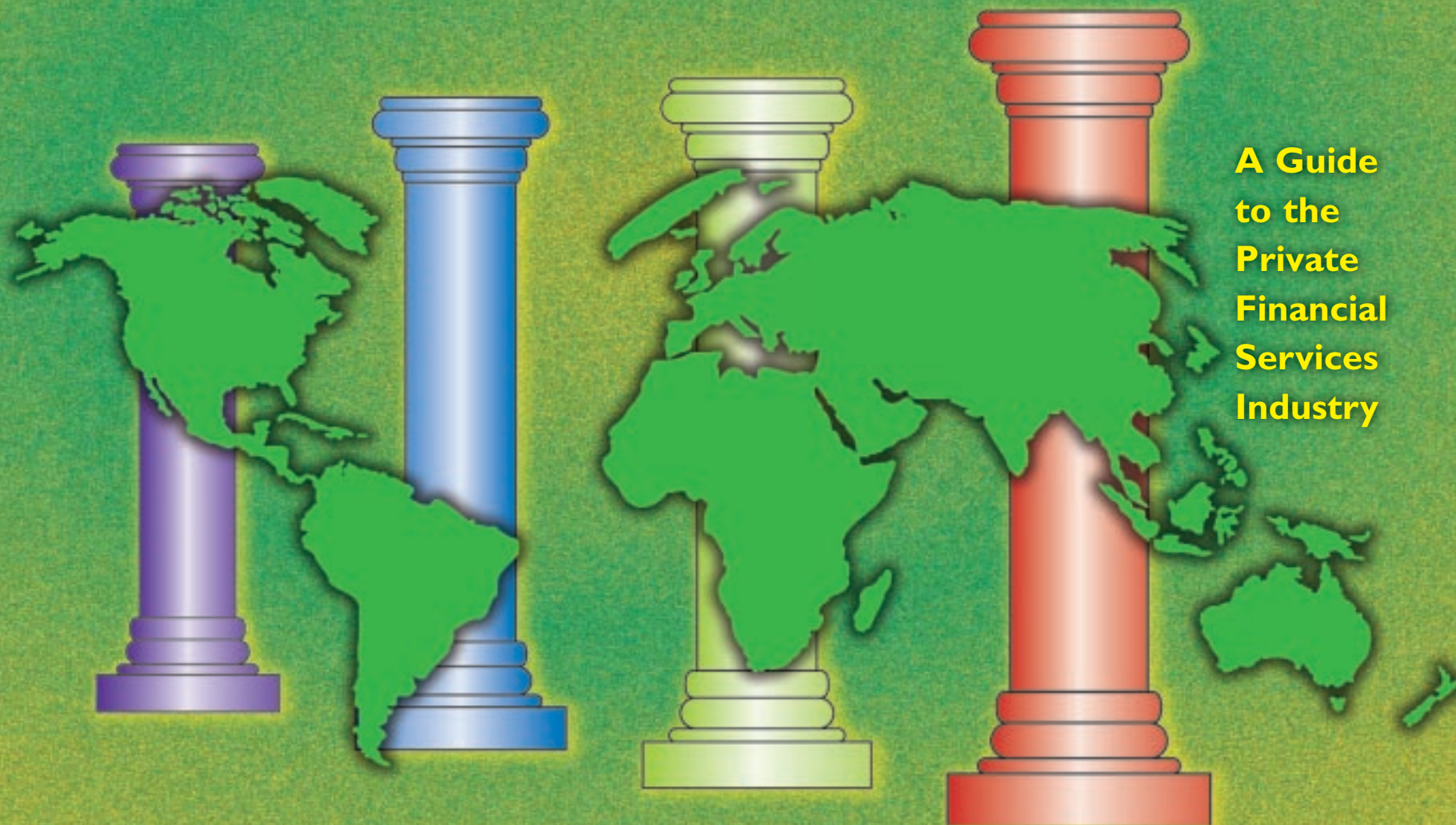


LEVERAGE FOR THE ENVIRONMENT



**A Guide
to the
Private
Financial
Services
Industry**

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Private
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Services
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**World Resources Institute
Washington, D.C.**

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FOREWORD

In the years since the Earth Summit in Rio, accelerated financial globalization has compounded the challenge of reconciling economic growth with environmental sustainability. Over this period, capital flows to developing and transition countries have risen dramatically, and their composition has changed in significant ways. Among the most important changes in the development finance landscape has been the absolute and relative increase in private capital flows to developing and transition countries. As recently as 1992, public financial flows were greater than private flows; by 1996, private flows were more than five times larger. For the public interest community, this shift implies the need to look beyond engagement with bilateral aid programs and multilateral donor agencies such as the World Bank in order to influence development finance decisions that are increasingly made in the private sector.

The strategic planning phase of the International Financial Flows and the Environment (IFFE) project was initiated in 1997 by the World Resources Institute (WRI) and World Wildlife Fund, with support from the C.S. Mott Foundation and the Wallace Global Fund, as a first step toward understanding the rapidly changing landscape of development finance. The purpose of the project is to identify the most promising avenues of inquiry and advocacy for public interest organizations concerned with how international financial flows affect the environmental sustainability of developing and transition economies, as well as the social and economic dimensions of environmental concerns.

Early on, the IFFE project identified portfolio flows as one of the fastest-growing and least understood components of increasing private capital flows to developing and transition economies. Analysts attribute this explosion to both “push” and “pull” factors: individual and institutional investors in industrialized countries seek higher returns and diversification by investing abroad, and new investment opportunities are created by the liberalization of so-called “emerging market” economies. It is important to note, however, that these changes are not spread evenly across developing and transition countries. Some 80 percent of private financial flows in the first half of the 1990s were captured by only 12 emerging market countries, none of which was in Africa. (World Bank. *Private Capital Flows to Developing Countries: The Road to Financial Integration*. 1997.) Portfolio flows have been relatively more prominent in Central and Eastern Europe and Latin America than in other regions, in part due to large-scale privatizations of state-owned enterprises.

Whatever their genesis and despite their current geographic concentration, the increase in portfolio flows as part of the broader increase in private capital flows has raised the question of how public interest organizations might influence international capital markets to promote investments in environmental sustainability. The information provided in this guide is thus designed to illuminate this one small area of the development finance landscape—the private financial services industry—for members of the public interest community seeking to understand and influence how investors think.

Jonathan Lash
President
World Resources Institute

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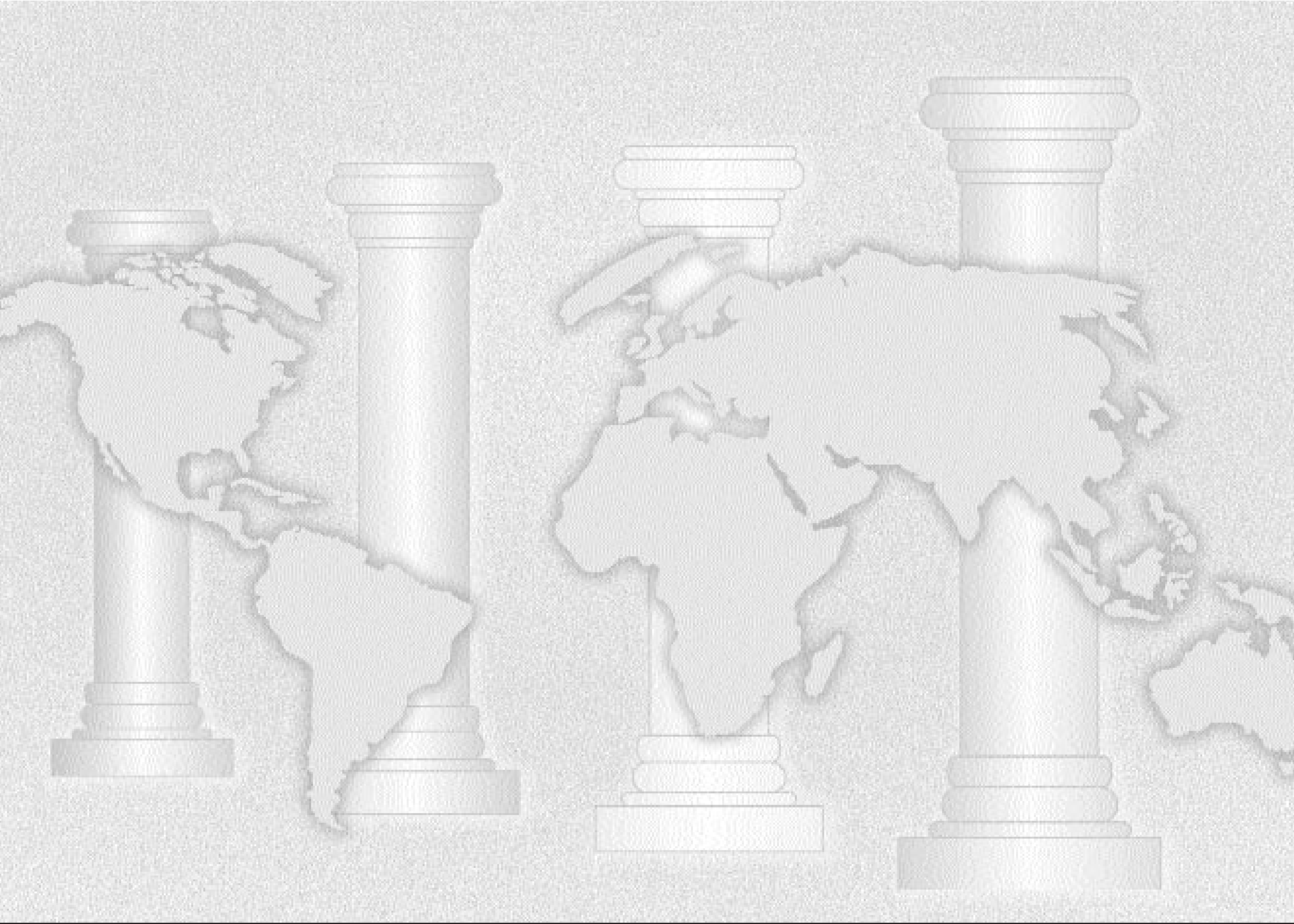
Many individuals contributed to the conceptualization and refinement of the materials during initial brainstorming sessions and subsequent reviews. Each industry segment was informally reviewed by at least three professionals active in that industry. Special thanks are due to Bradford Gentry of Yale University and Don Reed of WRI for providing extensive comments on the manuscript.

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INTRODUCTION

I. INTRODUCTION

BACKGROUND

This guide is designed to acquaint members of the public interest community with the inner-workings of the private financial services industry so that they will be able to communicate to financiers the importance of environmental issues and promote environmentally sustainable development paths in developing and transition economies. The materials assume that readers have no prior knowledge of the industry and attempt to provide the nonspecialist with the minimum level of information and understanding necessary to participate in a strategic planning discussion. As noted by one reviewer, these materials look with binoculars at institutions and transactions that are usually studied under a microscope. This guide is intended to help readers generate the right questions about designing a strategy for influencing the private financial services industry rather than supplying the right answers or selecting particular tactics.

Scope of This Guide

This guide focuses on the activities of the private financial services industry, which is only one part of the global finance landscape. It does not address public international financial institutions such as multilateral development banks or bilateral export credit agencies, except where operations of these public entities intersect with private financial transactions. This guide focuses on financial flows that enter capital markets, and thus does not treat foreign direct investment by operating companies, which currently represents the most significant component of total private transboundary financial flows to developing and transi-

tion economies. Similarly, this guide does not cover private transfers, such as investments made by “angels,” wealthy individuals who invest significant sums directly in private enterprises. Rather, the focus is on mainstream financial institutions and instruments and not on so-called “socially responsible investment” (SRI) vehicles, although SRI trends are discussed where appropriate. In the context of strategic planning, the reader should consider the potential impact of leverage points within the private financial services industry relative to opportunities for influence in these other public and private investment arenas. Finally, this guide is not intended to be comprehensive, nor to serve as a “how-to” guide for advocacy directed at the financial community.

Variations Across Countries

Because international capital markets are concentrated in industrialized countries and there is only limited information on such activities in non-industrialized countries, this guide is based on how the financial services industry operates in the United States. Accordingly, readers must keep in mind the huge variations across countries in terms of opportunities to influence the behavior of private investors, creditors, and underwriters. In emerging market economies, regulatory frameworks, information disclosure requirements, and enforcement capacity are likely to be less well developed in both the financial and environmental spheres than is the case in industrialized countries. For example, the threat of being held legally liable for environmental damage has been a critical factor in getting the U.S. commercial banking and insurance sectors to pay attention to environmental issues. However, in countries where environmental standards and judiciary systems are weak, the financial industry faces a different set of incentives.

Segments of the Industry

This guide introduces readers to eight segments of the private financial services industry: commercial banks, investment banks, mutual funds, pension funds, property and casualty insurance, life insurance, venture capital, and foundations. The first six capture the largest financial services industry segments or vehicles in terms of the magnitude of assets that they control or manage. They are presented in order of relative size.

Bonds, which are an increasingly important source of finance for developing country governments, are discussed briefly in the investment banking segment. The venture capital industry is presented because it is a rapidly growing and evolving area in developing and transition economies, it is linked to international financial institutions such as the World Bank Group's International Finance Corporation, and it is highly flexible due to lack of regulation and high tolerance for risk. Foundations—which make both programmatic and endowment-related investments—are presented as an example of institutional investors of particular interest to the public interest community.

Some of the eight segments are defined by type of institution (e.g., commercial bank); others are defined by type of vehicle (e.g., mutual fund). Note that the lines separating these various types of financial institutions have become increasingly blurred, and therefore their definition should be understood at the functional level of an operating business unit. The eight segments include principal examples of financial institutions that provide the three types of financial service functions: credit extension, equity investment, and underwriting activity. Extenders of credit, such as commercial banks, provide debt financing by making loans to enterprises; investors, such as pension funds, provide equity to enterprises by purchasing stock in companies; risk underwriters, such as property and casualty insurers, help enterprises manage risk by receiving premiums in exchange for compensation of loss. Note, however, that many of the segments are in at least two businesses. For example, the property and casualty insurance industry is in the risk underwriting business, but this industry is also a significant investor in capital markets.

HOW TO USE THIS GUIDE

This guide contains one chapter for each of the eight industry segments with the following information available on each type of financial institution:

Profile

- **Introduction:** What is the industry? What services does it provide? How does it make money?
- **Size and Leaders:** What is the relative size of the industry globally, and which are the most prominent firms?
- **Key Features:** What else is important to know about the industry? What is the industry's risk tolerance and time horizon? What are significant variations and trends in the industry?
- **Regulation:** How is the industry regulated, and what information disclosure is required?
- **Attention to Environmental Issues:** To what extent does the industry currently integrate environmental factors into its decisionmaking?
- **Relevance to Developing and Transition Economies:** What activities of the global industry influence industry operations or capital flows to nonindustrialized countries? To what extent is a domestic financial industry developed in these countries?

Each sector profile also includes a bar chart depicting that segment's regulation, time horizon, risk aversion, and availability of information. We assume that a higher degree of regulation and information availability provide external actors with more opportunities for influence, and that more risk aversion and longer time horizons increase the relevance of environmental considerations to financial decisionmaking.

Diagrams

For each industry segment, this guide presents a diagram that shows flows of capital and information between the industry segment and external actors. The diagrams use a common set of symbols, as illustrated in *Figure 1.1*:

- **Cross-hatch shading** represents the diagram's starting point, or where demand for the financial service originates.
- **Blue boxes** represent the financial entity. Within the blue box, there is a central decisionmaker and the entity's main operational units.
- **Orange boxes** represent the corporate client.
- **Black boxes** represent entities external to the firm or vehicle.
- **Yellow boxes** represent activities.
- **Green circles** represent sources or uses of capital.
- **Green arrows** represent flows of money.

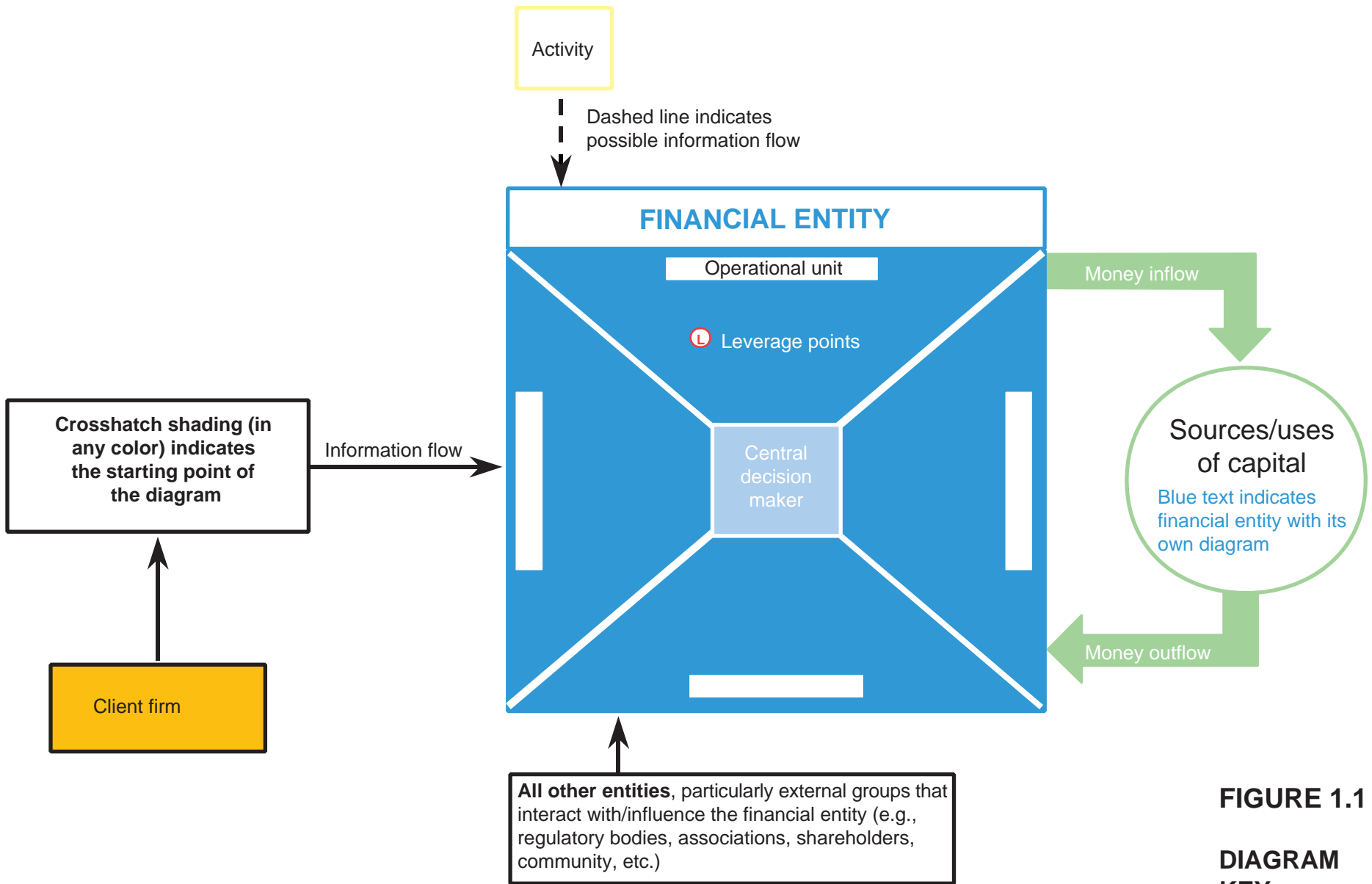


FIGURE 1.1

DIAGRAM KEY

- **Black arrows** represent flows of information or influence.
- **Dashed arrows** represent optional flows of information.
- **Red circles with a letter “L”** represent potential leverage points.

The diagrams provide a visual “map” of the relationships among various actors internal and external to the industry segment. Each diagram is accompanied by an explanation that guides the reader through the diagram’s various elements and discusses the activities and roles played by the various functional participants in a transaction.

Leverage Points

For each industry segment, we have identified a preliminary list of potential “leverage points” for influencing various actors to integrate environmental considerations into decisionmaking. The identified leverage points are intended to serve as a starting point for discussion by the public interest community in the context of strategic planning, and are not intended to be comprehensive or prioritized.

The guide focuses on leverage that external actors can exert on the private financial services industry. In some cases, however, we have also noted opportunities in which the financial services industry itself can exercise leverage over capital markets or over other corporate entities. For example, the proxy power held by pension funds and foundations is identified as a leverage point to influence the operating companies in which these institutions hold shares. Leverage points are described in this guide in terms of four types: bottom-line leverage, policy leverage, reputational leverage, and values-based leverage.

Bottom-line leverage uses information or analysis to demonstrate to financial decisionmakers that taking environmental performance into account will directly result in improved financial performance. Bottom-line leverage appeals to a decisionmaker’s desire to avoid environmental risk and identify new profitmaking activities. It is important to stress that most professionals in the mainstream financial services industry—including fund managers, analysts, financial advisors, and ratings agencies—are interested in environmental considerations *only* to

the extent that they can be translated into financial gains or losses. Unfortunately, empirical data and analysis conclusively linking environmental and financial performance remain limited and are inadequately disseminated throughout the financial community.

Policy leverage exploits the sensitivity of financial decisionmakers to changes in regulations or to taxation consequences related to environmental performance. Legislators, courts, and government agencies set the “rules of the game” for standards to be achieved, for information to be disclosed, and for remedies for noncompliance. Tax policies provide incentives or disincentives for certain kinds of investing, lending, and underwriting behavior. Some types of policy leverage—such as banning certain pollutants or imposing a carbon tax—affect the financial services industry indirectly through their impact on corporate valuation. This guide focuses on regulatory or tax-related leverage points specific to the financial services industry.

Reputational leverage exploits the sensitivity of financial decisionmakers to information or analysis that demonstrates that taking environmental performance into account—or failing to do so—will have an impact on a financial institution’s public image (and thus perhaps indirectly on the bottom line). Actions that generate positive or adverse media attention are examples of reputational leverage. Firms that have a high level of brand name recognition—such as a commercial bank with a significant consumer base—are more susceptible to reputational leverage.

Values-based leverage exploits the willingness of individual and institutional investors to promote environmental values even at the possible expense of financial value. The socially responsible investment (SRI) movement has utilized this leverage to deny funds to corporations that cannot pass various social and environmental “screens,” and to attract funds for socially or environmentally friendly companies.

Case Studies

Each chapter in this guide includes a case study that illustrates how leverage was applied to or by the financial services industry in the

interest of environmental change. Each case study presents the background to the case, the action taken to effect change, the resultant outcome, and an analysis of the type of leverage exercised and its effectiveness.

Available Information and Bibliography

For each industry segment, we suggest places to find additional information—particularly on the Internet—and list the sources we found most useful in compiling the industry-specific information.

