards will be enhanced. This enables these small borrowers to grow more successfully and ultimately become better bank customers, in effect jump-starting a virtuous circle.

13 Dal Maso D., Marini, C. and P. Perin (2001) A Green Package to Promote Environmental Management Systems among SMEs. Chapter 3 in Sustainable Banking edited by Jan Jaap Bouma, Marcel Jeucken, Leon Klinkers. Published in association with Deloitte & Touche. Sheffield: Greenleaf Publishing. Pp.56-65.

Factors impacting commercial viability of environmental products

The five participant banks offering environmental products were asked to outline the factors that could influence them to expand or withdraw their specialist products. Environmental products were said to be profitable, and their continued commercial viability was uniformly regarded as key to their retention. Further influences on commercial viability are illustrated in Figure 13.

Barclays, ING and Royal Bank of Scotland all noted that the withdrawal of the EIB could pose a risk to the products' commercial viability. In addition, in each bank, other factors that could influence a decision to withdraw the product included tax breaks available in the Netherlands, possible changes in consumer preferences (e.g. less uptake of ethical or "green" products) and a general shift in bank strategy.

Figure 13. Influences on commercial viability of Environmental Products

Bank	Barclays	Credit Suisse Group	ING	RBOS	Santander	Unicredito
EIB guarantee withdrawn	**Y**	**N/A**	**Y**	**Y**	**Y**	**N/A**
Tax breaks changed	**N/A**	**N/A**	**Y**	**N/A**	**N/A**	**N/A**
Changing consumer preferences	**Y**	**Y**	**Y**	**N/A**	**Eco-efficiency**	**Eco-efficiency**
Overall bank strategy	**Y**	**N/A**	**N/A**	**Withdrawn May 2002**	**Y**	**N/A**
Other influences	**–**	**–**	**–**	**Reputation**	**–**	**–**

Outstanding Issues: Do environmental products contribute to business performance?

The above research has established that environmental products represent only a very small proportion of the banks' overall lending portfolio; that the benefit to the customer is difficult to identify; and that, with the exception of UniCredito Italiano, all banks offering environmental products evaluate the products accordingly to their standard ECRA policy and procedures.

Therefore, are these specialist products:

- A largely immaterial sideline and diversion from the real business at hand, which is cleaning up the core loan business?
- A way for banks to avoid turning away business and still positively encourage good practice?
- An opportunity for the bank to promote its policy commitment environmental best practice and gain PR benefits?

Observations: The Impact of ECRA on profitability

ECRA protects against downside risks by lowering:

- Default (bad debt) risk
- Liability (security) exposure
- Risk to reputation

ECRA can grow the top line by improving:

- The customer's own growth prospects and business strength
- Reputation and customer loyalty
- Staff loyalty and attractiveness to best graduates
- Market share of products promoted on "green credentials"

When is ECRA a drag on resources and profitability?

- Costs of administering ECRA: no participant bank felt that the cost of administering ECRA outweighed its benefits. However, as demonstrated in Section 4, there is a need for banks to improve their performance measurement relating to ECRA which could ultimately impact their view of the costs involved.
- Competitive disadvantage: when borrowers perceive ECRA as an additional burden (rather than a risk-management benefit) and consequently prefer to do business with competitor banks without ECRA processes.

SECTION 7: Shareholder Value and the Future of ECRA

This final section concludes by addressing the impact of ECRA on shareholder value, real or perceived, and the challenges and opportunities that lie ahead for banks as they confront the question of reconciling good environmental practice with financial sustainability.

- **Does ECRA impact shareholder value?**
  This question a key question of this study is extremely challenging to answer. Although lenders believed a link exists between sound environmental credit risk assessment and bottom line results, it was difficult to draw clear links to share price performance. This reflects the fact that ECRA is but one of several risk factors that impact financial performance, and banks, and indeed their shareholders, do not typically track financial results in relation to one single risk variable.

> The overwhelming consensus was that sound ECRA was a fundamental constituent of thorough overall credit risk assessment, and, all other things being equal, environmental risk factors played a potentially material role in financial outcomes.

Indeed, this was cited as the fundamental justification for conducting ECRA in the first place. The impact of ECRA on profitability was discussed not only in terms of a reduction of liability exposure, but also, in some cases, as a potential source of additional revenue generation. These distinctions are considered in detail below.

ECRA's share of importance to overall results may vary depending on a range of external factors (geography, regulation, public awareness, industry characteristics) and internal factors (bank culture and experience), but its importance in the overall risk management framework is well established and, indeed, increasing.

