

# Your Financial Institution and the Environment

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*“Proactively addressing environmental issues, especially environmental risks to the bottom line of our respective financial institutions”*



We live in an era where the environment is recognised as an important part of virtually everything we do.

Nowhere is the direct impact felt more than in the business community. Whether it is mining, manufacturing, transportation or energy, the business community can be targeted as the primary cause of pollution and other negative impacts on our air, water, open space, and natural resources.

There is a strong connection between finance and the environment.

The environmental risks that confront a financial institution's clients such as violation of laws, responsibility for cleaning up contamination or loss of franchise and brand reputation have an impact on their bottom line and, in turn, can pose risks to your institution.

On the other hand, these same environmental issues can also present opportunities to finance new products, to learn how to build environmentally-based efficiencies into your own operations and to enhance the reputation of your institution.

OTEK believes that a healthy environment is one key to a strong economy and that we all benefit far more from a collective strong economy than by individually cutting corners at the expense of the environment. In this spirit we have prepared this booklet.

OTEK believes strongly in proactively addressing environmental issues, especially environmental risks to the bottom line of our respective financial institutions.

This booklet provides you with an introduction to the approaches that OTEK has developed from years of experience and draws on what we have learned in collaboration with other groups including the Environmental Bankers Association of Australasia (EBAA) and the United Nations Environment Programme Financial Institutions Initiative (UNEP FII).



# What Does “Environment” Mean To A Bank



The word “environment” can bring many images to the mind of a banker - some that are critical to the profitability of the services and products of the bank, some that are helpful for expense control, and some that may seem more discretionary, but are nevertheless beneficial to the bank and the environment in less tangible ways.

In general, OTEK has identified six categories that make up a total definition of environment for a bank. These are:

## Risk Management

The environmental problems of borrowers and equity investments can have serious impacts on the ability to repay debt or realize a gain on investment and, increasingly, negative public opinion on the financing of environmentally high profile projects is impacting the reputations of financial institutions.

## Infrastructure Finance

Financing of environmental infrastructure such as clean water supply and wastewater treatment as well as solid and hazardous waste disposal are examples of environmental financing.

## Internal Operations

Most corporations recognise the benefits of the wide variety of internal environmentally beneficial actions that contribute to bottom line savings and other corporate benefits.

These may include energy efficiency programs, recycling, source reduction and waste minimisation, and programs to educate and engage employees, suppliers and clients.

## Community Responsibility

Financial institutions have a responsibility to the communities in which they operate which can include involvement in environmentally relevant issues through activities such as corporate grant-making, public policy participation, and community volunteering.

## Marketing

Banks can use environmental causes for marketing their services to consumers that are interested in doing business with environmentally proactive companies or by participation in cause-related marketing.

## Sustainable Product Finance

The environmental products and services industry is often in need of financing, particularly for new technologies that can help solve environmental problems.

Proactive financial institutions can play a major part in their successful development.

In addition, banks can have a major impact through financing the redevelopment of contaminated properties (brownfields) and promotion of smart growth methods of greenfield development.

Stand-alone investment products allow a financial institution to offer issue-specific products for customers that wish to make investments aligned with their values.

A comprehensive environmental approach for a financial institution would involve an appropriate combination of all of these elements. However, these initiatives may not all have the same impact, and hence, priority. Our initial focus has been on risk management as it is viewed as having the potential for the biggest and most tangible impact to the bottom line success of our member institutions. Risk management provides a good starting place to build a relevant corporate environmental program at any financial institution, regardless of its size, products, or domestic or global market.



The financial industry is a complex web of organisations offering a wide variety of services including retail, commercial, investment and development banking and insurance to international markets, controlling billions of dollars in cash and assets.

The sheer size and complexity of the business makes it inevitable that the activities of financial institutions will affect or be affected by some aspect of the environment.

We think of environmental risks as being either direct, meaning that the actions of the financial institution itself create the environmental problem (real or perceived) or indirect, meaning that the financial institution is affected by the actions of another party such as a borrower or an investment.

Indirect risks generally are associated with monetary loss related to the extension of credit or investment.

Borrowers can face legal liability for violations of law, have financial responsibility for cleaning up contamination, and can suffer damage to their franchise and brand reputation.

For instance, a borrower may contaminate their real estate collateral that, in turn, creates potential for loss to their lender.

The lender is not directly responsible for the actual contamination but indirectly faces the financial consequences, nonetheless.

Examples of direct environmental risks may include causing environmental contamination at your own facilities that you have to clean up, or publicly supporting an unpopular public policy position that impacts reputation.