Key Concepts

This guide is designed to be accessible to a relatively sophisticated layperson, such as the average reader of *The Economist*. Set out below are definitions of a few key concepts to ensure a common understanding of terms.

Debt versus equity. There is an important distinction in capital market transactions between debt and equity. A debt transaction involves a loan, mortgage, bond, or other instrument that requires the borrower to repay the lender in full plus interest. In a public equity transaction, the investor purchases a share of a company, for example in the form of stock, the value of which will vary over time. Possession of equity in a public company usually implies a degree of shareholder control, which can be exercised through shareholder resolutions and voting of proxies. Large companies or projects in developing or transition economies often utilize a mixture of debt and equity to finance their activities. In general, companies in Asian countries have tended to rely heavily on debt finance, while Latin American companies have tended to seek equity investment from capital markets.

Bonds. A bond is a security issued by a corporation or a government, and purchased by an investor. The bond-issuer is obligated to pay the bondholder interest on the principal at a specified rate and to repay the principal at a specified point in time. For this reason, bonds are often referred to as “fixed-income” investments. Bonds are an important means by which corporations and governments raise long-term capital. On

the investor side, because bonds provide predictable income they are the preferred investment vehicle of the life insurance industry, property and casualty insurance industry, and most pension funds.

Underwriting. The term “underwriting” has two distinct meanings in the financial services community, one associated with investments and one with insurance. From an investment perspective, underwriting is the role played by investment banks when they agree to arrange for and guarantee to buy at a set price a new debt or equity security issued by a corporation or a government entity with the intention of selling the security via a private placement or in the public market. Profit is realized by underwriters based on their ability to sell the security at a price higher than the guaranteed purchase price. From an insurance perspective, underwriting is the role played by insurance companies when they assume the financial risk of paying claims for loss or damage suffered by a client in exchange for the client’s payment of premiums to the insurance underwriter. The profit realized by insurance underwriters is a function of their ability to estimate accurately the frequency and magnitude of claims that will need to be paid and adjust the price of coverage accordingly.

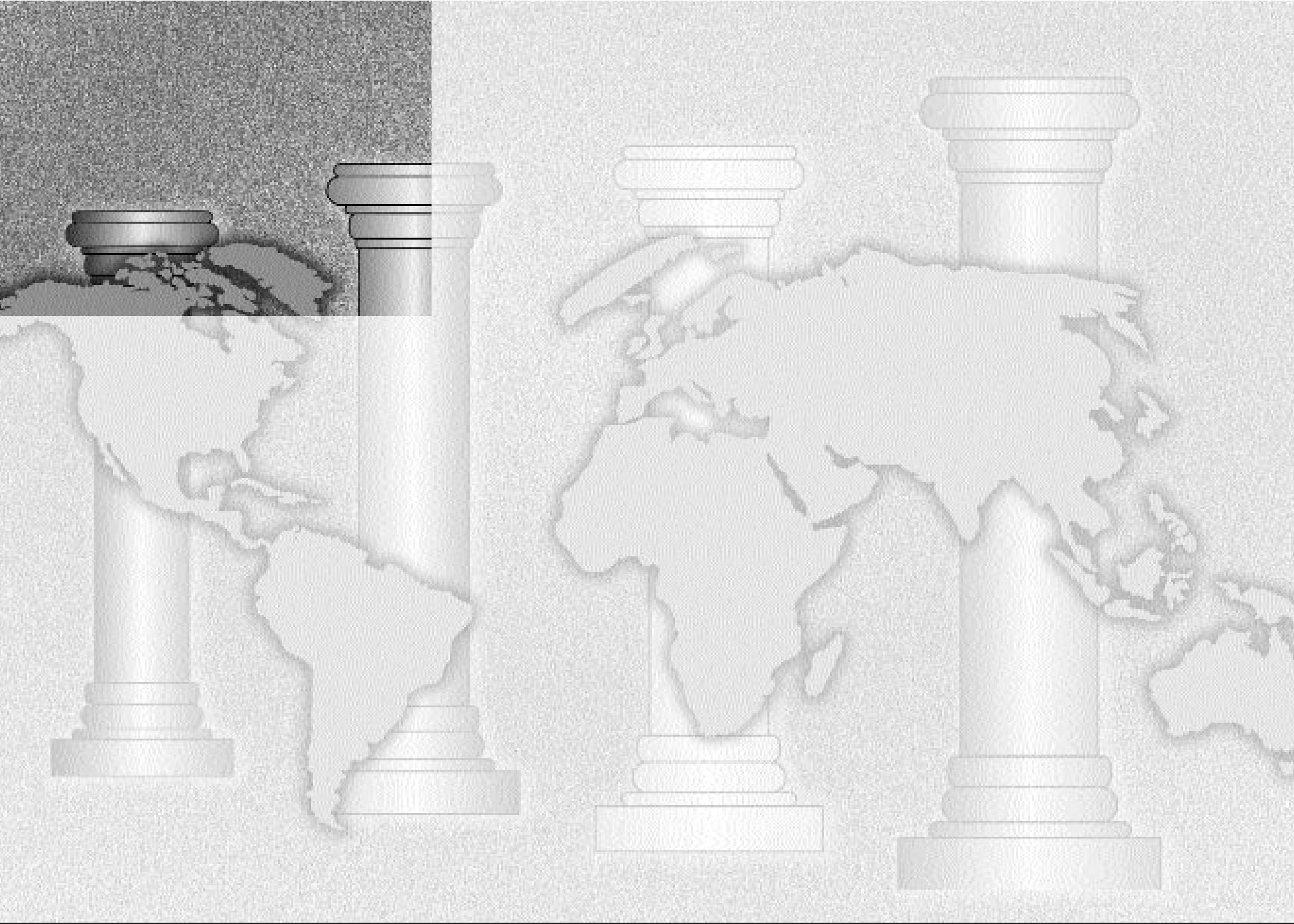
Risk management. Risk is the perceived chance for a measured increase or decrease in the value of an asset over time. With greater risk, the rational investor demands a greater rate of return. For example, a venture capitalist takes enormous risks by investing in new companies and expects a return of up to ten times or more on the initial investment. In contrast, individuals who put their savings in U.S. commercial banks face virtually no risk and thus earn only a nominal interest rate. Investors often try to diversify their asset holdings to spread risk and usually seek to reduce risk through acquiring additional information about their assets. The mainstream financial services industry tends to perceive environmental considerations in terms of increased risk—for example, potential liability for clean-up costs or negative public relations from an environmental disaster—rather than in terms of the potential for improved environmental performance to generate increased returns.

Intermediation. The private financial services industry is based on the concept of intermediation, that is, an institution serving as a go-between on behalf of parties seeking financing and others seeking a return on capital. Financial intermediation involves making decisions about how to manage large volumes of other people's money. Typically, institutional investors such as pension funds or foundations delegate investment discretion to an asset manager or team. Mainstream asset managers understand their role to be maximizing financial return, and thus do not take environmental considerations into account unless they understand that those considerations will affect financial return or they are specifically directed otherwise.

Securitization. Securitization is the repackaging of multiple individual assets that are too small or risky to attract investors if sold one by one. The assets, such as mortgages, are bundled as bonds or other financial instruments for resale in the secondary market. Some observers see the trend toward increased securitization as an important opportunity to package small, environmentally friendly investments (such as those in energy efficiency) in ways that are more likely to attract financing from international capital markets. Others are concerned that securitization severs the direct link between investors and enterprises, rendering asset holders less likely to know or care about the environmental and social impacts of their investments.

Glossary

The glossary provides additional definitions of a select number of commonly used terms. It was compiled from Barron's *Dictionary of Finance and Investment Terms*.



COMMERCIAL BANKS

2. COMMERCIAL BANKS

PROFILE

Commercial banks are institutions that primarily accept deposits and extend credit to serve consumer and corporate needs for capital (1). In contrast to most other financiers, commercial banks extend credit rather than taking an investment position in a corporate enterprise. Commercial banks receive deposits in two main ways: (a) consumer or commercial deposits, and (b) central bank and other bank deposits. Commercial banks generate revenue from the interest charged to consumers at rates above those received, and through a variety of customer service fees. *Figure 2.1* summarizes four key characteristics of commercial banks of particular importance to the public interest community.

Size and Leaders

Commercial banks, which exist in nearly every country, represent the largest individual pool of available private sector capital in the world, the majority of the world's debt financing, and the largest global funding of project finance activities. Globally, 10 of the top 25 commercial banks (in terms of total assets and deposit holdings) are from Japan. They include the Bank of Tokyo/Mitsubishi (BTM), Dai-Ichi Kangyo, and Sumitomo. The other leading commercial banks are from Germany, Switzerland, the Netherlands, the United Kingdom, China, and the United States. They include the Union Bank of Switzerland (Switzerland); Chase Manhattan (U.S.); Hong Kong Shanghai Bank, or HSBC (U.K.); Barclays Bank (U.K.); Deutsche Bank (Germany); ABN Amro Holdings (the Netherlands); Bank Nationale de Paris, or BNP (France); Societe Generale (France); and Citigroup (U.S.) (2). Many of

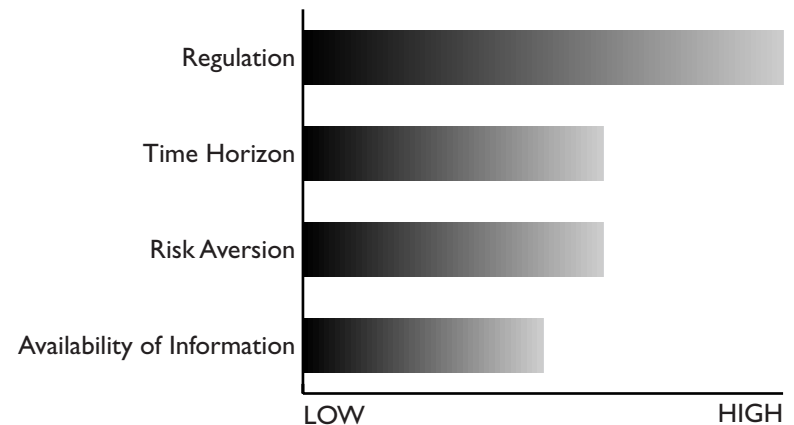
the large domestic commercial banks in developing countries are government-controlled, such as the Industrial and Commercial Bank (China).

Key Features

The focus of commercial banks on debt finance rather than on investment results in three specific characteristics. First, a bank is more interested in the borrower's cash flow and ability to repay the loan with interest than in the underlying value of the borrower's assets. Second, a bank is linked to the physical assets of the borrower only if those assets are pledged as collateral. Third, a bank is not always able to sell its involvement with a borrower to a third party.

In years past, banks tended to make loans and extend other forms of credit, and then waited for the borrower to repay the money. In the modern banking era, many credit extensions (although usually not project finance transactions) are sold to servicing agents or bundled together with other similar debt instruments (securitization) and sold in the secondary market to other financial intermediaries, thus spreading the financial risk. This practice is most frequently done with high volume, low value, standardized loans such as mortgages and credit cards.

Figure 2.1 Key Characteristics of Commercial Banks



Project finance refers to any large long-term loan specifically tied to a particular capital-intensive project, with future project cash flows serving as the primary source of repayment for the loan and the physical assets of the project serving as the primary collateral for the loan. One of the objectives of the corporate borrower in the structuring of project finance is to limit or eliminate the recourse nature of a project—the direct liability of the corporate project sponsor in the event that the borrower defaults. So-called “nonrecourse” financing limits the potential liabilities of a project finance deal to the project itself and provides no obligation for the sponsoring corporation to repay the debt if the project fails. “Limited recourse” is usually a more accurate description than nonrecourse, because most project financings have some degree of recourse to the sponsoring or equity entities (3). Recourse liability in project finance deals can be allocated to third parties (public or private) through various credit enhancement guarantees.

Project finance funding is traditionally designed for 10 to 15 years, but it can have a term of 30 years or longer, with the amount rarely less than US\$10 million. If the risk is to be spread, the commercial bank will typically form a loan syndication, that is, a group of several commercial banks working together on a deal prior to loan approval. The syndication can occur at any point up until the transaction is closed with the borrowing corporate client. Chase, the largest underwriter of project finance in the world, underwrote 92 projects in 1996 totaling US\$8.75 billion (4).

Regulation

Commercial banks, particularly those in industrialized countries, are heavily regulated institutions. The central bank (in the United States, the Federal Reserve System) is usually the single most important regulator. The central bank sets overall monetary policy for the country, controls the country’s currency, and oversees any major regulatory or compliance issues that may face the commercial bank in its lending and other credit-related activities. At the international level, the Bank of International Settlements (BIS) serves as a forum for central bankers—primarily from industrialized countries—to discuss international regu-

latory standards and coordinate central bank policies. For example, the Basle Accord on guidelines for assessing the capital adequacy of banks operating globally was formulated under the auspices of the BIS (5). In the United States, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) are also significant in that they provide regulatory/audit guidelines and monitor currency flows. The OCC implements the Uniform Financial Rating System, referred to as “CAMELS,” which examines capital adequacy, asset quality, management administration, earnings, liquidity, and sensitivity to market risk (6). Banking regulators in the United States are served by an umbrella organization called the Federal Financial Institutions Examination Council (FFIEC). This council requires U.S. banks to disclose international lending data by country. This information is made public in the “Country Exposure Lending Survey,” which reports aggregate loan flows by country of destination. Individual bank exposures remain confidential (7).

Attention to Environmental Issues

In the United States, commercial banks ignored environmental issues until the advent of the so-called Superfund liability. In the spring of 1990, a U.S. court found a bank liable for the clean-up costs of a site contaminated by a corporate client of the bank, on the grounds that the bank was in a position to influence decisions made by the corporate client. As a result, nearly all major U.S. and Canadian banks have invested time and money establishing and maintaining an environmental due diligence process for any loan for which real estate serves as the primary source of collateral. European banks, and a few Asian and Australian banks, have followed suit. Some have also placed more emphasis on identifying possible opportunities for increased lending to firms with “good” environmental performance based on management, regulatory compliance, and other selection criteria. Of the largest commercial banks, the following are most often mentioned as the leaders in voluntarily integrating environmental considerations into their lending practices: NatWest Group, Bank of America, Royal Bank of Canada, Credit Suisse, Union Bank of Switzerland, HSBC, Barclays, Deutsche Bank, Sumitomo Bank, and Westpac.

Few countries at present have any direct legal environmental requirements or regulations for commercial banks. However, guidelines published by the FDIC in the United States in 1993 require all banks to reserve a senior-level position for environmental risk management. The central banks of a few other countries such as the United Kingdom, Canada, and Switzerland have provided similar guidelines. World Bank environmental 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 the default standard of environmental assessment from which a bank may model a minimal standard of its own (8).

Since 1991, the United Nations Environment Programme (UNEP) has worked with the international banking industry to encourage integration of environmental practices and management into banking operations. At this writing, there are 115 signatories to the UNEP Statement by Financial Institutions on the Environment and Sustainable Development. (See Chapter 10, Box 10.1.)

Relevance to Developing and Transition Economies

Commercial banks in industrialized countries are providing loans to the developing world to support the construction of roads, power generation projects such as dams and coal-fired powerplants, and other projects with significant environmental and social impacts. The structure of a limited recourse finance project in a developing or transition country may include a public sector guarantee from a bilateral or multilateral financing source, such as the U.S. Overseas Private Investment Corporation (OPIC) or the World Bank Group's Multilateral Investment Guarantee Agency (MIGA). In 1995, the World Bank Group supported about US\$25 billion of private sector finance, amounting to approximately 10 percent of all investment by private enterprise to developing and transition economies (9).

Worldwide, new commercial bank loans to developing countries totaled US\$34 billion in 1996 (10). Japanese banks, with US\$495.3 billion in outstanding loans, account for the largest aggregate lending to

developing and transition economies. European banks rank second with US\$167.5 billion. U.S. banks, however, are experiencing the greatest rate of increase in this sector, growing 10.4 percent during the first half of 1996 to US\$114.9 billion. Lending to the developing world by U.S. banks is concentrated among a few institutions such as Bank of America, Citigroup, and Chase (11). According to the *American Banker*, Asian borrowers rely heavily on commercial bank loans for capital needs whereas Latin American borrowers rely increasingly on capital markets; three-quarters of new commercial bank lending activity in 1996 took place in Asia (12). By the close of 1997, however, net lending to Asia appeared to have dwindled to zero as a result of the currency crisis in the region (13).

COMMERCIAL BANK DIAGRAM

Figure 2.2 illustrates a commercial bank's role in a **project finance** transaction. Project finance is depicted for the following reasons: (a) it is the primary focus of lending into developing and transition economies, and (b) it is long term in nature and thus more likely to be influenced by environmental concerns. Each project finance transaction begins with the need for funds by the **corporate client**, the **borrower**. The demand for credit extension usually begins with the **client** contacting one of its commercial banks to discuss various financing options available for the particular need. This may be a new banking relationship, but normally it is an expansion of an existing one. The typical transaction involves the building of a structure (e.g., dam, manufacturing plant, resort) with the revenues generated from the sale of products or services produced paying off the loan and the interest due.

The **corporate client**, represented by the **Chief Financial Officer (CFO)** or his or her designee, approaches the **commercial bank** via an **account officer**, usually in geographic proximity to the potential borrower. The **account officer** functions as the **corporate client's** representative in dealing with the bank's internal review and approval of the transaction. The **local community** (NGOs, **government**, **business**) where the corporation is operating may be in contact with the corporate client through the **facility manager**, **external advisors**, or **legal and technical staff**.

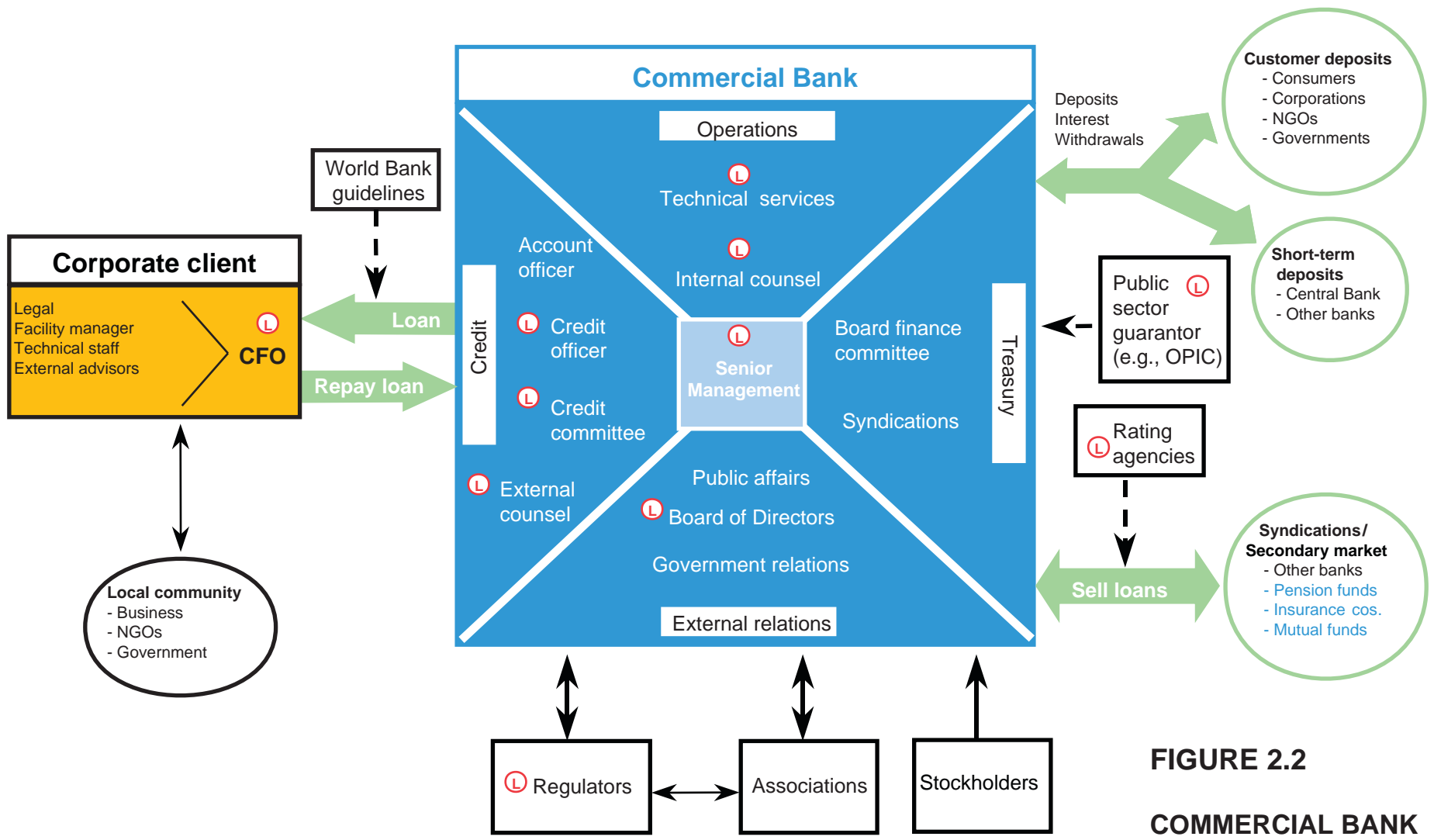


FIGURE 2.2
COMMERCIAL BANK
 Example: Project Finance

The **account officer's** team works with the corporate client in clearly defining the financial needs of the project and the most effective way to structure the transaction. The proposed deal is then reviewed and discussed internally within the bank, driven by the **account** and **credit officers**. The goal is to receive approval for the requested amount, from the **credit officer** and **credit committee** who serve, in effect, as the final authority on each extension of credit. The **credit committee** is responsible for the overall credit quality of a bank's portfolio, deciding how much risk a bank will support against expected rates of return. The **credit committee**, with guidance from **senior management**, helps set the overall credit criteria and process to achieve the targeted risk levels, and thus influences the policy and portfolio of an entire institution as well as influencing each transaction. **Senior management** and the **Board of Directors** serve to establish the bank's broader credit guidelines and policies and oversee the long-term health of the institution. Banking **associations** provide information and education to their members.

If the **credit officer** and **credit committee** agree to proceed, the **account officer** then coordinates with **external counsel** (for all documentation, regulatory, statutory, and other legal requirements) and **technical services** (for all physical requirements such as environmental and structural) to confirm that no significant problems exist with the project. It is at this point that environmental and social factors may be considered in a legal or scientific context. The bank likely will perform environmental due diligence for site contamination, regulatory compliance, legal titles to property and physical structures, as well as engineering and legal issues. If the bank does not have its own environmental guidelines, it may refer to **World Bank guidelines**. If the project finance deal is in a developing or transition country, the loan may be packaged with a public guarantee by a **public sector guarantor** to ensure against commercial risk (e.g., insufficient cash flow) or noncommercial risk (e.g., political instability).