The following comments reflect the range of views expressed in the course of the investigation:

Several banks *"doubted ECRA has a direct impact on share price", but were "convinced it pays off in the long term"* **(Credit Suisse Group).**

On the subject of balancing the costs of developing and administering an effective ECRA capability, one lender observed that:

> "any possible short-term financial loss through introducing ECRA would be offset by sustained growth and long term shareholder value" **(HSBC).**

On the issue of long-term performance, a number of banks (**e.g. Royal Bank of Scotland**), also noted that ECRA could potentially improve the bank's recruitment and retention of quality graduate staff, which ultimately impacts performance although measuring this is extremely difficult and none of the banks reported having attempted to do so.

One bank alluded to ECRA "encouraging socially responsible investment, thus influencing shareholder value" **(Lloyds TSB).**

- **What does the future hold?**
  In the light of growing public awareness surrounding environmental and broader sustainability issues, and the influence of pension fund disclosure legislation,[14] shareholders are increasingly focusing on aspects of environmental risk that might potentially affect business results. Although this study goes a long way in clarifying both the risk factors and management challenges that banks must confront, it is fair to expect that banks will increasingly come under the microscope for their association with environmentally controversial clients and projects.

> It is fair to expect that banks will increasingly come under the microscope for their association with environmentally controversial clients and projects.

Their ability to provide the necessary assurances to their shareholders, to document their environmental exposure and management practices, and to engage pro-actively with a range of stakeholders, will surely reflect positively on them, and benefit themselves and their investors alike.

However, for many banks, as one lender on the starting grid highlighted: *"Environmental credit risk assessment is a cultural issue that requires long-term changes to be made in the bank"* (**UniCredito Italiano**).

The implementation of successful environmental credit risk assessment undoubtedly presents banks with considerable challenges. In addition to addressing some of the operational difficulties highlighted by this report - the need for improvements in training, performance measurement and reporting of ECRA the risks that banks need to address are constantly evolving. Public perceptions play a key role in defining risk, and it is in a company's best interest to keep abreast of how these perceptions are changing. For example, while in the past, issues like sustainable development, environmental management and social impact assessment were largely the domain of industrial companies, there is now growing consensus that the financial community also has a role to play. Similarly, companies are increasingly being scrutinised and held accountable for their actions in the international arena as well as their actions in their home country. Banks that take the first steps to address these challenges, will ultimately be best placed to reconcile good environmental and, going forward, social practice with financial sustainability.

14 Disclosure legislation requiring a statement as to whether pension funds take account of social, environmental and ethical concerns in the retention and selection of shares and voting are in effect in the UK, Germany, Australia, Canada and elsewhere.

Appendix I

Original Guidance Questions and Issues for Discussion

This is not a questionnaire! The list of questions and issues in this document are provided as a provisional guide for interview and follow-up discussions. It is unlikely that all questions will be appropriate to the form of environmental credit risk assessment taking place within your organisation, this is an issue that will be addressed during interviews.

The questions are set out in 4 sections:

1. Scope of Environmental Credit Risk Assessment (ECRA)
2. Method of ECRA
3. Motivation and Influences on ECRA
4. Management and Communication of ECRA
Each section includes a brief introduction outlining its objectives.

At the end of the document is a final discussion point. Please give this your attention.

Participants are reminded that the scope of this study will include personal, retail and commercial lending products, project and other transaction financing. Investment banking, institutional asset management and brokerage services will not be given direct consideration.

As a further guide to discussion, a list of provisional answers or background material may be provided to the research team in advance of the main interview. To assist in the compilation of our final report, please signal during interview any information provided that is confidential or particularly sensitive.

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Scope of Environmental Credit Risk Assessment (ECRA)

The objective of this section is to identify your commitment to environmental credit risk assessment (from here termed ECRA) and the ECRA currently taking place within your organisation.

1. **Please broadly describe the policy framework/ organisational structure that your bank has in place to facilitate the adoption of environmental credit risk assessment.**

   Including all applicable environmental policies and risk policies, provide details of the following:

   - Year of policy adoption?
   - Policy reviews? Please provide dates
   - Policy amendments? Please provide dates
   - Who has ultimate responsibility for the policy (please state their position)
   - Who has ultimate accountability for the policy
   - Scope of policy: Geographic and Product/market segmentation (see guide below as applicable)

2. **Please indicate, by ticking the box provided, which of your Bank's target product markets currently incorporate environmental credit risk assessment (ECRA)? Please provide additional details as necessary.**

By target market category:

Individuals (Personal banking)	☐		
SME (Retail banking)	☐	Larger corporate (Commercial banking)	☐

By sub-category:
Loan finance

Unsecured	☐		
Secured on land	☐	Other secured	☐
Project finance as Recourse	☐	Non-recourse	☐

For Project finance:
Please specify the size criteria applied for assessment of project finance (e.g. <£25million, ≥£25million) and product classification (i.e. how do you book the risk? investment banking or trade finance)

By area: Please repeat if different for each category mentioned above)

Domestic lending	☐	European lending	☐
Global lending	☐	Only environmental products (ie. products marketed on environmental credentials)	☐

The following questions address "environmental products or services" (i.e. products or services marketed on their environmental credentials): please answer if applicable.