For instance, the United States experience has shown us that excessive involvement in a borrower's environmentally sensitive activities, specifically being involved in the operational decisions of the borrower's business, can result in the institution being directly liable for the cleanup of what was thought to be the borrower's environmental problem.

Similarly, if care is not taken to understand and adhere to corporate legal structures, it is also possible for a parent corporation (the bank or its borrowers) to be held liable for the environmental activities of its subsidiaries.

Identifying and managing these liability risks is particularly important for financial institutions operating in multiple international jurisdictions, where corporate and lender liability rules may differ.

Risks also exist for financial institutions involved in investment research and asset management.

Increasingly, financial institutions and investors should be aware of and respond to market data or perceptions that link positive environmental performance to positive impact on shareholder value.

At the very least, the environmental problems of equity investments clearly can affect the ability to realise a gain on investment.

In the future, financial institutions that fail to consider market demand for environmentally focused investment products could be perceived as being remiss in their fiduciary responsibility.

Finally, your financial institution's own operations have environmental risks.

Activities such as disposal of used electronic equipment, management of wastes from printing operations, and recycling of office wastes are subject to environmental laws in many jurisdictions. Failure to comply with these requirements can result in liability or loss in asset value.

In addition, financial institutions involved in the insurance industry have a direct stake in the frequency and severity of claims relating to environmental matters.

Growing concerns about the environment have contributed to a major shift in public expectations about the role of corporations and financial institutions in society.

A financial institution's particular reputation risks will depend on the activities and statements of the institution, and the institution's existing reputation, which has been developed over time among the relevant stakeholders. If subjected to specific scrutiny, a financial institution's reputation will be judged using criteria such as:

- **Credit** - involvement in financing environmentally controversial projects and the degree to which the projects are subjected to some sort of screening (which can, in fact, be the basis for their core environmental credit risk management program).
- **Investment** - incorporation of environmental aspects in the institution's investment advice and availability of environmentally responsible investment products.
- **Internal Operations** - level of environmental management practices, such as waste prevention, recycling and energy conservation and the magnitude of charitable environmental giving programs.

The discipline of risk management was first introduced to business by the insurance industry over fifty years ago.

Financial institutions first applied systematic risk management methods to environmental risks in the United States during the late 1980s in response to the unique legal precedents of the "Superfund" laws.

This liability led to lenders initiating environmental risk programs and due diligence policies, procedures and practices in order to avoid direct environmental liability as well as the indirect financial losses associated with borrowers' liability.

Virtually all of the environmental credit risk management programs include the basic building blocks of risk management - identification, assessment, control, mitigation and monitoring.

Each of these can be successively integrated with conventional credit risk underwriting using the 5 C's of credit: Cash flow, Collateral, Character, Capacity and Conditions specific to considering environmental risk.

## Identification

Risk identification may be completed prior to making a new loan or during the life of the loan. Identifying environmental risks is critical since environmental issues can impact a borrower's cash flow and value of the collateral. These impacts may affect the ability of the customer to service debt.

## Appraisal

Once there is a perception of risk or risks are identified, a lender should try to establish the impact the risk may have on the specific transaction or overall line of business. Institutions consider the many due diligence tools available for assessing and characterising the environmental risks. The environmental impact to the financial transaction must be adequately characterised using available information or new investigations.



## Control

Risk control measures are designed to prevent losses from occurring not just for the financial institution, but more importantly for the customer. Institutions tackle these potential losses by considering the legal, technical and business tools available to minimise the risk. Some of these tools include loan documentation and covenants that require the customer to mitigate risks and evaluate environmental conditions during the life of the loan.

## Mitigation

Environmental risks may be mitigated either prior to or during the life of the loan. One of the tools that may be used by the financial institution involves the transfer of risk to another party, either through contractual documents or insurance.

Banks should consider whether or not they will manage these internally (self-insure) or transfer the risks through environmental insurance mechanisms. Protecting bank assets and net income from environmental risk can also be achieved with risk financing techniques through the employment of environmental indemnifications, holdbacks/escrows, or letters of credit.

## Monitoring

Monitoring should be an integral part of any financial institution's risk management system. With risk monitoring, the systems for tracking the loan or loan portfolio life cycle that are already implemented for traditional risk management can also be used to monitor the environmental conditions at a site.



Risk assessment is a scientific methodology endorsed in Australia and internationally to manage site contamination.

There are opportunities for financial service companies both large and small to take part in practices that are sustainable and contribute to the bottom line.

In reality, most financial service companies are already involved with these practices but may not realise how they contribute to sustainability.

## Facility Management

Financial institutions operate real estate portfolios that range from one or two buildings to vast numbers of retail branches and large high-rise operation centers.