The following questions would be considered by the **account officer** as the transaction is processed in the bank:

- Does the transaction need to be cleared with **regulators**? Are there any relevant legal issues with the transaction? If yes, then the **internal counsel**, in conjunction with **government relations**, will need to walk the entire transaction through the necessary regulatory guidelines and protocols. If this process is not managed closely, it could significantly delay the financing transaction.
- Will **stockholders** care about it? Is the transaction important from either a financial, political, or reputational perspective? If the answer to any of these questions is "yes," then stockholders would most likely care and the bank must decide whether shareholders should be informed. Most commonly, shareholders are informed through the firm's annual report, proxy statement, or, in the United States, the 10-K filing.
- How does it affect the **local community** (where the bank is based or where the structure will be built)? Who will be affected negatively or positively? Based on this evaluation, the bank needs to consider how to maximize the bank's opportunities and minimize the negative implications.
- Will the transaction be sold into the **secondary market**? This decision, driven by the **Board finance committee**, should be made early on since the disclosure, due diligence, and **public affairs** will be different if the transaction is to be offered in the public secondary market.
- If the deal is to be **syndicated**, at what time should the other banks be brought into the transaction by the **syndications** staff?
- What will the **rating agencies** think? For any transaction to be sold into the **secondary market**, the review and "rating" by the **rating agencies** is critical to the pricing and eventual selling of the offering. If the transaction is **syndicated**, however, this may not be critical if each participant has had the ability to influence the due diligence process early on. If, however, the syndication is formed late in the process, then the other financiers would have almost no input into the due diligence process and would rely on third parties' opinions of the transaction.
- Should the transaction be promoted by **public affairs** to the press and/or the general public?

Assuming no significant issues exist that cannot be addressed by contractual covenants, the deal is closed. The bank then funds the transaction with **deposits** received. Incoming deposits are received from **customer deposits** and **short-term deposits** from the **central bank** and **other banks**. The former tend to be for long- or medium-term periods, while the latter (“inter-bank deposits”) tend to be overnight deposits made at the end of each business day as each bank “balances” its books.

LEVERAGE POINTS

Regulators—Policy leverage. Regulators could be urged to broaden existing FDIC and OCC guidelines requiring banks to report to the

government their performance on environmental due diligence. The CAMEL rating system could broaden its analysis of market risk to include environmental risk factors.

Corporate Client CFO—Bottom-line leverage. One of the best potential educational resources on environmental issues for banks are their clients that are currently leaders in sustainable business practices. CFOs within client companies could exert influence by conveying quantitative data that demonstrate the economic value of environmental activities. Bankers in turn would be able to use the newly acquired expertise to evaluate all clients and extend preferential credit terms to companies utilizing best practices.

Box 2.1 The Incremental Exercise of Reputational Leverage: The Pangué Dam in Chile

Background: In the mid 1990s, the International Finance Corporation (IFC) of the World Bank Group provided financial support to ENDESA, a Chilean company, for the construction of the Pangué Dam on the Biobío River. After a Chilean NGO, Action Group for the Biobío (GABB), filed a complaint with the World Bank Inspection Panel alleging social and environmental irregularities in project implementation, the World Bank increased pressure on ENDESA. ENDESA therefore refinanced the project with a loan from Dresdner Bank in Germany. Subsequent actions taken by a German NGO, Urgewald, illustrate the use of reputational leverage to encourage a commercial bank to give increased attention to social and environmental concerns.

Action: Urgewald adopted a strategy of incremental engagement in multiple arenas. In a detailed initial letter to Dresdner, Urgewald documented technical flaws in the project’s environmental impact assessment and questionable methods for resettlement of affected communities. In addition, the letter questioned the project’s impact on Dresdner’s image in Chile, where the Bank had only recently established a presence. With no response forthcoming, Urgewald’s actions unfolded in three steps. First, they asked their members to query local Bank branches about the project. Next, Urgewald presented a resolution at a Dresdner Bank shareholders’ meeting detailing the financial, political, and ecological risks of the project, and noted that Dresdner had failed to meet its obligations as a signatory of the UNEP Statement by Financial Institutions on Environment and Sustainable Development. Third,

Urgewald presented a claim against Dresdner to the International Indigenous Tribunal held in Denver at the time of the 1997 meeting of the Group of Eight (G8) governments.

Outcome: Following media coverage of the shareholder resolution and the tribunal claim, Dresdner Bank agreed to a meeting between Urgewald, GABB, a senior board member, and the head of project finance of the Bank. Citing contractual obligations, the Bank did not withdraw the loan for the dam, but it did agree not to finance subsequent dams planned by ENDESA before consulting with GABB and Urgewald. More significantly, Dresdner Bank states that it has modified its project finance approval procedures to include an environmental impact assessment.

Analysis: Urgewald’s appeals to values-based sentiments and bottom-line concerns expressed in the initial letter to Dresdner received no response. Those same criticisms, however, provoked a rapid and positive reaction when they were publicly aired. Strategically, Urgewald’s incremental and factual approach enhanced its credibility with the press, while the Bank was negatively portrayed in the media for its lack of response. This credibility enabled Urgewald to leverage Dresdner’s concern about its reputation into a considerable change in Bank policies.

Sources: Fact sheet produced by Urgewald and interviews with Urgewald staff.

Credit Officer/Credit Committee—Bottom-line leverage. If the credit officer and credit committee could be convinced that increased attention to environmental issues is in their own and the bank's financial self-interest, they will act. Documentation of how environmental issues can have a positive or negative effect on cash flow is critical.

Board of Directors/Senior Management—Reputational/Bottom-line leverage. Officials at this level were pivotal in banks' decisions whether or not to adhere to the so-called Sullivan Principles regarding South African divestment. Issues related to institutional image, costs, or loss of customers will likely get the attention of senior management. Although this group is difficult to reach, their actions and decisions will influence the entire bank, and perhaps other banking institutions as well.

Technical Services—Bottom-line leverage. These technical experts are hired or employed by the bank to identify factors that may affect the cash flow of a transaction, either directly or indirectly. They are frequently the only individuals involved in the financing transaction who understand environmental issues from a scientific or engineering perspective, and are regarded as the "experts" by the borrower and the credit officer.

Internal/External Counsel—Bottom-line leverage. Frequently, lawyers are the final ratifiers of the deal. They provide legal expertise on environmental issues and regulations. Both groups of attorneys (internal and external) are significant influencers with the delegated responsibility to create contractual covenants and, in some cases, supervise technical staff.

Rating Agencies—Bottom-line leverage. Rating agencies have an impact upon a bank's ability to syndicate loans in the secondary marketplace. If these agencies can be convinced of the financial value of proactive attention to environmental issues, they could alter their ratings of various offerings based on environmental characteristics of the loans. These agencies are interested in the same issues as credit officers, and are most likely to be influenced by quantitative demonstrations of the impact of environmental considerations on financial rates of return.

Public Sector Guarantor (e.g., OPIC or MIGA)—Bottom-line/Reputational leverage. Bilateral export credit agencies and private sector arms of development banks are in a strong position to require that project finance deals to which they provide guarantees adhere to environmental standards and information disclosure requirements. Officials of these agencies should be sensitive to analyses showing the relationship between environmental and financial risk.

NOTES

1. This profile does not examine savings institutions or credit unions, which are primarily consumer focused.
2. "The World's 100 Largest Banks." *The Wall Street Journal*. September 18, 1997. p. R27.
3. Limited recourse ranges from substantial recourse during construction through completion testing, to more limited, very specific recourse after completion to the end of the term loan.
4. Andrew Taylor. "Private Sector Fills the Gap." *Financial Times*. Friday, May 23, 1997. p. 5.
5. Kavaljit Singh. *A Citizen's Guide to the Globalisation of Finance*. New Delhi: Madhyam Books. 1998. p. 159.
6. Office of the Comptroller of the Currency website: <http://www.occ.treas.gov/>
7. Personal communication with the FFIEC: <http://www.ffiec.gov>
8. Personal communication with several commercial bankers.
9. The World Bank. *1995 Annual Report*. Washington, DC: World Bank. 1995.
10. Hilary French. "Assessing Private Capital Flows to Developing Countries." *State of the World*. Washington, DC: Worldwatch Institute. 1997. p. 152.
11. James R. Kraus. "U.S. Banks Gaining Ground in Loans to Developing World." *American Banker*. Vol. 162 No. 6 (January 9, 1997).
12. *Ibid.*
13. "Capital Flows to Emerging Markets." Institute of International Finance. January 28, 1998. Available online at: <http://www.iif.com>

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- Central bank (the Federal Reserve in the United States): <http://www.bog.frb.fed.us>
- Federal Financial Institutions Examination Council (quarterly report on “Country Exposure Lending Survey”): <http://www.ffiec.gov>
- Federal Deposit Insurance Corporation (FDIC): <http://www.fdic.gov>
- Office of the Comptroller of the Currency (OCC): <http://www.occ.treas.gov/>
- Securities filings by companies (SEC in the United States): <http://www.sec.gov>
- World Bank environmental guidelines on project finance: <http://www-esd.worldbank.org/pph/>
- Rating agency reports on companies (produced by *Standard & Poor's*, *Moody's*, and others in each country where an active public securities market exists)
- Independent Bankers Association of America, Washington, DC: <http://www.ibaa.org>
- American Bankers Association, Washington, DC: <http://www.aba.com>
- Environmental Bankers Association, Alexandria, VA, (703) 549-0977: <http://www.envirobank.org>
- World Business Council for Sustainable Development: <http://www.wbcsd.ch>
- UNEP Financial Services Initiative on the Environment: <http://www.unep.ch/eteu/envr-fin.htm>
- Bank of International Settlements: <http://www.bis.org>
- Trade periodicals:
Project and Trade Finance
American Banker
Journal of Project Finance
Bank Accounting and Finance

Journal of Commercial Lending
ABA Banking Journal
Project Finance International
Global Finance
EBA Bank Notes

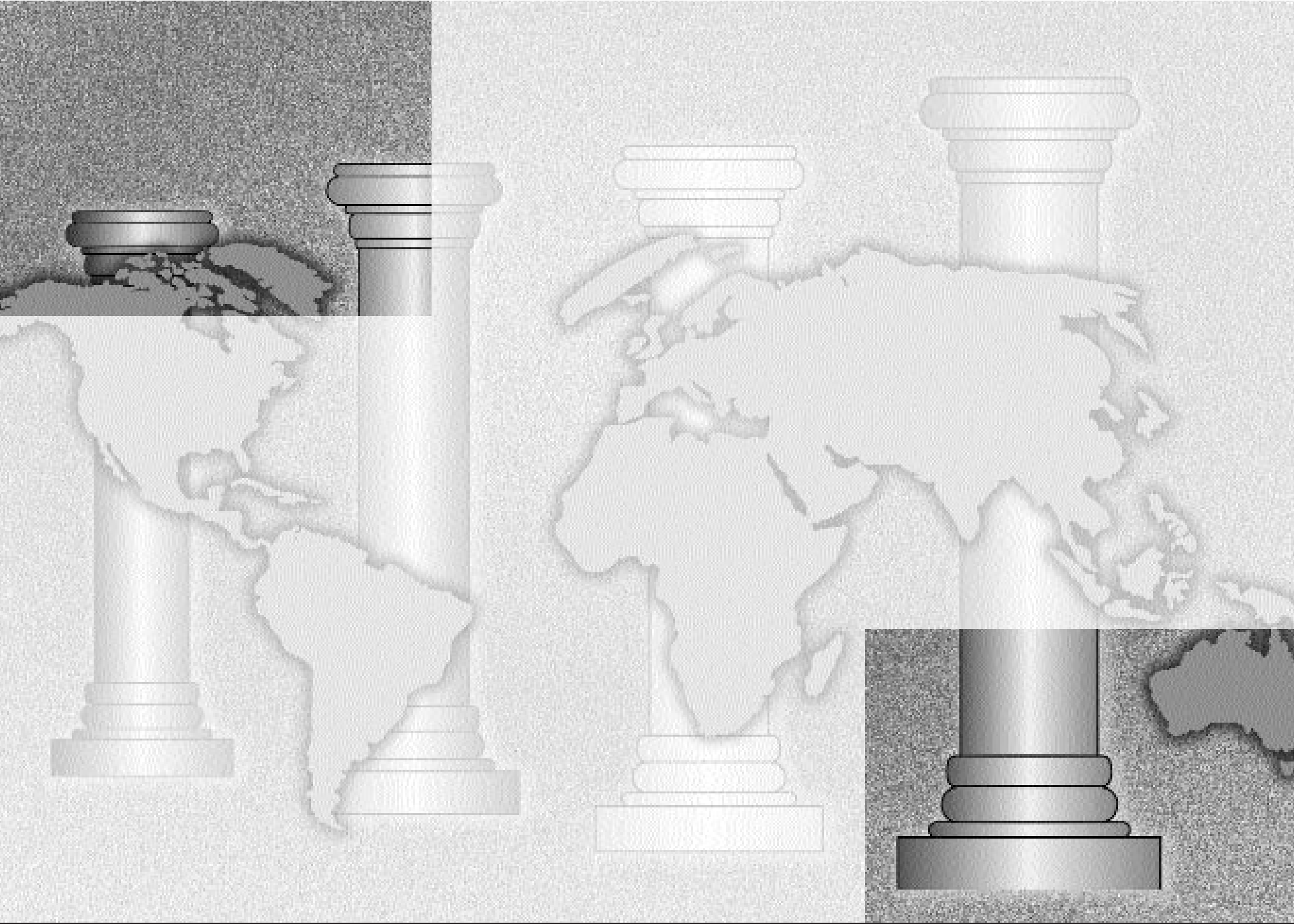
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INVESTMENT BANKS

3. INVESTMENT BANKS

PROFILE

Investment banks function as a liaison “agent” between corporations or governments that want to attract investment capital and investors who have money to buy securities. Investment banking covers a wide range of functions within the financial services industry, but generally focuses on equity investments rather than credit extensions. Unlike commercial banks, they tend to have little or no long-term stake in a transaction. Investment banks generate revenue by charging a fee for transactions. The specific characteristics of an investment bank vary based on the legal and regulatory systems of the country where the bank is based. In Japan, the United Kingdom, and the United States, investment banks tend to be independent, publicly traded companies. In continental Europe, investment banks are frequently part of larger financial institutions involved in both investment and commercial banking, and in some cases, insurance as well. *Figure 3.1* summarizes four key characteristics of investment banks of particular importance to the public interest community.

Size and Leaders

Because there are various methods of ranking the size of investment banks (assets under management, total deal volume, total profits), it is not possible to provide a single ranking of the largest firms. Among the world’s leading investment banks are Morgan Stanley Dean Witter and Co., Credit Suisse First Boston, Citigroup, Merrill Lynch, and Goldman Sachs in the United States, and Nomura Securities in Japan. Morgan Stanley Dean Witter’s assets alone totaled US\$131 billion in 1996 (1).

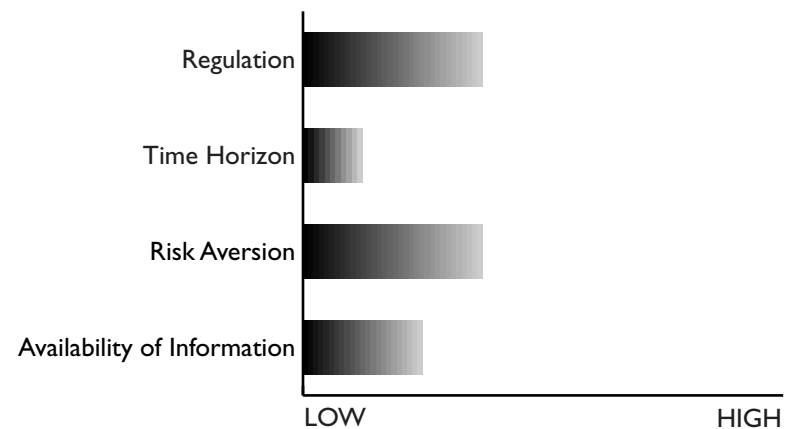
Key Features

For many corporate financial transactions, both parties utilize and are advised by an investment bank. These transactions include initial public offerings (IPOs, described below), mergers and acquisitions, divestitures, liquidations, structured or project finance (described under commercial banking), private placements (the sale of financial instruments to a targeted group of investors), and various forms of asset-backed lending activity (such as the acquisition of new equipment or plants as collateral for a loan).

Investment bankers also manage the buying and selling of stocks, bonds, and other financial instruments for their own portfolio and on behalf of clients; this move into asset management represents a diversification from their traditional role as agents. Another trend in investment banking is securitization, or bundling of assets, to sell in the secondary market.

One of the specialties of investment banks is bringing an IPO of a new financial security to the market. An IPO enables a company to raise new funds, or to cash in private stock for public stock. An IPO may consist of common stock (equity stock that has voting rights, but virtu-

Figure 3.1 Key Characteristics of Investment Banks



ally no security if the firm goes bankrupt), bonds (a legal debt commitment by the issuing company to pay the bondholder a fixed amount of money at a specific time in the future, and often just called “offerings” or “issuances”), or preferred stock (which has some characteristics of both common stock and bonds). The IPO process is managed closely by the investment bank from its inception until the completion of the transaction, which can take from 6 to 24 months. In some cases, the investment bank will acquire a portion of the IPO for its own investment portfolio.

The most common IPOs are bonds issued by companies that are already publicly traded, or by governments seeking to raise additional capital in the international public market. Bonds are traded, with price fluctuations discounted by factors such as maturity dates and credit ratings of the issuing company or government. Bonds are the most commonly issued security in the world and comprise 30 percent of total financing activity on capital markets worldwide (2). However, common stock IPOs are more visible because they represent the selling of a company to the general public for the first time. In the United States, where about half of the world’s IPOs take place, approximately 80 percent are for bonds while the remaining 20 percent are common stock IPOs. After the United States, the largest IPO markets based on the total number of new issuances are in Korea (prior to the 1997 Asian crisis), Sweden, and the United Kingdom.

Regulation

In the United States, the principal regulator of investment banking activity is the Securities and Exchange Commission (SEC). The SEC sets standards for what information must be disclosed about companies that are publicly traded. It is the responsibility of the investment bank to obtain that information as it performs due diligence.

Attention to Environmental Issues

In general, most investment banks focus on environmental issues, if only nominally, in two circumstances: (a) as part of the IPO due diligence and disclosure process when investigating a company’s potential

liabilities, and (b) when handling transactions related specifically to the environmental services industry (e.g., waste disposal or water treatment). Environmental considerations, such as real estate contamination, are just one of a variety of factors considered during due diligence. The extent of the environmental due diligence process varies enormously depending on the investment bank and type of transaction, and can range from no activity to an extensive analysis of current and future environmental conditions. For U.S. transactions, investment banks have an interest in mitigating environmental problems before submitting a prospectus to the SEC.

Relevance to Developing and Transition Economies

Underwriting government bonds issued by central banks has become big business for investment banks. Many developing and transition countries issue bonds through investment banks to raise capital for major infrastructure development, such as the Three Gorges Dam in China. In turn, individual and institutional investors such as mutual funds and pension funds buy and trade these bonds. In 1997, international bond issues by developing countries reached US\$108 billion. Half of those issued were from Latin America, with Brazil alone issuing US\$18 billion (3).

Investment banks in developing and transition economies may also play a role in brokering privatizations. In the context of a privatization transaction, shares of a state-owned enterprise such as a water or electric power utility are offered for sale to the public as an IPO. Typically, a government (the seller) enlists the services of an investment bank to design and market the newly available security to domestic and international private investors. Several recent privatizations, particularly in Latin America, have been private placements with pension funds as investors.

Stocks of foreign companies can be offered in the U.S. market through a unique certificate resembling shares called an American Depositary Receipt (ADR). ADRs are receipts for shares that allow U.S. investors to purchase shares of foreign companies on a U.S. exchange. Different

numerical classifications of ADRs and GDRs (Global Depositary Receipts) require different levels of disclosure to the SEC. One restricted type of ADR, or RADR, is the 144A transaction, which is the sale of an unregistered security. This type of private placement does not require SEC disclosure. In 1995, four of the top 12 ADRs were privatized telecommunication issuances by developing countries (4).

Most investment banking activity in developing and transition economies is dominated by foreign investment banks and the private sector arms of multilateral development banks such as the World Bank Group's International Finance Corporation (IFC). IPOs are limited to countries that have operational stock markets. In countries without functioning stock markets, investment banking tends to focus on structured or project finance (*see Chapter 2, Commercial Banks*) or foreign direct investment such as joint venture activity (when an international company partners with a local company to set up an enterprise).

INVESTMENT BANK DIAGRAM

Figure 3.2 illustrates the role of an investment bank in a common stock IPO, which represents the selling of a company to the general public for the first time. A stock IPO is depicted here because of its relative visibility and potential opportunity for leverage. IPOs are usually initiated by the company (**corporate client**) that wants to sell its common stock to the public. The **chief financial officer (CFO)** represents the interests of the **corporate client** during the IPO process. The **client firm owners** influence the transaction through contact with the **CFO**.

Initially, the **CFO** hires an **investment bank** that understands the industry, and ideally, one that previously has taken a similar firm public. The **deal manager** scrutinizes the company to determine whether the client and the market are ready for this firm to go public. Occasionally, the decision to take on a **corporate client** may be referred to **senior management**. The opinions of leaders within the **investment community** also can influence a bank's decision to accept a client. Upon acceptance of the corporate client, the **bank** decides whether it will manage the deal alone or with others (**co-lead banks**). Most large deals involve

multiple investment banks brought into the transaction by the lead bank at various points.

The **deal team** creates the **prospectus** (or **offering circular**) that describes the company and security to be offered. Its contents are determined, through the due diligence process, by **internal counsel**, in concert with the **deal team**: the **deal manager**, **financial analysts**, **technical support**, and **external advisors/consultants**. The documents contain everything an **investor** needs to know about the company such as its products, markets, finances (including contingent liabilities), legal or regulatory issues, and tax implications. The **prospectus** is filed with the **regulators** (SEC in the United States) and then distributed to potential **investors**.

During the transaction, the deal manager considers the following questions:

- What relevant **tax laws** affect the company going public?
- Does the company have any historical environmental issues (such as site contamination) that require disclosure?
- Is the timing appropriate for an IPO (e.g., market conditions, government regulations, other competing IPOs)?

The following activities occur concurrently:

- The **sell-side analysts** evaluate and rate the corporate client to determine the potential price of the IPO shares offered to the market.
- **Marketing** and **salesforce**, led by a representative of the **deal team**, begin to travel and meet with potential **investors** to explain the transaction (the "roadshow"). These potential investors include **corporate clients**, **private clients**, **investment houses**, **pension funds**, **mutual funds**, and sometimes the investment bank's **own portfolio**.
- For potentially visible or sensitive transactions, **external relations** may be consulted to ascertain how the transaction will be promoted outside traditional sales channels. Within a few weeks of the selected IPO date, **public affairs** prepares a **press release** (a "tombstone").