3. **Please provide the name of your "*environmental products or services*".**

4. **Please indicate, by ticking the boxes provided, the type of environmental product/services that your Bank offers:**

Green savings	☐	Efficiency loan (e.g. energy)	☐
Green mortgage	☐	Technology loan (e.g. clean)	☐

Please provide brief details of:

- Target market/ customer characteristics
- Screening criteria
- Loan conditions
- Special pricing offers

5. **What are the key drivers behind ECRA? Please rank in order of importance* (from 1 onwards):**

- Regulation
- Income generation
- Default risk minimisation
- Security value
- Reputation risk
- Other?

6. **How does the profit potential of this category of product compare to other product lines? (E.g. is the break-even point/payback period/hurdle rate different from than that of other products, has the asset and liability committee signed off on the profitability of these products or services?) Have other factors been considered to justify the resources allocated to such products? What are they?**

7. **What factors do you foresee impacting on the commercial viability of these unique products?**

   - EIB guarantee withdrawn
   - Tax breaks changed
   - Changes in buying "triggers"
   - Bank strategy
   - Other?

   The following questions address underwriting/ guarantees: please answer where applicable

8. **Is ECRA applied in cases where a product enjoys a third-party guarantee? (E.g. Export credit guarantee, EIB guarantee) If so, how is it adapted to reflect this?**

9. **Is ECRA applied where the bank is not the lead bank in a syndicated transaction? Please provide details of the scope of ECRA and the due diligence procedures applied to lead banks.**

Method of Environmental Credit Risk Assessment

The objective of this section is to gain an understanding of how ECRA is conducted in your organisation and specific 'triggers' that you use to identify environmental credit risk.

1. **Please provide a brief outline of your ECRA process noting the following:**

   - Type of risk identified

     E.g. Direct risks?
     Indirect risks?

   - The primary tool for assessment at each stage

     E.g. Lender/ borrower questionnaire?
     Risk matrix?
     Other?

   - Key issues that are given priority assessment

     E.g. Industrial sectors/ processes?
     Geographic location?
     Contaminated land, and/or air, water?
     Legislation/ compliance issues?
     Environmental certifications?
     Market dynamics?
     Size of borrower?

   - Do you break down your potential customers into environmental risk classifications? If so, what specific factors act as "triggers" which establish the need to proceed to a higher level of risk analysis?

   - What form does the result of the ECRA take?

     E.g. Note on file?
     Influence on credit rating/ ranking?
     Other?

- What impacts may the ECRA have on the terms of the financing or the nature of the overall client relationship?
  E.g. Pricing?
  Loan repayment schedule?
  Additional covenants or waivers?
  Availability of other products?
  Other?

Please repeat this section as necessary if a number of methods of ECRA take place (E.g. where ECRA of an environmental product differs from other products)

In particular, please note any specific conditions which apply to finance underwritten by guarantee/ syndicated finance.

2. Do external advisers play a role in the conduct of your ECRA? If so, what is the profession of such advisers and what function do they provide? How extensively are they used?

3. In what proportion of cases does ECRA involves the use of the following, please state an average percentage (%) for each:

- Manual desktop review?
- Face to face discussion?
- Site visits?
- Site investigation?
- Standard on-line assessment
- Expert (IT) systems analysis?
- Other?

4. Do you formally measure the level of environmental risk within your portfolio? If so, how is this risk measured?

Motivations and Influences on Environmental Credit Risk Assessment

This section examines the drivers behind ECRA and, in particular, seeks to highlight regional similarities and differences.

1. What are the key drivers behind ECRA? Please rank in order of importance* (from 1 onwards):

- Regulation
- Income generation
- Default risk minimisation
- Security value
- Reputation risk
- Other?

*Please note any significant differences in priority between product categories (e.g. Loan Finance, Project Finance etc.)

2. How is ECR linked to other risks, credit or otherwise within the corporate governance procedures of the bank? (e.g. reputational & political risk exposure) Please specify type of risk and association

3. **Please provide additional details on your motives for conducting ECRA:**

E.g.

- Local and European legislation and regulation (e.g. land registration/ liability regimes/ define requirements/ certification requirements)?
- Government incentives (e.g. tax incentives)?
- Reputational risk management?
- Political risk management?
- Exposure to certain customer groups/sectors?
- Competition/ other banks?
- Stakeholder demand?
- Wider demands of society?
- Corporate governance?
- Transparency (e.g. accuracy in reporting of liabilities)?
- Desire to bring down default rates?
- Protection of security value?

Please expand, giving priority to your motives.