**Energy efficiency issues are at the core of cost savings and the need to ensure maximum resource use.**

Power consumption including heating and cooling, transportation, waste management and source reduction all provide opportunities for eco-efficiency.

For instance, financial institutions consume significant volumes of paper.

We have the ability to manage paper production and consumption from forest to mill to desk and back to the mill for recycling, resulting in efficiency that directly contributes to the bottom line and shareholder value.

The logical next step is to understand that environmentally focused property management practices all are contributors to the making of an environmentally sustainable financial institution.

## Products

There are market-based solutions that encourage sustainable development and provide positive solutions for environmental challenges.

Many financial institutions have found an under-served market niche created by the desire of the investor to act as a responsible global citizen through the power of their investments.

**Issue specific investment products including socially responsible investment strategies, eco funds and green investments allow financial institutions to tap new markets, provide customers with sustainable investment choices and generate revenue.**

Other markets are created from new products and services such as the demand for recycled material or components associated with energy efficient products such as

photovoltaic cells, geothermal and fuel cell technologies.

In addition, larger infrastructure projects associated with clean water supply, wastewater management or solid waste disposal demand specific knowledge and financial expertise.

As an example, a small 20-employee US based company may supply a developing country in Asia with a specific component for a wind turbine.

The global market fosters this type of trade and financial institutions take advantage of this kind of environmental market niche as an opportunity to create a dynamic new line of business.

## Community

We can benefit our communities and, in turn, our standing in our communities through actions such as public policy participation, employee volunteering, and promotion of positive community reinvestment.

**Brownfield lending is an example of how financial services directly benefit under-served communities.**

Brownfield sites are typically located in urban areas; these often idle or abandoned properties represent sites that were once economically strong centers of commerce and business.

Using their expertise and specific knowledge related to contaminated real estate redevelopment, institutions have financed hundreds of millions of dollars in brownfields redevelopment, resulting in cleanup of contaminated real estate, providing business access to under-served urban markets and creating jobs.

## Marketing

Many environmentally beneficial organisations and causes raise funds for their activities through partnerships with businesses including financial institutions.

Examples include cause-related marketing associated with credit cards or other retail banking services where the company gets the visibility and public relations benefits of the partnership and some portion of the revenues go to the environmental cause.

Even without such partnerships, promotion of the environmental actions of the financial institution, whether related to core business or internal greening, can result in marketing advantage to the growing base of environmentally conscious clientele.

## Corporate Integration

Unfortunately, emergencies by their very nature happen unexpectedly and we are inadequately prepared.

A growing number of financial institutions have recognised the benefits of integrating environmental issues into company strategy and developing an organisational commitment to conducting business in an environmentally responsible manner.

While this process is relatively new for many, there are existing mechanisms and best practices available which may assist banks in making their commitment to the environment operational.

A starting point is a corporate environmental policy statement.

### Corporate Statements and Policies

Many manufacturing and retailing industries companies have had environmental policy statements for the past decade or so.

More recently, financial service institutions are getting on board.

**Statements serve to transparently affirm a corporation's dedication to environmental stewardship.**

They deliver a message for both employees and external stakeholders, and can be general or specific depending on how far along an institution is in articulating and acting on its environmental commitment.



## Environmental Reporting

Effective environmental management and certified Environmental Management Systems (EMS) including ISO14001 can provide unique business advantages and bottom-line savings for companies that are seeking a competitive edge over their opposition.

Corporate Environmental Reports are used to demonstrate company-wide, integrated environmental management systems, corporate responsibility and the implementation of voluntary initiatives and codes of conduct as stated above.

Obtaining information for a corporate environmental report may be a challenging task.

However, the process itself encourages a financial institution to think about its information management system and realize how much it is already doing regarding environmental stewardship.

Reporting is a good way for a company to track its own progress and identify internal strengths and weaknesses.

**By initiating environmental reporting, a bank may put into place processes and systems that can help gather information and make the firm more efficient.**

Facts often covered in corporate environmental reports include:

- environmental policies and systems
- indicators of environmental/social/economic performance
- financial implications of environmental/social/economic actions
- relationships with stakeholders
- sustainable development business opportunities
- business initiatives that support environmental/social/economic development

Producing an environmental report may lead to internal and external benefits for a financial services institution.

Internally, employees are often pleased to learn that the bank they work for is environmentally engaged and the report serves to boost company morale.

Senior management is better able to learn and speak knowledgeably about the company's environmental program, including its many benefits to the corporation.

Externally, many individuals and organisations are increasingly asking banks to provide environmental reports and they may find that reporting is a good way to respond to environmental criticism.

Furthermore, reporting gives a bank the opportunity to demonstrate environmental leadership.

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