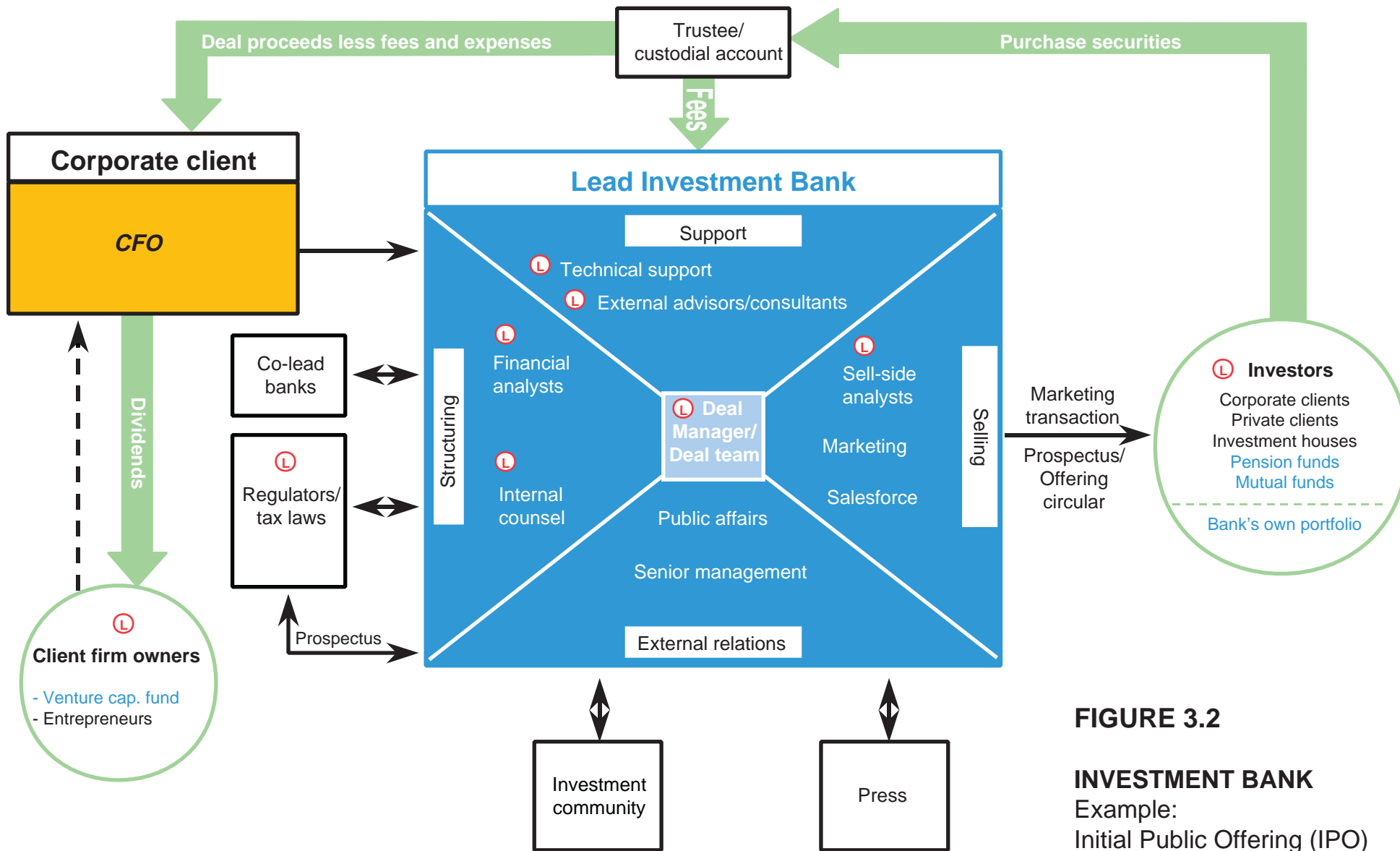


FIGURE 3.2
INVESTMENT BANK
 Example:
 Initial Public Offering (IPO)

The offering is made on a particular day with various investor groups buying the company's newly issued stock. All the funds obtained during the IPO sale flow through a third-party **trustee/custodial account** for legitimization of the flow of funds. The original **entrepreneurs** or **venture capital fund** receive a sizable return on their investment to date and may maintain some level of ownership that could result in future profits.

LEVERAGE POINTS

Regulators (SEC in United States)—Policy leverage. The SEC and its counterparts in other countries represent one of the most significant potential avenues to influence investment banks and their corporate clients. Guidelines for the IPO process, including requirements for due diligence, are set and enforced by the SEC as authorized by relevant legislation. Securities regulatory agencies could require disclosure of

Box 3.1 Three Gorges Dam Campaign: Watching Wall Street

Background: In 1992, China's National People's Congress approved construction of the Three Gorges Dam, the world's largest dam project. From the start, critics have argued that the dam's destructive potential will be just as impressive as its size. Specifically, opponents noted that 1.8 million people will be uprooted, and that the risk of reservoir-induced seismic activity and of siltation threaten the dam's technical viability. Moreover, project costs have ballooned to five times the original figure in six years, which calls into question the financial viability of the project. Financing this project has proved to be difficult: three bond issues have been canceled due to lack of investor interest. In 1994, China formed the State Development Bank (SDB) to help finance infrastructure projects, including Three Gorges. In early 1997, a group of six investment banks, Credit Suisse First Boston (CSFB), J.P. Morgan, Lehman Brothers, Morgan Stanley Dean Witter and Co., Salomon Smith Barney (SSB), and Bank of America underwrote a US\$330 million bond issue for the SDB. A further bond issue was planned for later that year.

Action: In late 1997, a group of 46 nongovernmental organizations (NGOs) from 14 countries, led by the International Rivers Network and Friends of the Earth, sent a joint letter to the six bond underwriters, urging that they avoid any further activities in support of the project. The letter catalogued the technical, environmental, social, and financial risks associated with the project, and noted that support of the project ran counter to the UNEP Statement by Banks on Environment and Sustainable Development signed by CSFB and SSB, and the Coalition for Environmentally Responsible Economies (CERES) Principles signed by the Bank of America. The letter was followed by a media campaign, which named the banks involved in the deal and urged investors not to purchase the SDB bonds.

Impact: The second bond issue never materialized. The reason for this is difficult to establish because the campaign coincided with the growing financial crisis in Asia. Three of the banks—notably those that had formally signed statements of environmental concern—sent responses to the NGO letter. CSFB and Bank of America noted that SDB bonds are not targeted exclusively to Three Gorges but to infrastructure projects in general, and stated that they were not aware of a second bond issue for SDB. Bank of America pledged not to commit direct support to Three Gorges, but also stated that the bank intends to continue dealings with Chinese financial institutions and those in other developing countries, consistent with their environmental commitments. SSB reiterated its commitment to sustainability considerations and offered a list of ongoing activities as evidence of this commitment.

Analysis: The NGO campaign used reputational leverage to urge disengagement from the Three Gorges project. The existence of an intermediary institution—the SDB—made reputational leverage harder to exercise. It is difficult to assess the campaign's direct impact on the banks' decisions regarding Three Gorges against the backdrop of the Asian financial crisis. However, it is noteworthy that the banks that have made a public commitment to corporate responsibility were also those most responsive to the campaign. In the case of those three banks, reputational leverage served as a reminder of their environmental obligations.

Sources: Information packet compiled by International Rivers Network. Additional information is available online at: <http://www.irn.org>.

specific kinds of environmental or other information from corporations seeking to trade their securities in the public market.

Client Firm Owners—Bottom-line/Reputational leverage. Owners can influence information in the prospectus as well as the marketing and public relations efforts of the investment bank. If a company has a positive environmental record, owners could use the IPO to get information out to potential buyers and the public about the firm's environmental and corresponding financial value.

Deal Manager—Bottom-line leverage. The deal manager is interested in environmental considerations only to the extent that they affect the offering price of the transaction. Deal managers are usually not concerned about the cost of performing additional environmental analysis within due diligence, but are very concerned if it slows down the transaction or reduces the offering price or liquidity.

Analysts (Financial and Sell Side)—Bottom-line leverage. These analysts are interested in environmental issues only to the extent that they can be convinced that a significant correlation, either negative or positive, exists between a company's environmental and financial performance. Such a correlation could be based on revenue opportunities or cost avoidance.

Internal Counsel—Bottom-line leverage. For legal and managerial reasons, the company and the investment bank grant lawyers enormous power in creating the prospectus. If it were possible to convince lawyers of the financial merits of performing additional environmental due diligence and disclosure, they would be in a position to educate the broader investment banking community. Internal counsel is also a strong entry point for leverage within an investment bank because any communication within the bank coming from counsel receives priority attention.

Technical Support/External Advisors/Consultants—Bottom-line leverage. These experts are the only people with technical environmental knowledge who are involved in investment banking transac-

tions and who can influence what potential environmental liabilities are investigated within the due diligence process. They may also influence what environmental information is included or excluded from the prospectus.

Investors—Bottom-line/Values-based leverage. If individual or institutional members of the investment community can be convinced to value environmental information, and begin to request it, the investment bank, in responding to their customers, will provide the requested information.

NOTES

1. "World Business." *The Wall Street Journal*. September 18, 1997.
2. OECD (Organisation for Economic Co-operation and Development). *Financial Market Trends*. Paris: OECD. March 1998.
3. "Capital Flow to Emerging Market Economies." January 28, 1998. Institute of International Finance.
4. The World Bank. *Global Development Finance 1997*. Washington DC: The World Bank. p. 15.

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Securities and Exchange Commission (SEC): <http://www.sec.gov>

Emerging Markets Companion: <http://www.emgmks.com>

USAID web site on public transactions: <http://www.info.usaid.gov/test/finance.htm>

U.S. Stock Exchange: <http://www.nasdaq.com>

UNEP Financial Services Initiative on the Environment: <http://www.unep.ch/eteu/envr-fin.htm>

Bank of New York, Global Equity Investing Depositary Receipt Service: <http://www.bankofny.com/adr>

Global Investor, American Depositary Receipts: <http://www.global-investor.com/adr/index.htm>

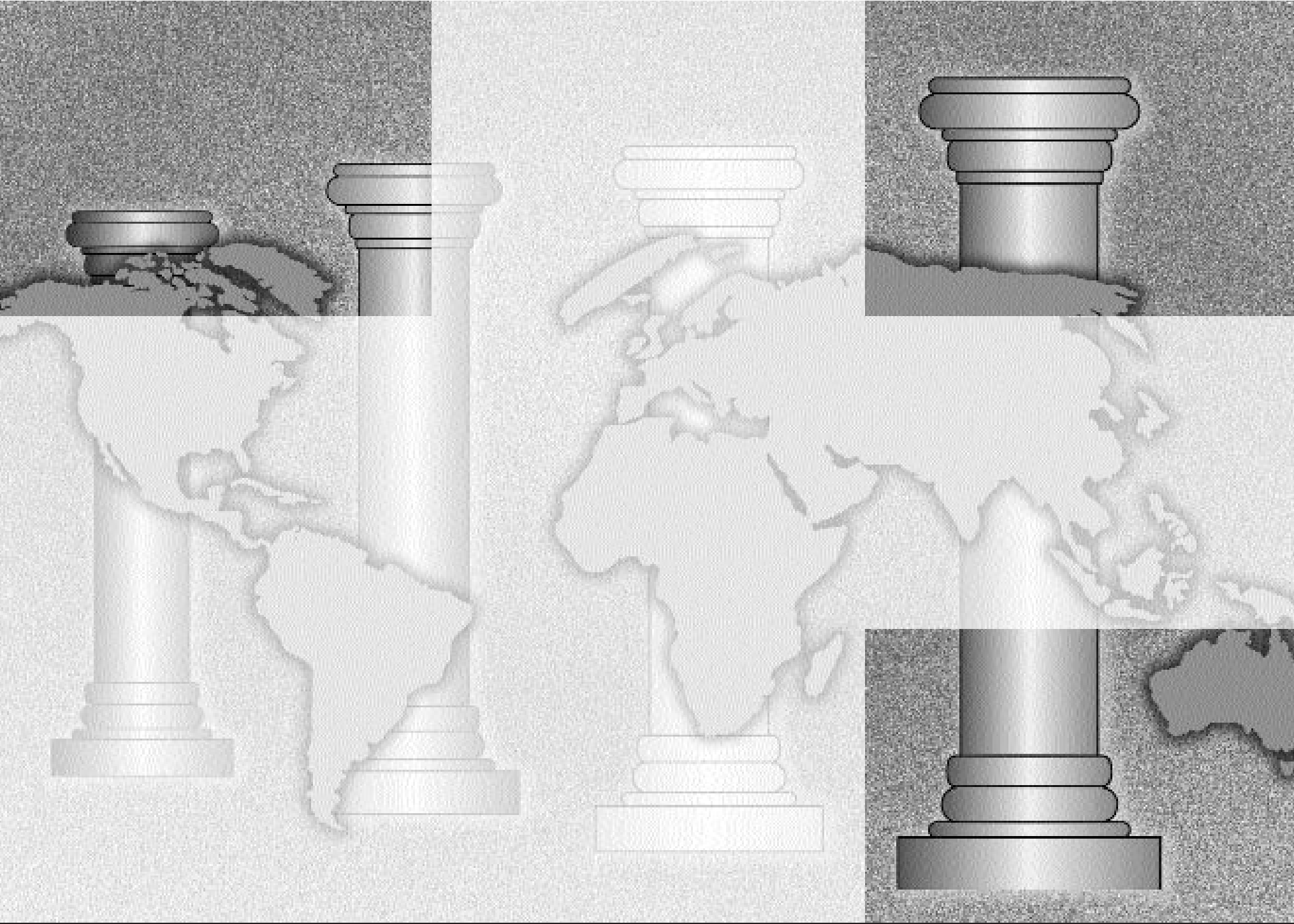
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MUTUAL FUNDS

4. MUTUAL FUNDS

PROFILE

A mutual fund is an entity, set up and operated by an investment management company, to raise capital for investing in financial instruments. A mutual fund allows investors to buy a portfolio of shares in small increments and to realize advantages over investing independently. These advantages include: (a) diversified investments across a large number of firms, (b) lower fees, (c) relatively lower risk than individual stock purchases, and (d) expert advice. For these advantages, mutual fund shareholders pay a fee. Mutual funds are invested in almost every traded financial instrument from common stocks and bonds to derivatives and money markets. Originally aimed at wealthy individuals seeking to diversify their portfolios, mutual funds have now become a typical investment vehicle for many consumer and some institutional investors. *Figure 4.1* summarizes four key characteristics of mutual funds of particular importance to the public interest community.

Size and Leaders

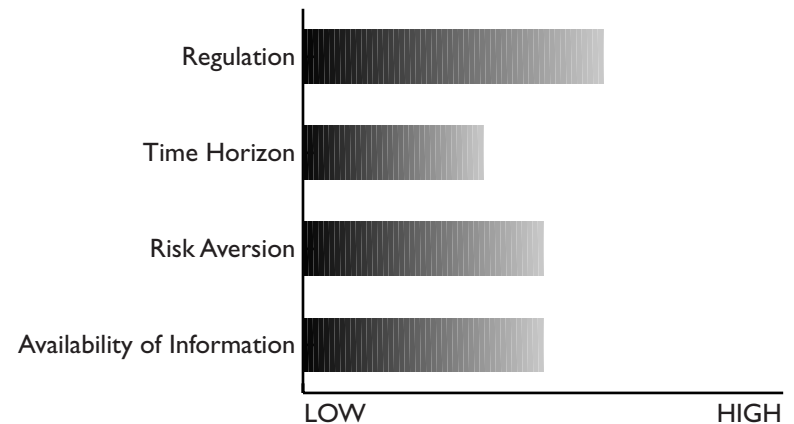
Known as investment trusts in most of Europe and Asia and unit trusts in the United Kingdom, mutual funds now represent the second largest pool of private capital in the world after the banking industry (1). In the United States, more than 6,500 mutual funds manage collective assets totaling more than US\$4.49 trillion (2). Mutual funds range in size from a few million dollars to US\$61 billion (represented by the world's largest fund, Fidelity's Magellan Fund). Other large mutual funds in the United States are managed by investment management companies such as Vanguard, Capital Research and Management, Dreyfus, and T.

Rowe Price. Much of the mutual fund industry's growth in the United States can be attributed to increased inflows of capital from 401(k) and defined-contribution pension plans. Approximately 37 percent of U.S. households have assets in mutual funds. Although individual households account for most mutual fund investors, U.S. institutional investor (such as pension fund) assets in mutual funds have increased 400 percent since 1990 (3).

Key Features

A mutual fund is established by an investment management company with a specific investment strategy and objectives. Investment governance and guidelines dictate the fund's risk tolerance and the areas into which it can and cannot invest. Objectives might include short-term capital appreciation or long-term returns, as well as targets for specific sectors such as an energy fund or specific financial instrument, such as a bond fund. An analysis may be performed to decide acceptable parameters of composition and risk versus return. With wider parameters, there is increased opportunity for diversification, which reduces overall risk of the fund. Conversely, with narrow parameters such as a sector-specific fund, there is increased risk, as well as a greater potential for higher returns. Both time horizon and anticipated rate of return are

Figure 4.1 Key Characteristics of Mutual Funds



functions of the fund's investment strategy. Any change in investment strategy, such as introducing a social or environmental screen, requires a vote by shareholders of the mutual fund.

Investment management companies typically manage several, if not dozens, of mutual funds to attract a wide consumer base. These companies generate revenue from mutual funds by charging investors one of the following management fees: a purchase (front-end loaded) or redemption (back-end loaded) fee and/or a fixed management fee deducted from the fund's overall revenues (no load). Recently, there has been a shift from load to no-load funds, with the result that consumers' assets are more liquid, allowing easier movement and short-term investing. Another new development is the increase in the number of "index" funds designed to match the activity of an established index. An index fund has fixed targets for the types of firms it will buy and the percentage of each type to hold in its portfolio. Index funds carry very low fees and are managed passively compared to traditional mutual funds.

Most institutional investors such as pension funds rely on advisors to identify investments, while individuals are relying increasingly on their own knowledge, using discount brokers, or buying directly from the fund. Some individual investors now get much of their information over the Internet and make purchases online, thus avoiding certain fees and trading costs. This trend is certain to escalate. These developments have resulted in a major movement away from mutual funds managed by full-service brokers, such as Paine Weber and Merrill Lynch, to discount brokerage and investment companies such as Charles Schwab and Fidelity. For investors still interested in receiving advice and guidance, commissioned financial planners, both independent and affiliated with fund organizations, have become increasingly important sources of information. Mutual fund investors also rely on tracking services such as Morningstar and Lipper Analytical that rate funds based on historical performance. According to *The Economist*, 80 percent of new mutual fund investments in 1996 poured into funds that had received a rating of four or five stars from Morningstar (4).

Regulation

The set up of a mutual fund is similar to that of a corporation, except that they receive more favorable tax exclusions under the U.S. Internal Revenue Code of 1986. Pursuant to the Investment Company Act (ICA) of 1940, U.S. mutual funds are required to register with the Securities and Exchange Commission (SEC) and to price daily the net asset value (NAV) of their assets. The ICA also requires that a mutual fund investment be redeemable upon demand by an investor. Disclosure is regulated by the SEC, which mandates that investors be provided with a prospectus prior to investing and also receive periodic reports and an annual proxy ballot. Under the Investment Advisors Act of 1940, investment advisors of mutual funds are required to register with the SEC. Sales and marketing practices of mutual funds by the investment management company are regulated by the National Association of Securities Dealers (NASD).

Attention to Environmental Issues

Typically, environmental and social considerations do not figure prominently in the design or in the investment operations of mutual funds. However, an increasing number of socially responsible investment (SRI) funds have been established in recent years, including Domini Social Equity, Calvert Managed Growth, Hudson Investors Fund, and Pax World Fund. SRI funds usually apply a negative investment screen to avoid, for example, investments in the tobacco industry. Some funds that have invested in environmental services include Alliance Global Environmental Fund and the Fidelity Select Environmental Services Fund. As reported by Morningstar Research, SRI-screened mutual funds have more than US\$4 billion in assets (5).

Significant research has been completed over the past several years, and many other studies are in progress examining the relationship between environmental investment screens and rates of return. Much of this information has been compiled by the Investor Responsibility Research Center, the Social Investment Forum, and the Innovest Group.

Another type of screen utilizes "best in class" or "eco-efficiency" investing. That is, the fund manager will invest in mainstream industries,

identifying “best in class” companies within each industry that integrate voluntary performance standards such as environmental performance indicators (EPIs). Some prominent funds to utilize environmental measurements are the Storebrand-Scudder Environmental Value Fund, the Swiss Bank Corporation’s Eco-Performance Portfolio, and the Dreyfus Third Century Fund. (*See Box 4.1.*)

Relevance to Developing and Transition Economies

In 1996, there were nearly 800 “international” and “global” funds. One of every eight dollars invested in mutual funds in the United States is invested overseas (6). Mutual funds have experienced the greatest increase of all equity investments in the emerging market economies. By 1996, emerging market funds had combined assets of US\$132 billion (7). Mutual funds are also being established in developing and transition economies such as Chile and Thailand.

Examples of how a mutual fund links an individual investor in the United States to environmentally or socially sensitive investments in developing countries can be seen by examining the portfolios of funds such as the Fidelity Select Natural Resources Fund or the T. Rowe Price Emerging Markets Fund, which have holdings in timber, energy, and mining companies.

MUTUAL FUND DIAGRAM

Figure 4.2 illustrates the operation of a mutual fund. A mutual fund begins with an idea by an **investment management company** for a targeted fund or specific portfolio of investments that will meet the objectives of a group of investors. A **market niche** is identified by examining a variety of factors such as consumer trends, companies, industries, and emerging markets. The **investment management company** (legal and the **fund manager**) establishes the **mutual fund** and its **Board of Directors** and registers it with the **regulators** (SEC in the United States) for approval to proceed prior to soliciting buyers.

Once the mutual fund is established, an ongoing symbiotic relationship exists between the **mutual fund** and the **investment management**

company. The employees of the **investment management company** operate the **mutual fund**, which serves as the vehicle through which the assets are **invested** and **liquidated**. Management of the **mutual fund** is driven by the **fund manager**. The **marketing** program is then launched by **marketing staff** and **analysts**, with or without a **public relations** effort, to attract **individual** and **institutional investors**. A **prospectus** (or **offering circular**) is distributed that details the investment guidelines of the fund. The **prospectus** discloses legally required information as well as marketing information, such as investment objectives of the fund, minimum individual investment, dividend policy, fees, and risk characteristics. This marketing and distribution of the **prospectus** is done through the **investment management company** and **financial planners/advisors/brokers**. **Investors** are likely to consider the **rating** of a fund as assessed by a tracking service such as Morningstar.