4. **Have you any third party affiliations that influence your conduct on ECRA?**

E.g. UNEP
WBCSD
Green parties/ NGOs
Government working groups
Banking associations
Environmental working groups
Other?

Management and Communication of Environmental Credit Risk Assessment

This final section is focused on establishing how you support your commitments to environmental credit risk assessment and the current level of implementation of ECRA within your organisation.

1. **Please provide details of resources made available to support policy implementation, including where available financial cost information.**

E.g.

- Policy and procedural guidance documentation?
  Handbook/manuals?
  On-line procedural assessment in the bank (i.e. bank's intranet)?
  Other?

- Lender training:
  Classes for new lending officers? Number of days? In-house?
  Classes for experienced lenders? Number of days? In-house?
  On-line/ CD-rom training package?
  Video training package?
  Other?

- Technical support team (dept./unit, please indicate external advisers roles*)

- Environmental business advisers?
  Environmental auditors?
  Property valuers incorporating environmental assessment?
  Environmental scientists
  Panel of external consultants
  Researchers
  Other?

- Environmental Help-line
  Bank specialists?
  External consultants?

2. **Do you set targets as part of policy performance review/evaluation? Please comment on examples of performance indicators and performance levels achieved.**

3. **How frequently is policy and implementation reviewed?**

4. **Does your organisation publish information/report internally and externally on its environmental credit risk performance? If so,**

   - What is reported?
   - What is your target audience (E.g. shareholders, brokerage community, employees, customers, regulators, environmental groups)?
   - How often do you report?
   - In what medium do you report
     E.g. Annual report
     Environmental/sustainable development report/other
     Internal newsletter
     Website
     Other

5. **What are the key factors you use to benchmark yourself against other banks?**

6. **What organisational structures/ procedures do you have in place for consultation/ feedback/ continuous improvement?**

Final discussion point:

Do you perceive ECRA to have an impact on your bank's profitability and/or shareholder value? Please provide a statement of opinion and justification for discussion.

Appendix II

UNEP Statement by Financial Institutions on the Environment & Sustainable Development

(As Revised - May 1997)
We members of the financial services industry recognise that sustainable development depends upon a positive interaction between economic and social development, and environmental protection, to balance the interests of this and future generations. We further recognise that sustainable development is the collective responsibility of government, business, and individuals. We are committed to working co-operatively with these sectors within the framework of market mechanisms toward common environmental goals.

1. Commitment to Sustainable Development

1.1 We regard sustainable development as a fundamental aspect of sound business management.

1.2 Believe that sustainable development can best be achieved by allowing markets to work within an appropriate framework of cost-efficient regulations and economic instruments. Governments in all countries have a leadership role in establishing and enforcing long-term common environmental priorities and values.

1.3 We regard the financial services sector as an important contributor towards sustainable development, in association with other economic sectors.

1.4 We recognise that sustainable development is a corporate commitment and an integral part of our pursuit of good corporate citizenship.

2. Environmental Management and Financial Institutions

2.1 We support the precautionary approach to environmental management, which strives to anticipate and prevent potential environmental degradation.

2.2 We are committed to complying with local, national, and international environmental regulations applicable to our operations and business services. We will work towards integrating environmental considerations into our operations, asset management, and other business decisions, in all markets.

2.3 We recognise that identifying and quantifying environmental risks should be part of the normal process of risk assessment and management, both in domestic and international operations. With regard to our customers, we regard compliance with applicable environmental regulations and the use of sound environmental practices as important factors in demonstrating effective corporate management.

2.4 We will endeavour to pursue the best practice in environmental management, including energy efficiency, recycling and waste reduction. We will seek to form business relations with partners, suppliers, and subcontractors who follow similarly high environmental standards.

2.5 We intend to update our practices periodically to incorporate relevant developments in environmental management. We encourage the industry to undertake research in these and related areas.

2.6 We recognise the need to conduct internal environmental reviews on a periodic basis, and to measure our activities against our environmental goals.

2.7 We encourage the financial services sector to develop products and services which will promote environmental protection.

3. Public Awareness and Communication

3.1 We recommend that financial institutions develop and publish a statement of their environmental policy and periodically report on the steps they have taken to promote integration of environmental considerations into their operations.

3.2 We will share information with customers, as appropriate, so that they may strengthen their own capacity to reduce environmental risk and promote sustainable development.

3.3 We will foster openness and dialogue relating to environmental matters with relevant audiences, including shareholders, employees, customers, governments, and the public.

3.4 We ask the United Nations Environment Programme (UNEP) to assist the industry to further the principles and goals of this Statement by providing, within its capacity, relevant information relating to sustainable development.

3.5 We will encourage other financial institutions to support this Statement. We are committed to share with them our experiences and knowledge in order to extend best practices.

3.6 We will work with UNEP periodically to review the success in implementing this Statement and will revise it as appropriate.