The structure of a **mutual fund** provides shareholders with **proxy power**. Every year, investors receive proxy ballots to elect members of the **Board of Directors** for the fund. Further, any changes in a fund’s investment strategy or governance must be approved by a shareholder proxy vote. The key to the success of a fund will rest on its ability to meet investors’ expectations (rate of return and others) while investing according to its **investment guidelines**.

The investment capital that flows into the fund from **individual and institutional investors** is used to make **investments** in securities in a manner consistent with the corporate governance of the fund. Key individuals in this process are the **research analysts** who are responsible for interfacing with the various companies. These analysts are the key link between the fund and companies for gathering information, evaluating information, and potentially influencing the industries where **investments** may be made. Although the responsibility for these activities is under the auspices of each **fund manager**, many of the **investment management company** employees, such as **research analysts**, may be working on multiple funds; thus, it is the **fund manager** that ultimately will have control over a specific fund.

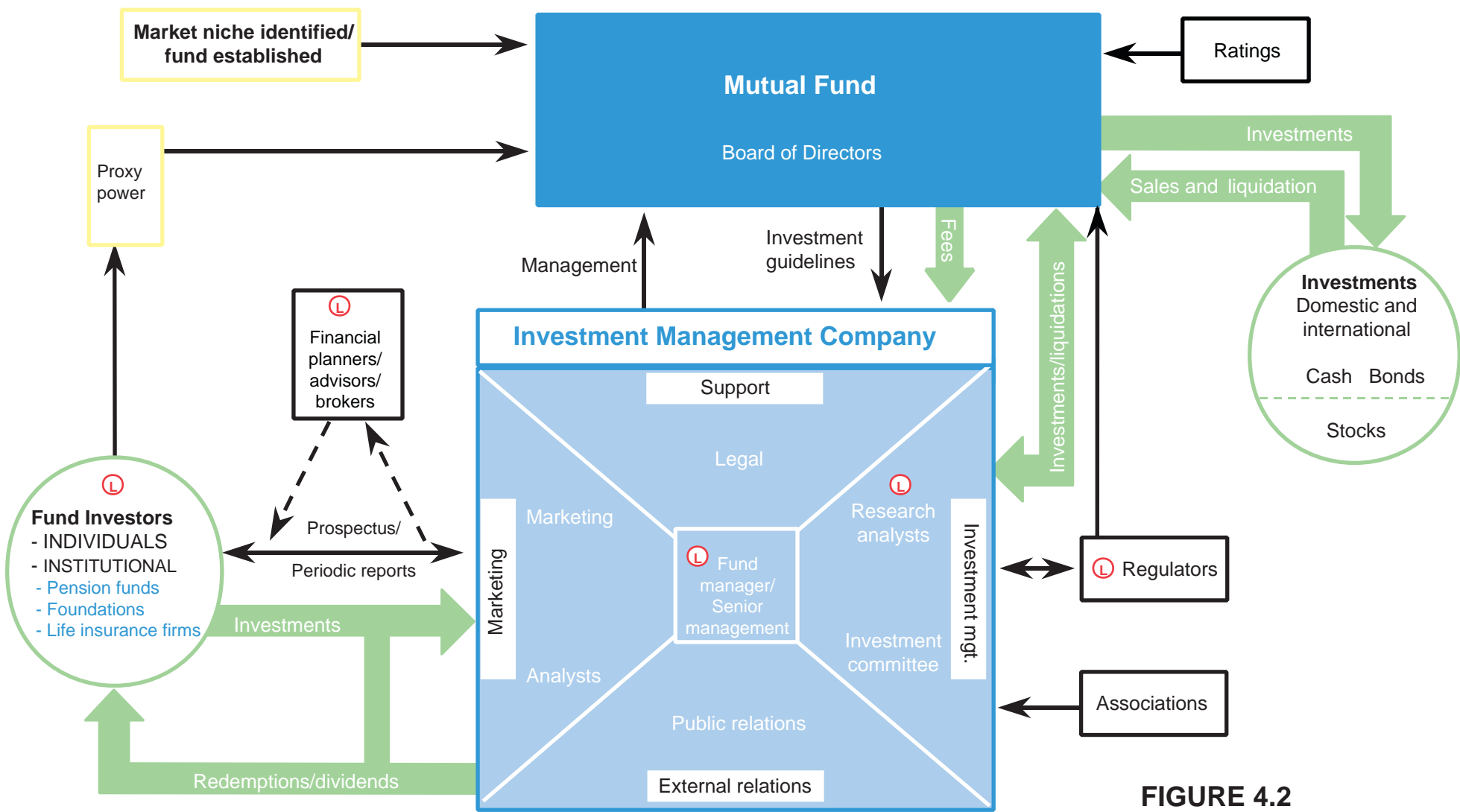


FIGURE 4.2
MUTUAL FUND

In deciding to invest in specific companies, the **research analyst** and **investment committee** will ask the following questions:

- Does a potential investment fit within the **investment guidelines** of the fund's governance? How does the investment fit with the current exposure to risk?
- Will the fund become a minority/majority owner by investing in the company?
- Will the investment make the press? Does it have positive marketing value for the fund?
- Will the investment attract long-term investors to the fund, thus stabilizing the investment pool of capital?
- What are the potential market conditions and government regulations that will impact the financial performance of a company? What are the economic forecasts for the region in which the company operates?
- How is the company going to perform compared to its competitors?

Investment management companies receive information and education from **associations** such as the National Association of Securities Dealers (NASD) and the Investment Company Institute (ICI) in the United States.

As the fund becomes more mature, the investment management company will begin to distribute **periodic reports** and handle **redemption** requests by investors. Investors may also receive **dividends** that may be reinvested.

LEVERAGE POINTS

Research Analysts—*Bottom-line leverage*. Research analysts drive the investment decisionmaking of a mutual fund within the fund's defined parameters by providing information and recommendations to the fund manager. In a typical fund, the analyst is interested in environmental or social considerations only to the extent that he or she is convinced that they are significant factors influencing performance. In an SRI fund, analysts are interested in information

regarding environmental or social characteristics of particular industries, countries, or companies. Because they are in frequent contact with companies seeking investment, analysts can request specific data and alert those companies to environmental and social issues that concern investors.

Fund Manager—*Bottom-line leverage*. Managers of typical funds are interested in environmental or social considerations for one of two reasons: (a) if he or she is convinced that those considerations are significant factors influencing financial performance; or (b) if he or she is convinced that application of environmental or social investment criteria will increase the number of investors or the amount of capital under management.

Government Regulation (SEC or equivalent)—*Policy leverage*. Regulators could facilitate the disclosure of information regarding the environmental or social character of a fund's investments by requiring that such information be included in a fund's prospectus and periodic management reports.

Individual Investors—*Values-based leverage*. As the mutual fund industry increasingly markets itself as a mainstream retail product, it will react to consumer demands. Individual investors have the power to select from a wide array of funds, and can indicate a preference for environmentally and socially responsible investing by choosing funds with those characteristics and by requesting information on the environmental and social character of mutual funds. If the mutual fund industry perceives that consumers want environmental information, the industry will react by including some environmental data within a fund's prospectus. Public interest groups can educate their members, employees, and the general public about the availability of screened funds and how they can evaluate their portfolios, including retirement and 401(k) investments.

Institutional Investors—*Values-based leverage*. NGOs, foundations, universities, and many other institutional investors are often willing to

Box 4.1 Environmental Investing: From Values to Bottom Line

Background: Individual investors have always had the option of exercising social responsibility by eschewing “sin stocks.” Institutionalized socially responsible investment (SRI), however, is a relatively recent phenomenon. The movement was spurred in the 1970s by two high-profile social issues—arms manufacture in the aftermath of the Vietnam War, and divestment from South Africa in the apartheid era. Consequently, the early focus of SRI was on avoidance and screening out ethically unacceptable activities. In the late 1980s, environmental criteria were added as an investment screen, fueled by a surge in green consciousness. Whether social or environmental criteria were used, until the mid-1990s, the financial performance of SRI was poor and the movement relied heavily on values-based leverage to attract investors.

Action: In the past few years, environmentally oriented investing has been supported by a new message: “green business is good business.” Recent studies suggest that firms attentive to environmental value—both in terms of risk avoidance and opportunity identification—reap financial value. Moreover, some analysts argue that developments in international policy and regulation are creating growing financial opportunities for firms that are environmental leaders. Perhaps most importantly, this message is buttressed by quantitative evidence from U.S. markets that financial performance is positively correlated with environmental performance (1).

Outcome: A change in the message has brought about a change in investment criteria. From application of a “negative screen,” some investment managers have begun to apply a “positive screen” to affect the environmental profile of investment portfolios. “Eco-efficiency” now serves as an investment criterion. A company’s efficient use of natural resources, suggest proponents of this approach, is an indicator of good management overall. Swiss Bank

Corporation’s “Eco-Performance” portfolio, for example, identifies “eco-leaders”—sector-specific leaders in environmental performance—and “eco-innovators”—leaders in emerging resource-efficient sectors—as a complement to financial analysis in selecting stocks.

Analysis: With the transition from negative screens to positive “eco-efficiency,” the target audience for environmentally oriented investing may shift from values-based to bottom-line investors. For values-based investors, the new approach raises questions about how to determine the environmental credibility of a “green fund.” Because the vast majority of investors are bottom-line investors, however, there is little doubt that the new approach may enormously increase the appeal of environmental investing, and is a step toward mainstreaming environmental concerns into global investment portfolios.

NOTES

1. For a compilation of studies correlating financial performance with environmental performance, see <http://www.innovestgroup.com/library.htm>

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consider criteria other than short-term rates of return for investing their endowments. They can create demand for environmentally and socially responsible mutual funds and for further information dissemination.

Financial Advisors—Bottom-line leverage. Financial advisors are extremely influential in directing their clients’ investments because they are seen as impartial experts who help their clients identify

investment goals and objectives. As a group, financial advisors could play an important role in educating individual and institutional investors on the environmental and social implications of investments.

NOTES

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5. Philippe Mao. "Socially Responsible Investing." *Sky*. June 1997.
6. Ted Fishman. "The Joys of Global Investment." *Harpers*. February 1997.
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AVAILABLE INFORMATION

Investment Company Institute: <http://www.ici.org>

Mutual Funds advisory newsletters, 1-800-442-9000

Association of Investment Management and Research: <http://www.aimr.com>

Rating reports: <http://www.morningstar.net> and <http://www.lipperweb.com>

U.S. Stock Exchange: <http://www.nasdaq.com>

U.S. Securities and Exchange Commission: <http://www.sec.gov>

Online guides to socially responsible investments: <http://www.greenmoney.com> and <http://www.goodmoney.com>

U.S. Social Investment Forum, Washington, DC: <http://www.socialinvest.org>

U.K. Social Investment Forum, (44-171) 377-5907

Calvert Group's "Know what you own" website: <http://www.calvertgroup.com/kwyo/index.htm>

Institutional Investment Report (the "Brancato report") The Conference Board, New York, (212) 339-0413

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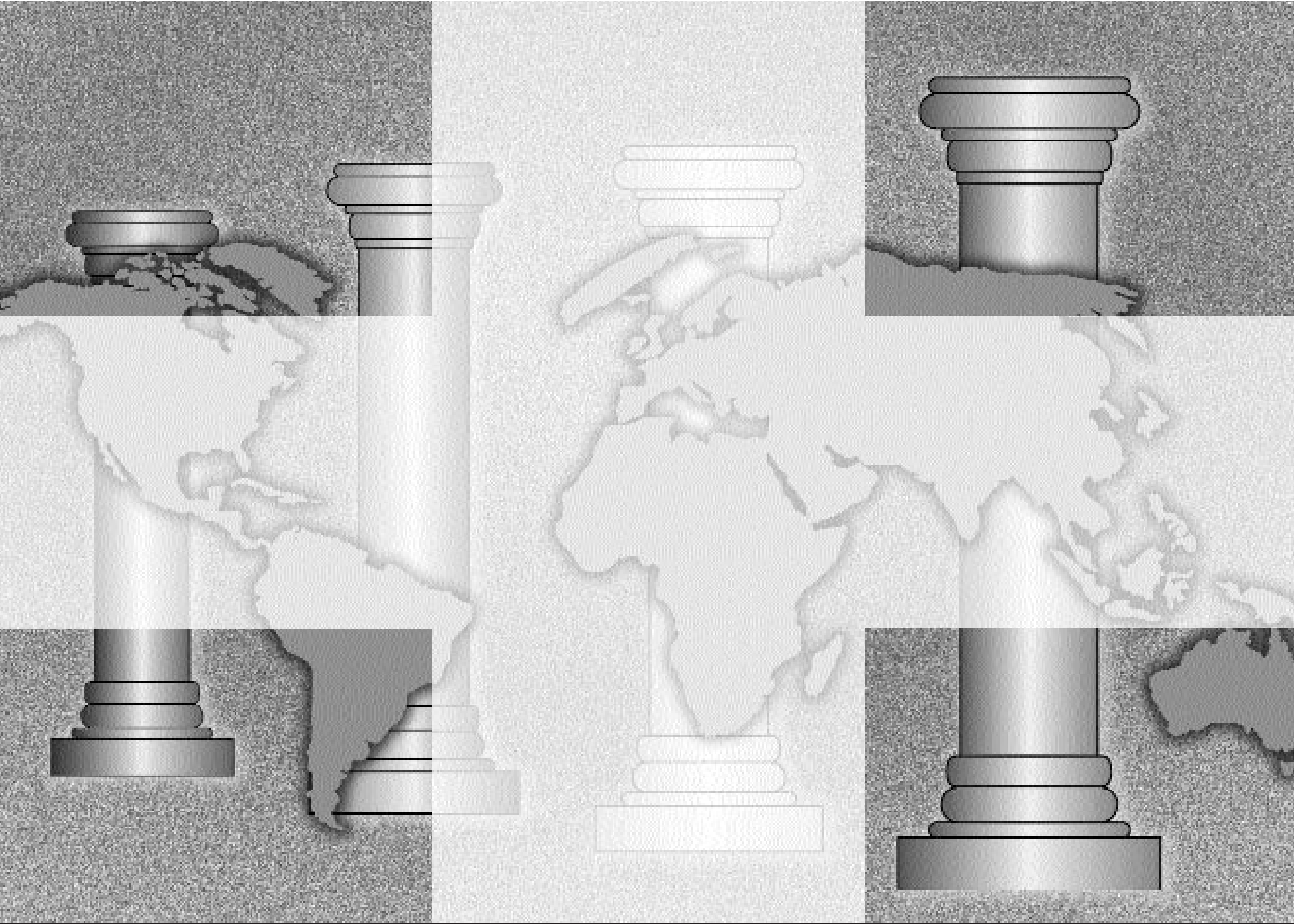
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PENSION FUNDS

5. PENSION FUNDS

PROFILE

Pension funds are a means for individuals to save for their retirement. Employers are often mandated or encouraged by governments to establish pension funds to supplement publicly managed social security by providing other sources of retirement benefits or to promote national savings. Pension funds encompass a broad array of savings plans ranging from social security to individual contribution-defined or benefit-defined company plans. Contribution-defined plans are those in which the employee and/or employer put in a set amount each month or pay period; benefit-defined plans guarantee the employee a set benefit upon retirement. *Figure 5.1* summarizes four key characteristics of pension funds of particular importance to the public interest community.

Size and Leaders

After commercial banks and mutual funds, pension funds represent the third largest global pool of private capital available for lending or investment purposes. In the United States alone, they represented more than US\$3 trillion at the end of 1993 and US\$4.7 trillion by 1996. The California Public Employees' Retirement System (CalPERS) is one of the world's largest public pension funds, representing US\$128 billion in assets. Other large U.S. pension funds include the New York Common, College Retirement Equities Fund (CREF), and General Motor's and General Electric's pension funds.

Key Features

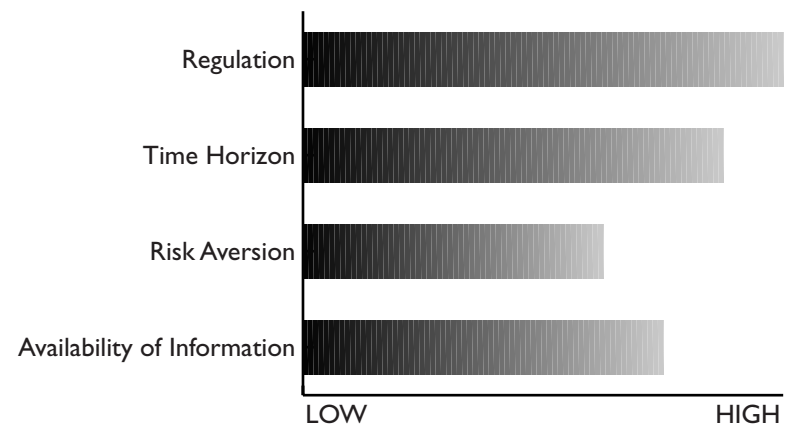
The governance and investment policies of a pension fund determine

how it can invest in the following categories: a company's own securities, international securities, stocks, bonds, and real estate. Pension funds tend to have long-term investment time horizons, because they have relatively stable and known inflows (contributions) and outflows (benefits). Because they represent individual savings for retirement, pension funds have traditionally been managed passively, for low risk, and have concentrated their investments in highly secure stocks and bonds. However, regulatory changes in the United States (see below) and a surge in available capital have encouraged pension funds to diversify into some higher risk and international investments. According to a survey on U.S. institutional investors, 30 percent of all foreign equity investments by U.S. investors are held by 25 U.S. pension funds (1). By 1995, pension funds were committing approximately 5 percent of their assets into "alternative" investments, such as timber and farmland, oil and gas, venture capital, and leveraged buyouts (2).

Regulation

In comparison with other institutional investors, pension funds are heavily regulated. In the United States, the 1974 Employee Retirement Income Security Act (ERISA) is the principal instrument for government regulation of pension funds, and the Securities and Exchange

Figure 5.1 Key Characteristics of Pension Funds



Commission (SEC), the Internal Revenue Service (IRS), and the Department of Labor govern rules of operation and required information disclosure. The following regulatory changes have made an impact upon pension fund investing:

- In 1979, introduction of the “Prudent Man (Investor)” rule allowed pension funds to begin to diversify into higher-risk investments.
- In 1980, the “Safe Harbor” regulation enabled pension funds to shift investments into venture capital by limiting the institutional risk borne by the pension fund.
- In 1988, courts ruled that pension funds were obligated under ERISA to vote corporate proxies in a manner consistent with the fund’s governance requirements.

Each pension fund has specific operating and investment guidelines that are established during the incorporation process and are periodically updated based on shareholder resolutions, trustee actions, and some government guidelines. Voting procedures of any pension fund can be altered by employee vote or a change in voting guidelines administered by the Board of Directors. Some pension fund managers such as CalPERS and CREF may actively acquire stock and sponsor shareholder resolutions. For example, CREF filed a shareholder resolution in February 1998 that demanded a reconfiguration of Walt Disney’s Board of Directors. The resolution received support from 35 percent of Disney’s shareholders (3).

Attention to Environmental Issues

Pension funds do not typically incorporate environmental considerations into investment management decisions. However, the portion of pension fund investments now being channeled into “socially responsible” (SRI) funds is growing. Nevertheless, the obligation to maximize returns within broad risk levels, as governed by the fund’s guidelines, is often cited as a limit to socially responsible investing.

Relevance to Developing and Transition Economies

Pension fund creation has been encouraged in developing and transi-

tion economies through structural economic reforms promoted by multilateral financial institutions such as the World Bank and the International Finance Corporation (IFC). These reforms have urged developing countries to privatize government social security schemes to encourage higher domestic savings and foster the development of local capital markets. Pension fund creation has supplemented privatization efforts by increasing the amount of domestic capital available towards investing in privatizations of state-owned enterprises. The countries of South America, with Chile leading the way, are experiencing significant growth in pension fund creation. The IFC has provided technical assistance and has invested capital into pension funds in several countries, including Peru and Argentina.

U.S. pension funds that invest internationally now have an average allocation of 15 percent invested abroad; U.K. funds average 30 percent (4). Pension funds have contributed significantly to the flow of capital towards “emerging markets” through investments in mutual funds (*see Chapter 4, Mutual Funds*) and private equity funds (*see Chapter 8, Venture Capital*). CalPERS has invested US\$250 million in Asian private equity funds primarily through the Asian Development Bank (5). Pension fund investors are fueling the growth of funds such as the Asian Infrastructure Fund and the Global Power Investments Company Fund.

PENSION FUND DIAGRAM

Figure 5.2 illustrates the operation of a pension fund. In general, the employer identifies the need for a pension fund or is required by law to establish one for its employees. When a fund is established, several key questions arise regarding its **design/creation**:

- Will the **pension fund** be contribution-defined or benefit-defined?
- Will it be funded by the **employee** and/or **employer**?
- Will it be voluntary or mandatory?
- What are the potential **tax savings** and **government regulations** involved?
- Will the investment portfolio be managed internally or externally?
- What investment guidelines will be given to the **treasurer** and the **money managers**?

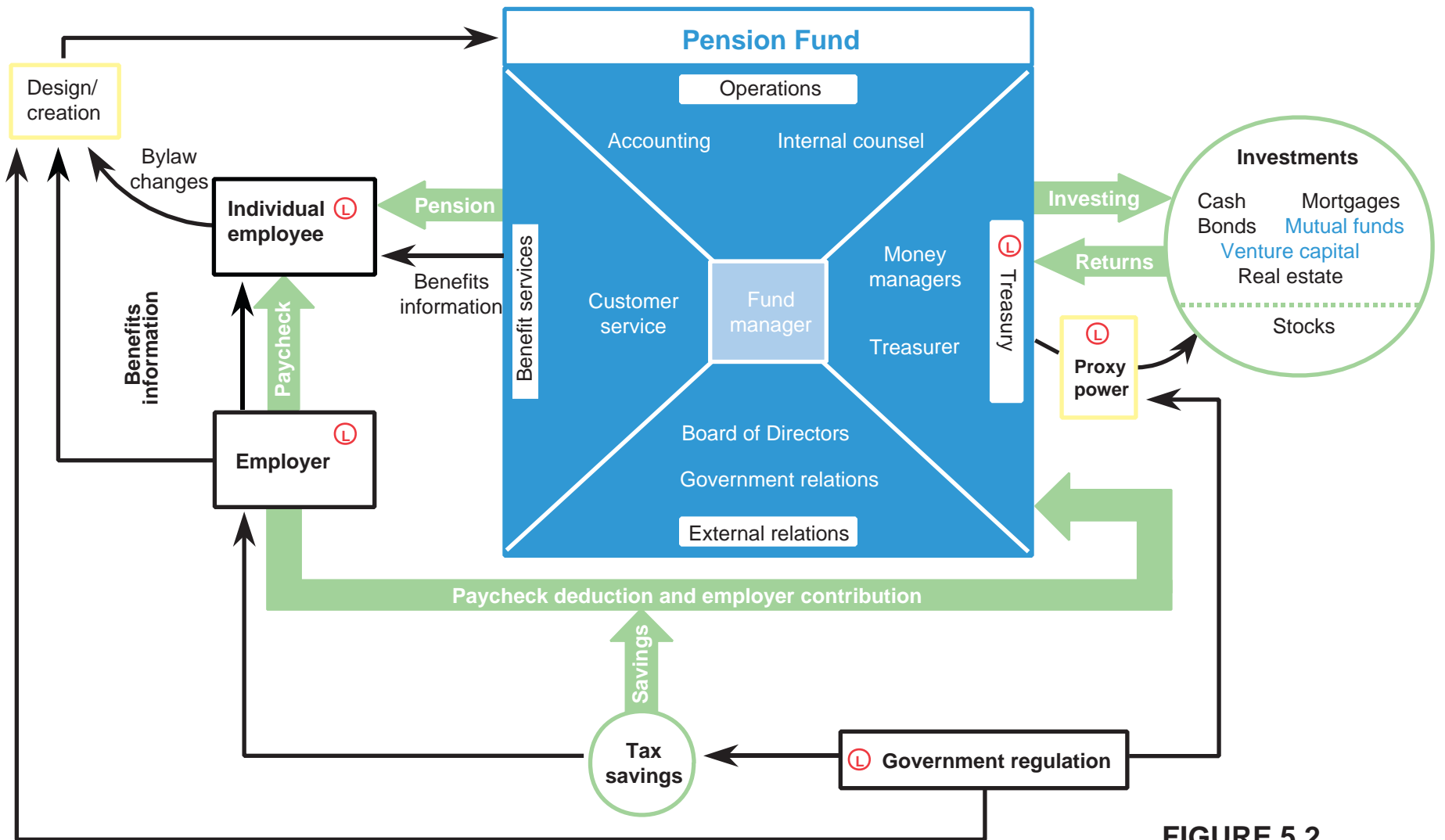


FIGURE 5.2
PENSION FUND

The answers to these questions are codified in the fund's bylaws or incorporation documents.

Once the fund is legally established, an institution is set up or hired to manage the various aspects of the **pension fund**. These areas consist of **benefit services** (responsible for customer service with the **employee**), **operations** (**internal counsel** and **accounting staff** responsible for compliance with all standards), **external relations** (**government relations**), and **treasury**. All of the functions are managed or coordinated by the **fund manager**.

The flow of **benefits information** to an **individual employee** is governed by the fund's bylaws or incorporation documents.

A **deduction** is made from each **paycheck** towards the **pension fund** and may be matched with an **employer contribution**. This money is then managed by the **treasurer** or **investment committee** of the pension fund and invested by **money managers**. Most funds have specific guidelines laid out in the **bylaws** defining the **investment** objectives for the fund's **money managers**. These guidelines traditionally cover risk and expected rates of return.

The **power of the proxy** and **shareholder resolutions** are tools that pension funds can use to influence companies whose stocks they own. The process by which a pension fund votes its proxies is determined by its voting guidelines and procedures, which can be altered through **bylaw changes** by employee vote or a change in voting guidelines administered by the **Board of Directors**.

Government regulation is significant to the pension fund on three fronts: in the initial **design**, in the power of the **proxy**, and in laws that have an impact upon **tax savings**. Besides ERISA, the SEC, the IRS, and the Department of Labor are the key U.S. government agencies involved with pension funds because they can influence the rules by which the funds operate as well as what information they disseminate to fund beneficiaries.

LEVERAGE POINTS

Treasury—*Bottom-line leverage*. The treasurer and money managers apply the fund's investment strategy. Because pension funds require predictable investment returns, these individuals should be willing to consider evidence that integrating environmental considerations into investment decisions makes financial sense over the long run.

Proxy Power/Shareholder Resolution—*Values-based/Reputational leverage*. The proxy is a very powerful tool for pension funds, which are highly visible, long term, and often very large holders of stock, thereby having a significant impact on a company's operating practices and procedures and possibly on the market value of the stock.

Government Regulation—*Policy leverage*. Government policy could be altered to provide incentives to pension funds for environmentally sustainable investments. For example, government policy could encourage pension funds to invest in "climate-friendly" corporations through tax breaks or other incentives.

Employer—*Bottom-line/Values-based/Reputational leverage*. Employers, particularly environmentally oriented businesses and public interest organizations, can offer environmentally screened pension fund options to match the image or the mission of their firm. Employers can also provide greater information about the pension fund to their employees.

Employee—*Bottom-line/Values-based leverage*. Employees with defined-contribution plans can demand more information about how their retirement funds are being invested, and can change the guidelines governing management of their savings. Employees can also become more active by being elected or appointed as a member of their pension fund's investment committee.

Box 5.1 Two Pension Funds Balance Fiduciary Responsibility and Responsible Investing

Background: Since 1990, the Maxxam Corporation has been embroiled in legal struggles over its logging of old-growth redwood forests in northern California. In May 1996, the federal government brokered a deal to protect a portion of the forests in exchange for unhindered logging access to the rest. This deal angered nongovernmental organizations (NGOs) active in the litigation who had been urging a “debt-for-nature” swap, which entailed protection of the entire old-growth holdings in exchange for forgiveness of Maxxam’s corporate debt. In late 1996, the balance of forces tilted. Two large public pension funds with holdings in Maxxam were persuaded by employees’ unions and NGOs to add their voices to the debate—the California Public Employees Retirement System (CalPERS), which has assets of US\$107 billion, and is the largest pension fund in the United States and is the second largest Maxxam stockholder with US\$13 million (3.7 percent), along with the California State Teachers Retirement System (CalSTRS), which has \$65 billion in assets, and is the tenth largest Maxxam stockholder with US\$3 million (0.82 percent).

Action: First, the Rose Foundation for Communities and the Environment led an outreach campaign to teachers’ and public employees’ unions, which highlighted Maxxam’s environmental record as well as its questionable labor practices. Rose charged that Maxxam was paying off a bank loan by diverting funds from its employees’ pension fund and that interest on junk bonds was paid by accelerated logging. In a series of letters, the unions expressed their concerns over Maxxam’s logging activities to CalSTRS and CalPERS, supported promotion of a debt-for-nature swap and, as a last resort, urged that the funds divest from Maxxam stock. Next, the pension funds were the subject of a hard-hitting media campaign that proclaimed: “We hear the retirement funds of California State employees and teachers are making a real killing.”

Outcome: CalSTRS and CalPERS responded that their primary duty is to maximize financial returns to their members and that investments cannot be dictated by social or environmental concerns. Yet both took measures that suggest they heeded the values-based concerns of their members. In early 1997, the President of CalPERS sent a strongly worded letter to Maxxam’s CEO, warning of a public outcry and legislative backlash in response to continued logging, adding that he would be “perceived as a pariah, unable to easily raise new capital.” In late 1997, CalSTRS divested from Maxxam stock, noting that although the decision was based on financial performance, the teachers’ actions had “brought attention to the stock.” Finally, in 1998, CalPERS co-sponsored a shareholder resolution with the Rose Foundation proposing changes to provide more shareholder influence, which was supported by 14.4 percent of votes cast.

Analysis: The Rose Foundation and the various public employee unions urged CalSTRS and CalPERS to act based on values-based and reputational arguments. They simultaneously brought reputational pressure to bear on Maxxam Corporation, with considerable bottom-line implications. The pressure enabled the pension funds to engage Maxxam on financial grounds, which allowed them to voice social and environmental concerns while maintaining their fiduciary responsibility to beneficiaries.

Source: Personal communication with the Rose Foundation, CalSTRS, CalPERS, and various press clippings.

NOTES

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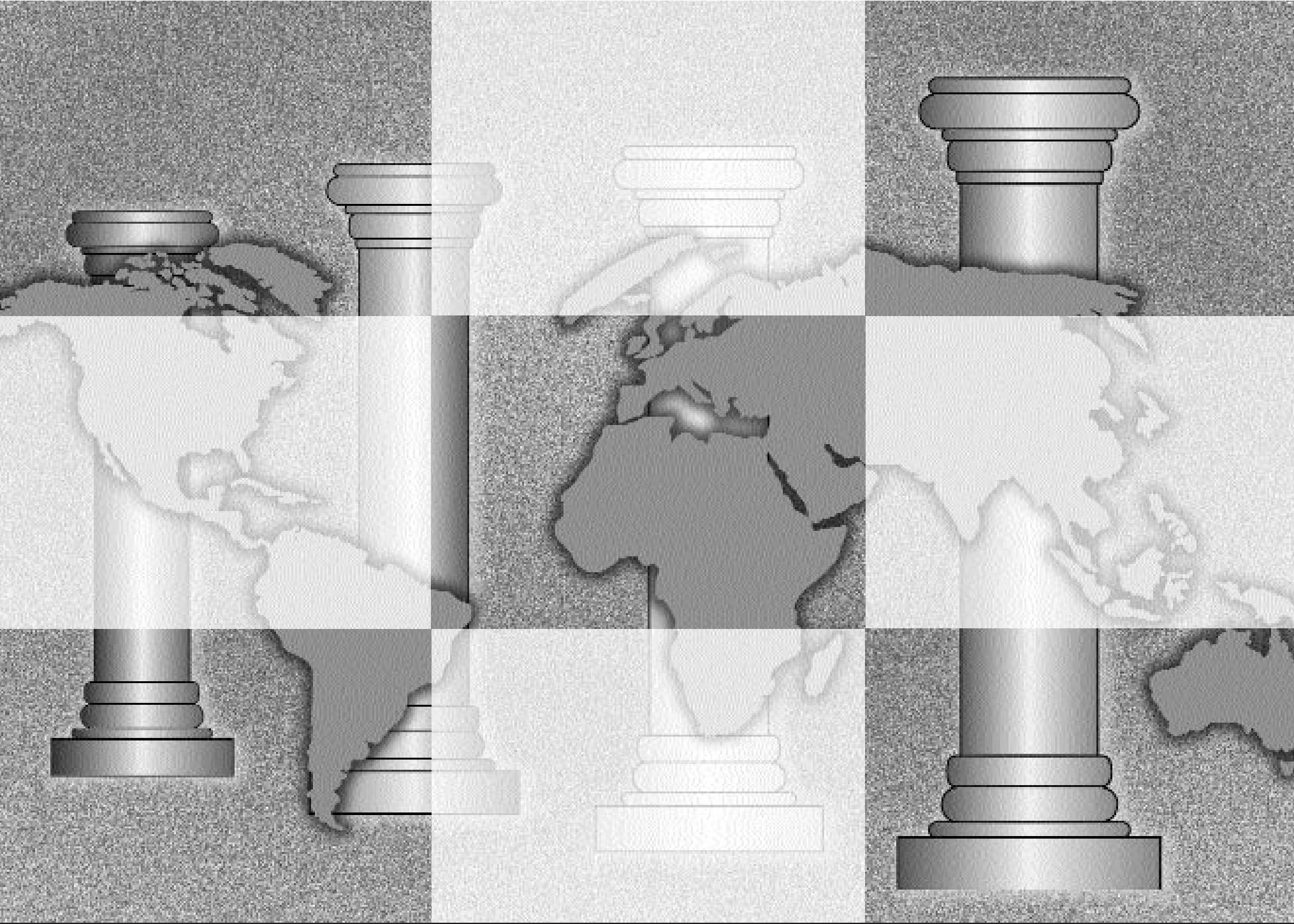
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The Council of Institutional Investors: <http://www.ciicentral.com>
Interfaith Center on Corporate Responsibility (ICCR), New York,
(212) 870-2600

CalPERS pension fund: <http://www.calpers.ca.gov>
 Teachers Insurance and Annuity Association—College Retirement
 Equities Fund (TIAA-CREF) pension fund: <http://www.tiaa-cref.org>
 Proxies for People: <http://host.envirolink.org/ebic/pfp/index.html>
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PROPERTY & CASUALTY INSURANCE

6. PROPERTY & CASUALTY INSURANCE

PROFILE

The property and casualty (P&C) insurance industry is in two businesses: underwriting risk and investment management. In its underwriting function, the industry examines the frequency and severity of potential damage to physical assets (property) or injury to persons (casualty), and then places a value on insuring against, or underwriting, those risks (1). The legal structure of P&C firms can take one of two forms: stock companies, which are public companies freely traded on the open market, or mutual companies, which are owned collectively by the policyholders. *Figure 6.1* summarizes four key characteristics of the property and casualty insurance industry of particular importance to the public interest community.

Size and Leaders

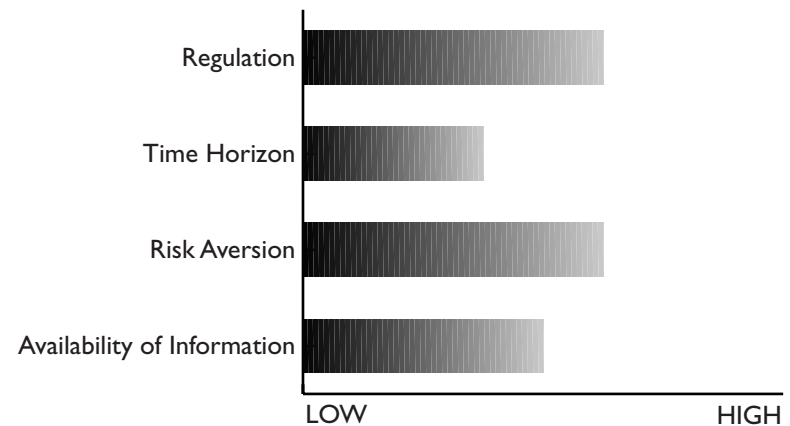
Globally, the P&C industry controls more than US\$1.4 trillion in capital (2), and in 1996, the U.S. P&C industry alone collected more than US\$250 billion in premiums. The industry is dominated by companies from Japan, Switzerland, the United States, Netherlands, Bermuda, the United Kingdom, and France. Bermuda is the offshore location of a large part of the global P&C industry. The largest stock firms in the United States are the American International Group (AIG), Allstate, Loews, the Travelers Group, ITT Hartford, and General Reinsurance. The only large mutual P&C insurance firm is State Farm. Most major corporations seeking P&C insurance utilize an insurance broker, such

as J&H Marsh and McLennan Inc., or Alexander and Alexander, to serve as an intermediary between the corporation and various underwriters.

Key Features

Today the P&C industry is made up of three main components: primary issuers, reinsurers, and “excess” insurers—each of which manages different levels of risk and exposure. Primary carriers write policies for firms and individuals looking to insure themselves against known and yet to be identified potential risks. Reinsurers buy or are ceded a percentage of the premiums collected by the primary insurer in a pooled or aggregate manner that covers a large group of policies, and the reinsurer’s insurance policy covers aggregate claims against the pool once the total amount of loss exceeds a certain value. Excess insurers tend to offer coverage above levels of US\$10 million to US\$100 million. For example, a corporation buys primary insurance or self-insures for the first US\$100 million in losses and then buys coverage for the next US\$100 million in coverage from an “excess” insurer. Reinsurers and excess insurers tend to take a more global approach, both in geographic markets and products, to spreading risk than primary issuers.

Figure 6.1 Key Characteristics of Property & Casualty Insurance



Until the last decade or so, the P&C industry was not generally considered to be a member of the investment community. Firms in the industry thought of themselves as “underwriters” who also happened to make investments, utilizing a mix of internal and external advisors and investment managers to manage their capital. Historically, the industry invested conservatively only in extremely high quality bonds with maturity dates that matched the expected needs to pay out claims. High rates of return were a third consideration after the timing of investment maturity and a high level of security. Although change has occurred in recent decades, the overall investment portfolio of the P&C industry has remained relatively stable in the 1990s with approximately 75 percent being held in high-grade government and corporate bonds, 19 percent in equities, 2 percent in real estate, and the remainder in miscellaneous investments and cash.

Regulation

The United States is the only major country that does not regulate the insurance industry at the national level. Instead, the industry is regulated at the state level by 50 state insurance commissioners, who are appointed in some states and elected in others. The industry is shaped by statutory regulations that govern accounting rules, minimum capacity (risk, assets, and staff), and specific underwriting knowledge. The National Association of Insurance Commissioners (NAIC) serves as the umbrella organization for the state commissioners and coordinates regulatory issues at the national level. NAIC requires all insurance firms doing business in the United States to submit a report each year called an “annual statement.” Annual statements, which are rich in information about the firm’s financial condition and are publicly available, must disclose all environmental liabilities of the insurance company’s underwriting activities. The NAIC has also issued official investment guidelines to insurers in an attempt to influence the overall direction of investment management within the industry.

Attention to Environmental Issues

The underwriting side of the P&C industry was the first segment of the financial services industry to become concerned about environmental

issues. In the late 1960s, the industry began to face claims related to asbestos, and in the 1980s U.S. courts deemed P&C policies to cover risks related to toxic contamination under the so-called “Superfund” legislation. Many P&C insurers began to offer specialty environmental liability insurance in the 1970s and 1980s, but they significantly underestimated their exposure. It is estimated that unanticipated asbestos and environmental claims have cost the industry more than US\$200 billion, driving several large insurance firms into bankruptcy and forcing several others into major divestitures, mergers, and restructurings.

In 1985, the P&C industry acted to limit future liability by introducing a new clause in the Commercial General Liability policy that in practice absolutely excludes liability for property damage or bodily injury caused by pollution. As a result, corporations needing to insure against environmental liabilities must choose between various specialty insurance policies that cover specific types of environmental damage and that normally have very narrow financial limits and types of coverage. An important recent development is that increasing numbers of corporations are choosing to self-insure by setting up reserve funds for specific types of risks, including environmental or catastrophic loss. It is not yet known whether a large percentage of corporations will aggressively pursue this path, given the potential of associated risks.

The P&C industry now employs thousands of environmental experts in various disciplines to analyze the financial implications of environmental exposures faced by clients and to work with clients to mitigate environmental risk. The industry is also on the leading edge of the financial services industry in analyzing climatological phenomena such as global warming and the increased frequency of storm events. As of July 1998, there were 78 signatories to the recently initiated United Nations Environment Programme’s Statement of Environmental Commitment by the Insurance Industry. At this time, nearly all of the signatories come from Europe or Japan.

Remarkably little spillover appears to have occurred from the underwriting side of the industry to the investment side of the industry in

terms of addressing environmental issues. As a group, environmental considerations do not appear to influence the composition of the investment portfolios of the P&C industry. (*For an exception, see Box 6.1.*)

Relevance to Developing and Transition Economies

On the underwriting side, the international P&C insurance industry is actively seeking markets in developing countries, although trade barriers have previously deterred the industry from such significant markets as India and China. There is a limited market for P&C insurance policies covering environmental risks in the developing world because legislation mandating coverage is unclear or nonexistent, and court decisions holding companies and their insurers liable for environmental damage are rare.

On the investment side, the P&C insurance industry invests in various domestic and international securities. Some global insurers are diversifying from traditional investment activities. For example, AIG has actively sponsored private equity funds in Asia. (*See Chapter 8, Venture Capital.*) The “Asian Infrastructure Fund” is capitalized at US\$1 billion, and a second fund has been capitalized at US\$1.53 billion for infrastructure investments (3).

PROPERTY & CASUALTY INSURANCE DIAGRAM

Figure 6.2 illustrates the operation of a property and casualty insurance company. The need for P&C insurance is usually identified by the **risk manager** of a corporation, the **corporate client**, who has ascertained a potential risk to earnings within the corporation in the case of property damage or employee casualty. Once other staff inside the corporation concur, the **risk manager** contacts one or more several large **insurance brokers** to discuss insurance coverage options. The **insurance broker** and the **risk manager** create a request for proposal (RFP) that will be used to approach various **account/field offices** of different primary P&C insurance companies.

Within the P&C firm, the **underwriter** and the **review committee**, with support from **external counsel**, **actuarial**, and **technical and in-**

dustry services, evaluate the risk, establish parameters for the **policy**, and price the transaction based on RFP characteristics and current market conditions. An offer is made and a policy written and signed between the **client risk manager** and the **P&C insurance company**. Once the contract is signed, **customer service**, with support from **claims and monitoring agents**, manages contact with the policyholder. If a client submits a claim, it undergoes vigorous review that often involves the **legal department**. Each claim is settled based on the merits and legal aspects of the transaction as well as the importance of the client.

Some of the following questions are considered by the underwriter:

- How does a potential policy fit within the insurance company’s overall portfolio?
- What experience does the insurance company have with the potential client’s industry and type of policy and geographic location?
- Is there a secondary market for the policy?

Concurrent to the underwriting process, the primary insurance firm must determine the percentage of its total collected **premiums** that will be **ceded** to the **reinsurance** market. The dollar amount ceded to **reinsurance companies** is negotiated on a case-by-case basis.

Once the insured client begins to pay **premiums**, the money is directed to the **investing** side of the insurer. The **finance committee** and **treasurer** set the investment guidelines. Typically, insurance company strategy is made on an annual basis with the assets of the firm divided up among various **internal or external portfolio managers** who will try to maximize rates of return by investing in various **domestic and international instruments**.

Rating agencies, such as A.M. Best, rate each P&C insurance company’s overall underwriting and investment portfolio.

Some of the following questions are considered by the portfolio managers:

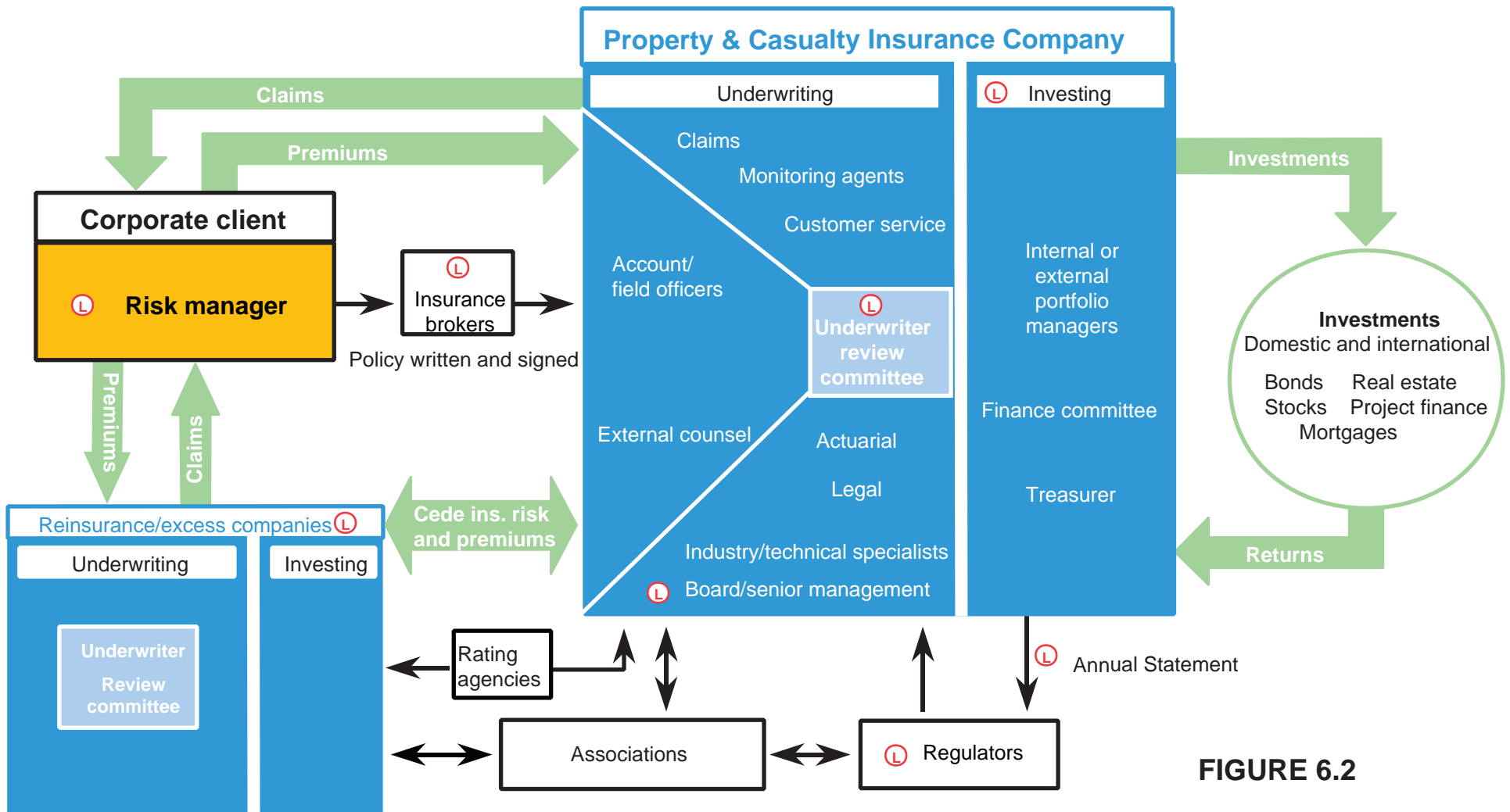


FIGURE 6.2

PROPERTY & CASUALTY INSURANCE

- How will the **rating agencies** react to a change in investment approach?
- How much risk can the portfolio assume?
- How should the overall portfolio be divided into different investment vehicles and financial instruments?

At this time, the **investing** side of the organization appears not to be leveraging (either intentionally or unintentionally) the environmental knowledge that has been acquired on the **underwriting** side of the firm.

In the United States, state insurance **regulators** oversee both the underwriting and investment activities of the P&C industry. Per NAIC regulation, each insurance company must submit an **annual statement** of its underwriting and investing activities. Trade **associations**, such as the American Insurance Association and the Reinsurance Association of America, provide information and educational materials to their members.

LEVERAGE POINTS

Underwriter—*Bottom-line leverage*. The underwriter is the most influential individual on the coverage side of a P&C firm. He or she decides what risks to insure, and what value, if any, should be placed on the environmental management system policies and practices of the company seeking insurance. The underwriter decides on the relevance of environmental exposures to a particular policy, and has an incentive to know and influence how the corporate client is managing and mitigating those risks.

Reinsurance Companies—*Bottom-line leverage*. Reinsurance firms are leading the discussion in the insurance industry regarding the impact of trends such as climate change and ozone depletion. They have strong incentives to understand the financial ramifications of environmental risks and to convince others of the importance of mitigating those risks, especially those associated with catastrophic events.

Insurance Brokers—*Bottom-line leverage*. Because relatively few major brokers exist worldwide, a small number of firms exercise an

enormous influence over the P&C insurance market. Brokers, for example, are in a position to influence the scope of coverage and the type of policies available for companies exhibiting superior environmental performance.

Corporate Client Risk Manager—*Bottom-line leverage*. The risk manager in the company seeking insurance has incentive to be proactive in mitigating environmental risk because lower risk should translate into lower rates.

Board/Senior Management—*Bottom-line/Reputational leverage*. These groups oversee the long-term health of the insurance company. Issues related to image, costs, or loss of customers will likely get the attention of senior management. Actions or decisions from this group will influence the entire company.

Regulators—*Policy leverage*. The NAIC establishes national reporting and disclosure guidelines on liabilities and assets, including what information must be provided in a firm's "**annual statement**." Additional regulatory guidelines could be promulgated to integrate environmental criteria into investment strategies, and more stringent guidelines could be provided to ensure environmental disclosure within the annual statement.

Investing: Finance Committee, Treasurer, and External or Internal Portfolio Manager—*Bottom-line leverage*. At present, these individuals in the P&C industry do not appear to integrate environmental variables into their investment decisionmaking process any differently than do other mainstream investment managers. If these investment officials could be convinced of the value of integrating environmental criteria into the investment side of the business, they could leverage internal expertise from the underwriting side of the business.

Box 6.1 A Property & Casualty Insurance Industry Giant Looks to the Future

Background: In the eight years since official negotiations toward a climate change convention began, the US\$1.4 trillion insurance industry has become increasingly sensitive to the potential implications of climate change for their business. Several industry analysts have noted that property-catastrophe losses from windstorms in particular have reached record levels in the 1990s. Although these losses cannot be definitively linked to climate change, industry insiders are concerned about the mounting evidence of changes in underlying weather patterns. This attention has been fruitfully channeled into a sustained dialogue among insurance firms, policymakers, and environmentalists.

Action: From 1993 onward, Greenpeace has organized a series of seminars with insurance and other financial services sectors to share perspectives on the costs of potential climate change and to seek productive ways to move forward. Following this initiative, the Solar Century was established in 1997 as a commercial entity to promote the development and use of solar power, with profits targeted towards community solar power projects. Solar Century has sought to involve the P&C insurance industry in a drive to achieve critical mass in the global solar-energy market, by showing how the industry could play a role both as consumers of energy as well as investors in the technology and its applications. Solar Century has been engaged in dialogue with several industry leaders to facilitate participation in this effort, including the giant Gerling Konzern group of insurance companies.

Outcome: In June 1998, Gerling decided to establish a separate entity to demonstrate the viability of sustainable development projects. These projects include but are not limited to solar power. This new group, known as “Gerling Sustainable Development Project Company,” will develop projects that integrate environmental, social, and economic goals and formulate indicators by which to evaluate progress. The long-term goal is to integrate such projects into the investment portfolios of Gerling and other industry leaders based on a track record of demonstrated success.

Analysis: The message of enlightened self-interest, forged jointly through repeated conversations between industry and environmentalists, has been embraced by some insurance industry leaders. In the notable case of Gerling, discussion has led to actions with extremely long-term horizons. Gerling’s actions are based on a fundamental reevaluation of long-term energy futures and a corresponding shift in values to embrace long-term goals of sustainability. This value shift was forged through a long process of collaboration and engagement between Gerling and partners at Solar Century.

Sources: Jeremy Leggett, ed. 1996. *Climate Change and the Financial Sector*. Munich: Gerling Akademie Verlag; Solar Century website: <http://www.solarcentury.co.uk>; and personal communication, Dirk Kohler, Gerling Konzern.

NOTES

1. The modern P&C industry began in the 18th century at a London dockside coffeeshop named Lloyd’s with the underwriting of England’s worldwide merchant fleet. The term “underwriting” dates back to the days when a vessel’s cargo or manifest was listed and valued at the top of a sheet of paper; individuals willing to insure the cargo *wrote* their names along with the percentage amount they would cover in case of loss *under* the manifest listing, thus becoming known as “underwriters.”
2. Stephen Schmidheiny et al. *Financing Change*. Cambridge, MA: MIT Press. 1996. p. 118.
3. John Arthers. “AIG Raises 41.53 Billion for Asia,” *Financial Times*. December 11, 1997.

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American Insurance Association: <http://www.aiadc.org>

National Association of Insurance Commissioners (NAIC): <http://www.naic.org>

Risk and Insurance Management Society, New York, (212) 286-9292

Society for Risk Analysis, McLean, VA, (703) 790-1745

Reinsurance Association of America, Washington, DC: <http://www.raanet.org>

The London International Insurance and Reinsurance Market Association: <http://www.lirma.co.uk>

Insurance Services Office, Inc., New York, (212) 898-6000

A.M. Best: <http://www.ambest.com>

United Nations Environment Programme, "Insurance Industry Initiative for the Environment." <http://eandc.lbl.gov/CBS/climate-insurance/UNEP.html>

Annual statements (required and available at NAIC, libraries, or companies)

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Trade periodicals:

A.M. Best's Property & Casualty

National Underwriters

CPCU Journal

National Association of Insurance Commissioners. *Investments of Insurers Model Act*. Kansas City, MO: National Association of Insurance Commissioners. 1996.

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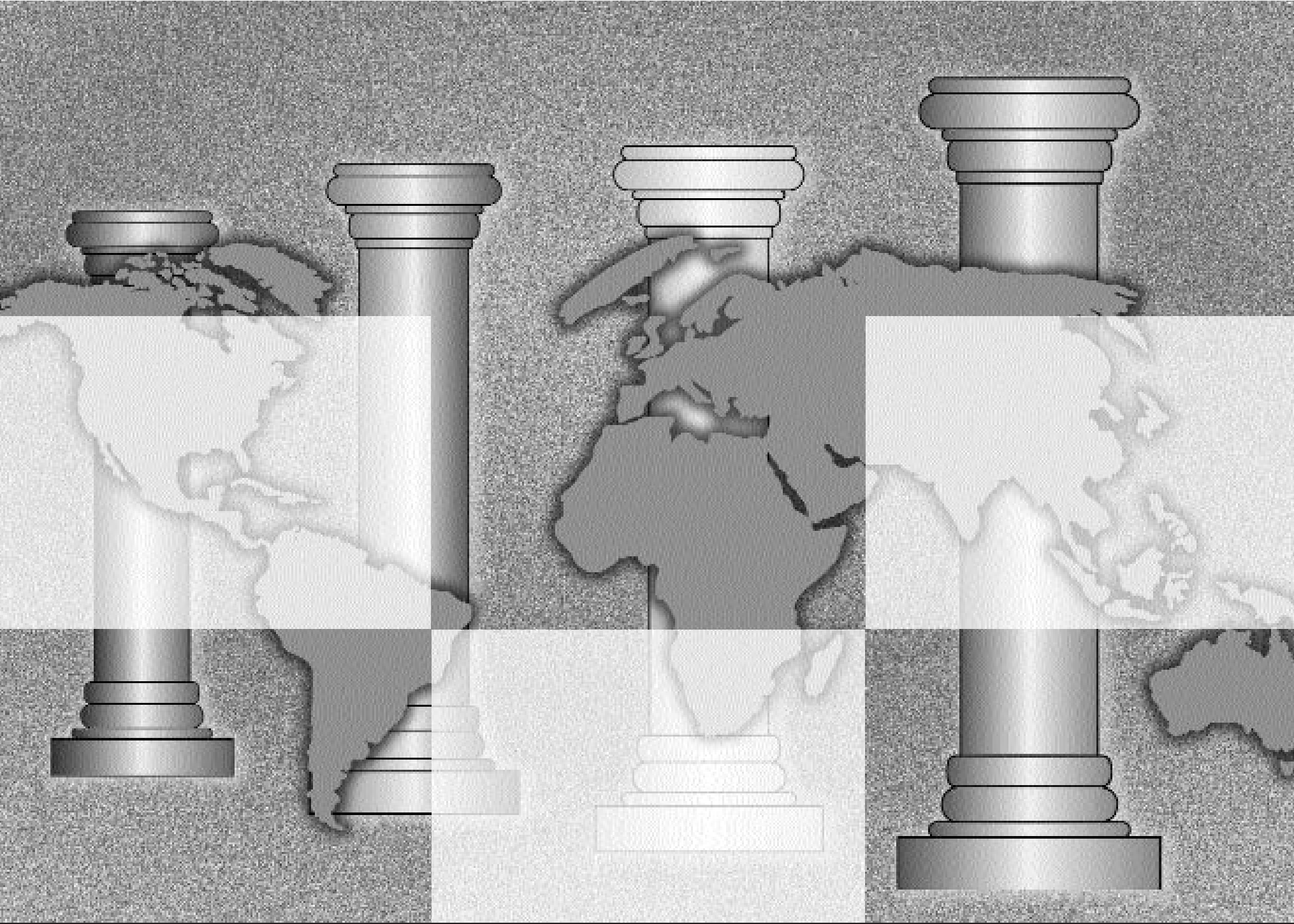
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LIFE INSURANCE

7. LIFE INSURANCE

PROFILE

The life insurance industry consists of two distinct businesses: selling life insurance policies to consumers, and investing the funds derived from the premiums for these policies. Depending on the type of policy, life insurance guarantees the insured consumer a predetermined monetary sum if the consumer dies before a certain age or lives beyond a certain age. In the United States, life insurance annuity policies were once a primary vehicle for retirement savings for average citizens, but as social security and pension funds have become available, reliance on life insurance as a retirement savings vehicle has decreased. This industry generates revenue by charging premiums calculated to exceed claims and by accumulating the interest and capital gains earned from its invested capital. *Figure 7.1* summarizes four key characteristics of the life insurance industry of particular importance to the public interest community.

Size and Leaders

While most people think of the industry in terms of the sale of life insurance policies, it also represents one of the largest pools of long-term investment capital in the world, with US\$2.3 trillion in assets. Two primary types of life insurance firms exist: stock companies, which are publicly traded companies, and mutual companies, which are owned collectively by the policyholders. The world's three largest insurance firms (based on total assets) are Japanese, led by Nippon Life. The next largest is the French insurer, AXA. The largest U.S. stock firm is AETNA, with the mutual firms led by Prudential, Metropolitan, New York, Nationwide, Principal, and Northwestern.

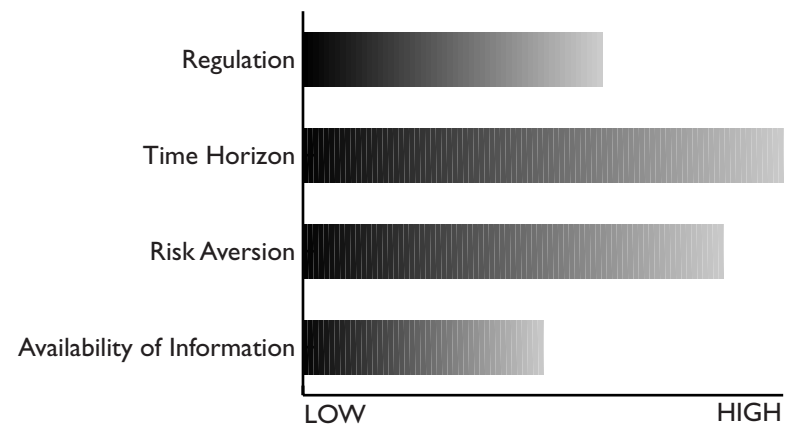
Key Features

Life insurance companies tend to employ conservative investment strategies because of their high aversion to risk. In the past, the industry placed its assets in long-term bonds and mortgages with maturity dates that matched anticipated claims by policyholders based on actuarial forecasts. This approach, although secure and easy to manage, did not generate a high rate of return. Currently, the industry is significantly reevaluating its approach to managing investments. The move towards pension funds as a vehicle for retirement savings is negatively affecting the life insurance industry in most developed countries.

Regulation

The United States is the only major country that does not regulate the insurance industry at the national level. Instead, the industry is regulated at the state level by 50 state insurance commissioners, who are appointed in some states and elected in others. The National Association of Insurance Commissioners (NAIC) serves as the umbrella oversight body for the entire U.S. insurance industry. NAIC establishes reporting and disclosure guidelines on liabilities and assets, and speci-

Figure 7.1 Key Characteristics of Life Insurance



fies information that must be included in a firm's "annual statement." In 1996, NAIC also issued guidelines on investment management for the insurance industry. The American Council of Life Insurance (ACLI) is the industry's major trade association; its 550 members represent some 85 percent of the U.S. industry's assets. ACLI exercises influence by providing information and educational materials and organizing conferences on new issues for its members.

Attention to Environmental Issues

The underwriting side of life insurance does not yet appear to be integrating the linkages between environment health and human health into its actuarial calculations. Nor has the industry drawn links between investment practices and the underwriting side of their business. On the investment side alone, however, the life insurance industry has acquired experience and expertise in a narrow set of environmental issues—toxic contamination related to real estate investment—due to its heavy investments in the real estate sector. (*See Box 7.1.*)

Relevance to Developing and Transition Economies

On the underwriting side, the life insurance industry is growing as a vehicle for savings in many developing and transition economies. For example, China's life insurance market is changing rapidly. The only foreign issuer, American International Group, is leading a boom in individual life insurance policies, a hitherto neglected segment of the market (1). On the investment side, the life insurance industry is relevant to the developing world as it invests its capital in various international securities. In this context the U.S. experience with the real estate market (*see Box 7.1*) may hold lessons for the global development of the life insurance sector. Important factors to consider include: the extent to which the host country places repatriation limits on earnings, the sectors in the host country that provide secure and predictable investment, and environmental regulations and enforcement in those sectors.

LIFE INSURANCE DIAGRAM

Figure 7.2 illustrates the operation of a life insurance company. The life insurance industry sells policies to clients, or **policyholders**, through

independent agents, its own **salesforce**, and **brokers**. Before starting the sales process, the **life insurance company** evaluates the risk profile of the country or region where the firm will be marketing its products. The **underwriter**, with the support of the **actuarial** staff, performs extensive analyses to ascertain key risks and exposures in order to predict the average lifespans of various subpopulations. From these analyses, the overall credit risk pool is evaluated and submitted to **senior management** and the **Board of Directors** for approval.

Agents obtain approval to write a policy for a potential **policyholder** from the **underwriter** and **policy committee**. Once the policy is approved, the **actuarial** staff price the policy, which is then **written and signed**. Once the contract is signed, **customer service**, with support from the **claims** department, manages contact with the **policyholder**.

As the **policyholder** begins to pay **premiums**, the money is directed to the **investment** side of the life insurance company where the investment strategy is set and managed by the **finance committee** and the **chief investment officer** or **treasurer**. **Mortgage bankers** help identify quality mortgages to hold in the investment portfolio.

In general, company strategy is determined on an annual basis by dividing the assets of the firm among various **internal and external portfolio managers** who try to maximize rates of return by allocating funds across various **investments**.

Rating agencies, such as A.M. Best, provide a rating of each life insurance company's overall underwriting and investment portfolio.

The following questions are considered by **portfolio managers**:

- How will the **rating agencies** react to a change in investment approach?
- Given the calculated approach to the timing and size of investment returns to match claims, what are the necessary rates of return?
- How much risk can the portfolio assume?
- How should the overall portfolio be divided into different investment vehicles and financial instruments?

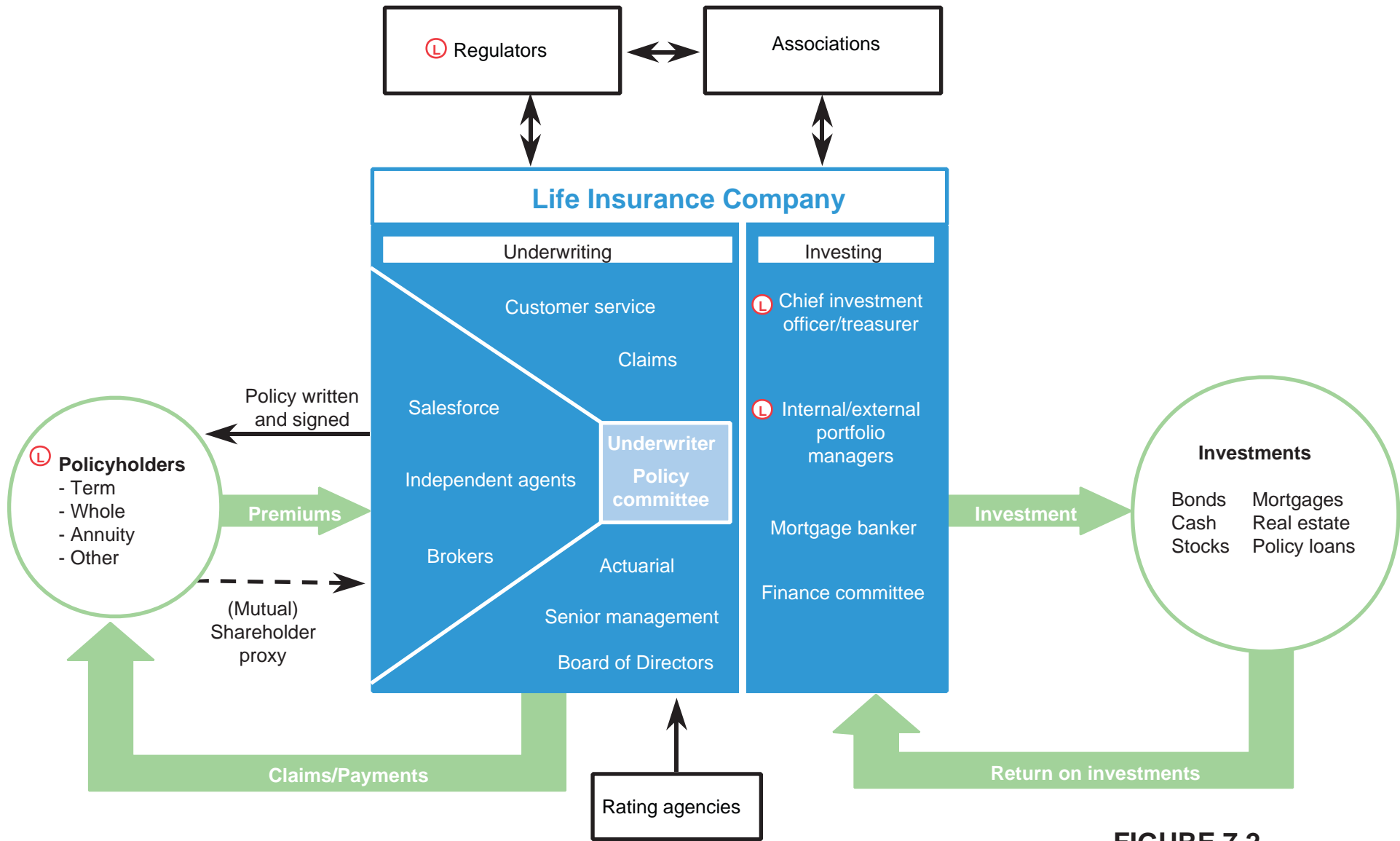


FIGURE 7.2
LIFE INSURANCE

In the United States, **regulators**, such as the NAIC and the 50 U.S. state commissioners, oversee the underwriting activities of the life insurance industry. Each insurance company must submit an annual statement of its underwriting activities. **Associations**, such as the U.S. ACLI, educate and provide information to industry members.

LEVERAGE POINTS

Chief Investment Officer/Treasurer—*Bottom-line leverage*. The chief investment officer and/or the treasurer determine the firm's investment strategy. Because the life insurance industry requires predictable investment returns, these officers should be willing to consider evidence that integrating environmental considerations into investment decisions makes financial sense over the long run.

Internal/External Portfolio Managers—*Bottom-line leverage*. Portfolio managers buy and sell securities for the insurance firm and could, in theory, be influenced in similar ways to the chief investment officer. However, portfolio managers are implementing the overall investment strategy set by others.

(Mutual) Policyholders—*Values-based leverage*. Similar to shareholders in a publicly traded company, mutual policyholders have certain rights to influence the insurer's actions because they are the owners. Policyholders could influence the firm's investment management approach to include environmental criteria.

Regulators—*Policy leverage*. In the United States, state insurance commissioners and the NAIC regulate both the underwriting and invest-

Box 7.1 The U.S. Life Insurance Industry: Environmental Management of Real Estate Investments

Background: The life insurance industry has traditionally focused on long-term investments that produce a fixed and predictable stream of income. In particular, a large portion of the industry's asset portfolio has been held in commercial mortgages, which it was presumed would fulfill this need. However, a series of real estate collapses around the world in the 1970s and 1980s proved this assumption unfounded. U.S. life insurers found themselves no longer holders of mortgages, but of the actual real estate. These changes attracted the attention of regulators, who changed industry reserve requirements to make real estate and mortgage investments less profitable. Between 1980 and 1997, the proportion of life insurance companies' investments allocated to commercial mortgages fell from 29.4 percent to 12.9 percent.

Action: In 1980, the United States passed the "Comprehensive Environmental Response, Compensation and Liability Act" (CERCLA) or "Superfund" legislation, which regulates the clean-up of toxic contamination. In the late 1980s, U.S. courts found mortgage-holders liable for the costs of cleaning up toxic contamination, even if contamination occurred prior to foreclosure of the mortgage, if they were involved in management of the facility. This alerted the life insurance industry to potential losses arising not only from real estate holdings but also from mortgage holdings.

Outcome: Many life insurance companies in the United States have now established special units to evaluate and manage environmental risks related

to industry assets invested in real estate and mortgages. The lessons of the 1980s have led to three changes in practice by the investment side of the industry. First, the industry is careful to do environmental due diligence prior to holding a mortgage. Second, in the event of default, the industry undertakes pre-foreclosure environmental due diligence. Third, upon assuming ownership of real estate due to default, life insurance companies have become environmentally proactive property managers.

Analysis: The example of the U.S. life insurance industry demonstrates that policy leverage can have broad and far-reaching consequences, often impacting sectors beyond the immediate goals of policy. In this example, holders of commercial mortgages were held accountable for the environmental integrity of the underlying asset. The exact circumstances under which lenders are liable, however, are a contentious issue and the subject of much debate in legal and regulatory circles. One positive outcome of this debate has been the enhanced visibility of environmental issues in the life insurance industry and the development of technical capability and instituted procedures for avoidance and management of toxic contamination.

Sources: *Institutional Investment Report*, Vol. 2, No. 1, June 1998; and Joseph S. Messer, "New Superfund Risks," *Mortgage Banking*, 50 (11).

ment activities of the life insurance industry. Regulatory guidelines could be promulgated to integrate environmental criteria in investment strategies and to elevate the level of environmental disclosure included in the annual statement.

NOTE

1. Craig S. Smith. "AIG Reshapes China's Insurance Industry." *Wall Street Journal*. February 9, 1996.

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American Council of Life Insurance (ACLI), Washington, DC, (202) 624-2000

Risk and Insurance Management Society, New York, (212) 286-9292

Society for Risk Analysis, McLean, VA, (703) 790-1745

National Insurance Law Service: <http://www.nils.com>

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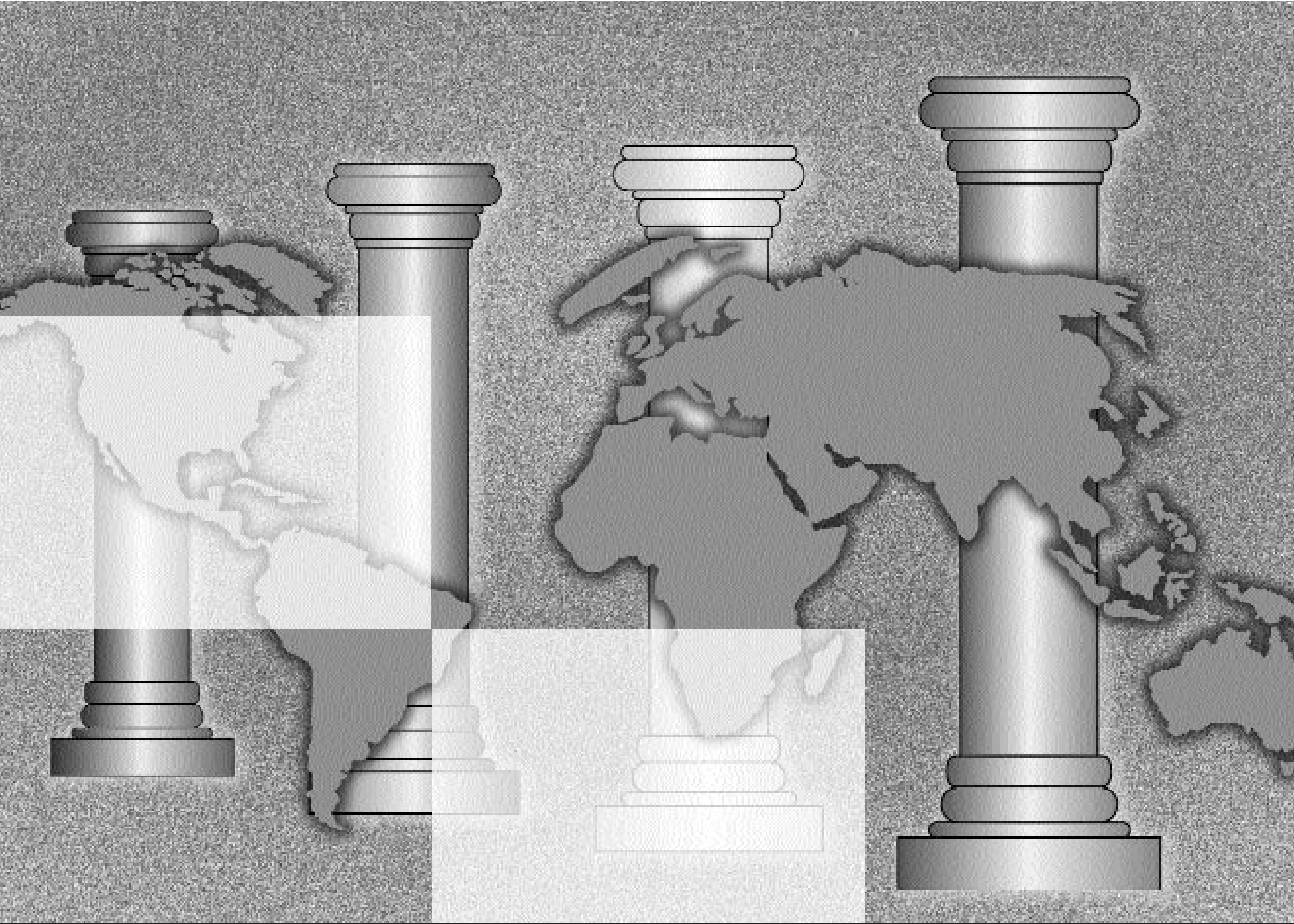
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VENTURE CAPITAL

8. VENTURE CAPITAL

PROFILE

A venture capital fund is set up to raise equity capital for investing in enterprises by a group of investors seeking significant capital gains offset by high risk of loss. Venture capital is an important source of capital for enterprises when financing from commercial banks or other traditional financial institutions is unavailable due to high risk. In contrast to mutual funds, which almost exclusively invest in publicly traded securities, venture capital funds tend to invest in not-yet-profitable companies that are not traded in the public market. Venture capital is typically associated with “early stage,” cash-poor, or rapidly expanding companies. In general, venture capital is attracted by attributes of individual entrepreneurs rather than those of companies, in support of the belief that it is the individual or management team that determines a company’s success. *Figure 8.1* summarizes four key characteristics of venture capital investing of particular importance to the public interest community.

Size and Leaders

Venture capital began in the United States in the late 1940s, spread to the United Kingdom in the 1980s, and became a fledgling industry in the rest of Europe in the 1990s. Currently, a fluctuation seems to occur in industry terminology between venture capital and “private equity,” especially in reference to international investing, where the type of finance for privately held companies is generally “later stage” (e.g., leveraged buyouts) rather than “early stage.” According to *The Private Equity Analyst*, U.S.-based private equity funds totaled US\$33.6 billion in

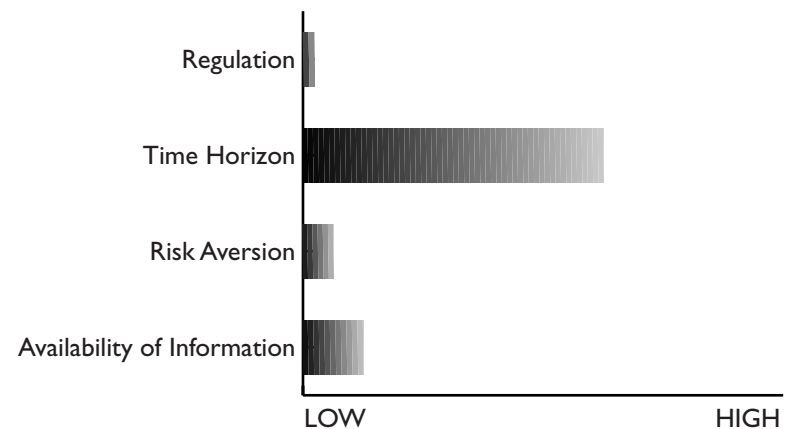
1996 and global private equity commitments totaled US\$47.8 billion (1). Venture capital (private equity) continues to evolve and now offers a variety of investment funds of different sizes—e.g., funds targeted at different stages of financing and funds offering different types of partnerships.

The typical U.S. venture capital firm manages between US\$50 million and US\$99 million in assets (2). Some of the largest venture capital firms are Warburg/Pincus Ventures, New Enterprise Associates, and Hambrecht and Quist (H&Q). Nearly 90 percent of the venture capital invested comes from institutional investors, particularly pension funds and foundations (3).

Key Features

A venture capital fund is managed by a venture capital firm or other financial institution. Venture capital firms often manage several funds at once. Venture capitalists typically seek to realize profits within three to seven years through an exit strategy, such as when the portfolio companies “go public” in an initial public offering (IPO) (*see Chapter 3, Investment Banks*), are merged with another company, or are liquidated. Venture capitalists seek returns of up to 10 times the original invest-

Figure 8.1 Key Characteristics of Venture Capital



ment, or a 40- to 60-percent annual return. Only about 7 percent of investments reach this optimum level. Those that do succeed, however, provide sufficient profit to make venture capital a potentially highly lucrative industry.

A recent phenomenon in venture capital/private equity finance is the creation of so-called “funds of funds,” which resemble mutual funds with diversified investments in various private equity assets. The number of “funds of funds” has more than doubled since 1994. They offer stability for private equity partnerships because the agreement locks in the investors for up to ten years. Significant “funds of funds” have been established by Goldman Sachs, capitalized at \$900 million, and Merrill Lynch Private Equity Fund, at \$200 million.

Regulation

In contrast to other financial vehicles or institutions, venture capital is not regulated by any securities regulatory body. The limited partnership structure of venture capital is a form of private placement and requires no formal registration. However, venture capital funds are subject to capital gains tax laws in the United States.

Attention to Environmental Issues

The mainstream venture capital industry has no relevant experience with or historical concern for environmental issues. A handful of small venture capital firms, however, now specializes in environmental technology funds. The International Finance Corporation (IFC) has begun to mobilize financing for a few small funds dedicated to environmentally sustainable enterprises, such as the new Terra Capital Fund for Biodiversity (*see Box 8.1*) and the Renewable Energy and Energy Efficiency Fund currently being capitalized.

Relevance to Developing and Transition Economies

The surplus of equity capital in the United States, particularly with institutional investors such as pension funds, has driven the growth of private equity investment in other regions. In Latin America, private equity commitments have grown from negligible amounts in 1990 to

3.2 percent of global equity commitments in 1996. Commitments in Asia fluctuated through the 1990s and by 1996, accounted for 6.3 percent of global commitments (4). The private sector arms of various bilateral and multilateral development banks, such as the IFC, are increasingly involved in international private equity investment as limited partners (in terms of committed capital and no fiduciary responsibility), and serve an important advisory role in due diligence and technical assistance in a fund’s creation. The IFC has encouraged private equity investment in the developing world, both by investing some US\$570 million of its own funds in more than 35 countries, and by attracting other institutional investors and venture capitalists as limited partners in various ventures (5). The IFC has established 15 major private equity funds with US\$2.38 billion total committed capital and 53 small venture capital funds with US\$1.55 billion dollars in total committed capital. In the United States, the Overseas Private Investment Corporation (OPIC) occasionally extends guarantees on U.S.-based venture capital funds investing in the developing world.

Latin American private equity partnerships raised US\$1.5 billion in 1996, compared to just US\$735 million in 1995. The major investors of private equity in the region are commercial banks, bond and equity investors such as ING Barings’ Latin America Enterprise Capital Corporation, large U.S. venture capital funds, and local venture capitalists. Asian private equity raised US\$3 billion in 1996, down by nearly half from the US\$6.7 billion raised in 1995. Some of the notable Asia funds favored by U.S. investors include HSBC Private Equity Fund and H&Q Asia Pacific Ltd. (6).

VENTURE CAPITAL DIAGRAM

Figure 8.2 illustrates the operation of a venture capital fund. Venture capital begins with a **venture capital firm** that has limited capital seeking high-risk/high-return investment opportunities. The firm decides to raise capital from various **investors** for a particular **venture capital fund**, which may have a sector or regional focus, with the intention of investing in 10 or more entrepreneurial efforts. The **venture capital firm** is considered the “**general partner**” (GP), or may be referred to as

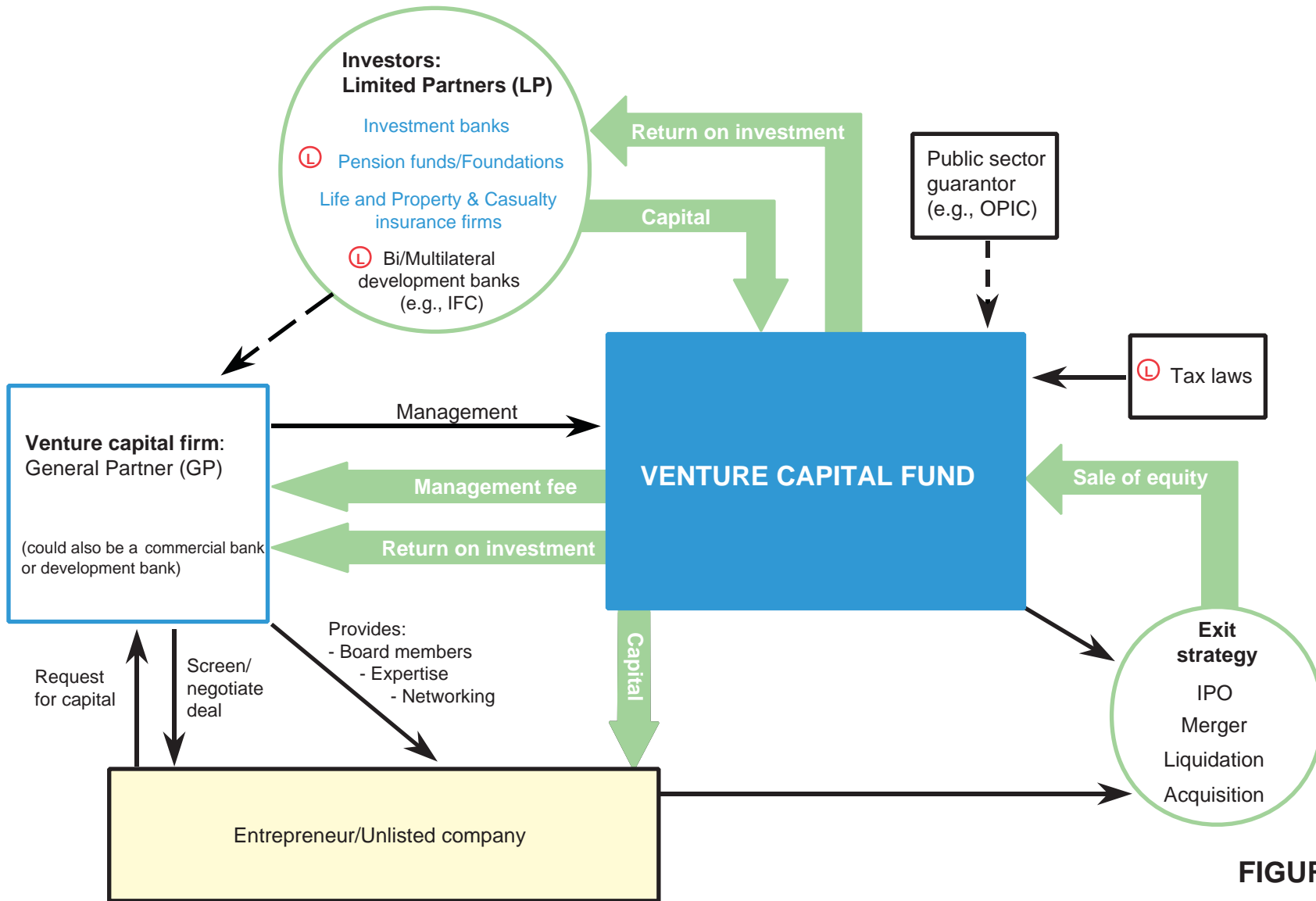


FIGURE 8.2

VENTURE CAPITAL

the managing partner, while the **investors** that it persuades to invest are the “**limited partners**” (LP). The LPs generally consist of various institutional **investors**. **Pension funds** and **foundations** are the most common institutional LPs. The private sector arm of a **bilateral or multilateral development bank**, such as the IFC, may also be a limited partner. The GP usually contributes about 1 percent of the fund’s capital, while the LPs contribute 99 percent of the capital. The GP also receives an annual fee of about 2 to 3 percent of the total committed capital.

For international investing, a **public sector guarantor**, such as OPIC, may extend a guarantee to the fund.

The GP then considers **entrepreneurs/unlisted companies** that need financing as companies approach the **venture capital firm** for **capital**. The firm **screens** them for their investment potential and **negotiates** each deal. The GP also conducts due diligence on the companies. The finance stages vary from “start-up” and first-stage financing for illiquid companies to second-stage financing and expansion capital.

An ongoing symbiotic relationship exists between the **venture capital firm** and the **venture capital fund**. The **entrepreneurs/unlisted companies** benefit, not only from the infusion of capital, but from the **expertise** and **networking** provided by the GP, who also may acquire a seat on the company’s **Board of Directors**.

Once the fund’s capital is invested, the search for new investors and new investment opportunities slows down. Thus, the investment activity of the **venture capital firm** is only visible at certain times of the venture capital cycle, and information may only be available on a fund during the fundraising/creation stage and when the **exit strategy** for a portfolio company is being implemented.

The successful **exit strategy**, which is normally three to seven years after the venture capital firm enters, is where the big returns are made on initial investments. The “exit” may be by an **IPO**, a strategic **merger** (sometimes merged with a limited partner), an **acquisition**, or **liquida-**

tion of the company. Upon the **sale of equity**, the **venture capital fund** distributes the **return on investment** among the partners and collects a **management fee** according to the contractual covenants of the partnership.

LEVERAGE POINTS

Development Bank’s Private Sector Lending Arm (such as the IFC)—*Reputational/Bottom-line leverage*. As the largest direct and indirect provider of equity capital to small companies in the private sector throughout the developing world, the IFC is in a strong position to require adherence to environmental standards and information disclosure requirements for its own investments and those of the private equity funds that it helps to establish. In addition, the IFC can help mobilize finance for environmentally positive enterprises.

Limited Partners—*Values-based leverage*. Institutional investors, particularly pension funds and foundations, could exercise influence over venture capital funds by proactively financing “green” venture capital funds or by making their financial commitments contingent upon fulfillment of environmental conditions.

Tax Laws—*Policy leverage*. By providing tax relief or incentives, governmental agencies can significantly influence how venture capitalists act in various countries around the world. For example, tax breaks could be provided for investments in companies that comply with environmental protocols.

Box 8.1 The Terra Capital Fund: A New Biodiversity Investment Vehicle for Latin America

Background: Consumer awareness has driven a growing market for products and production practices that protect biodiversity. For example, the demand for organic produce, sustainably harvested timber, and ecotourism are all expected to grow at double-digit rates. Yet, there is limited financial support for small- and medium-scale enterprises engaged in these sectors. Available support is piecemeal and has come from nongovernmental organizations (NGOs), foundations, and aid agencies. Private equity capital for biodiversity is scarce—most commercial banks are not familiar with this sector, many projects are too small for direct financing, and existing venture capital funds have focused on other high-return sectors.

Action: The International Finance Corporation (IFC) has been instrumental in bridging this funding gap. IFC, together with the World Bank, developed the concept of a biodiversity venture capital fund and retained external consultants to evaluate investor interest in a pooled venture capital fund aimed at biodiversity investments. IFC then brought together expertise in fund management and biodiversity project development from within the World Bank Group to further develop the concept. A major obstacle to the competitiveness of such a fund has been the high cost of financial and technical due diligence required to meet biodiversity criteria. IFC resolved this problem by obtaining US\$5 million from the Global Environment Facility (GEF), to be used exclusively to meet the incremental operating cost associated with biodiversity-related investments of the fund.

Outcome: The “Terra Capital Fund,” to be capitalized at US\$20 million to US\$50 million, is expected to commence operation shortly to fund biodiversity-related projects in Latin America. IFC will be a core investor with an investment of up to 20 percent of the fund’s total equity commitments. The fund will be based in Brazil and managed by a company whose shareholders—among them IFC—combine experience in venture capital, investment banking, and biodiversity project management. A Biodiversity Advisory Board will be created to prepare investment criteria and provide advice on particular projects.

Analysis: The Terra Capital Fund will allow investors to take advantage of bottom-line opportunities in biodiversity-related investments. The developmental role of IFC was critical in bringing equity financing to biodiversity-related ventures. In addition, the GEF funds required to meet the incremental cost of ensuring biodiversity gains were an indispensable component of the project. The success of the fund will demonstrate the viability of biodiversity projects and should enhance private flows to this sector in the future.

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European Venture Capital Association: <http://www.evca.org>

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Capital Venture: <http://www.capitalventure.com>

Venture One, VC, and private equity research and information: <http://www.v1.com>

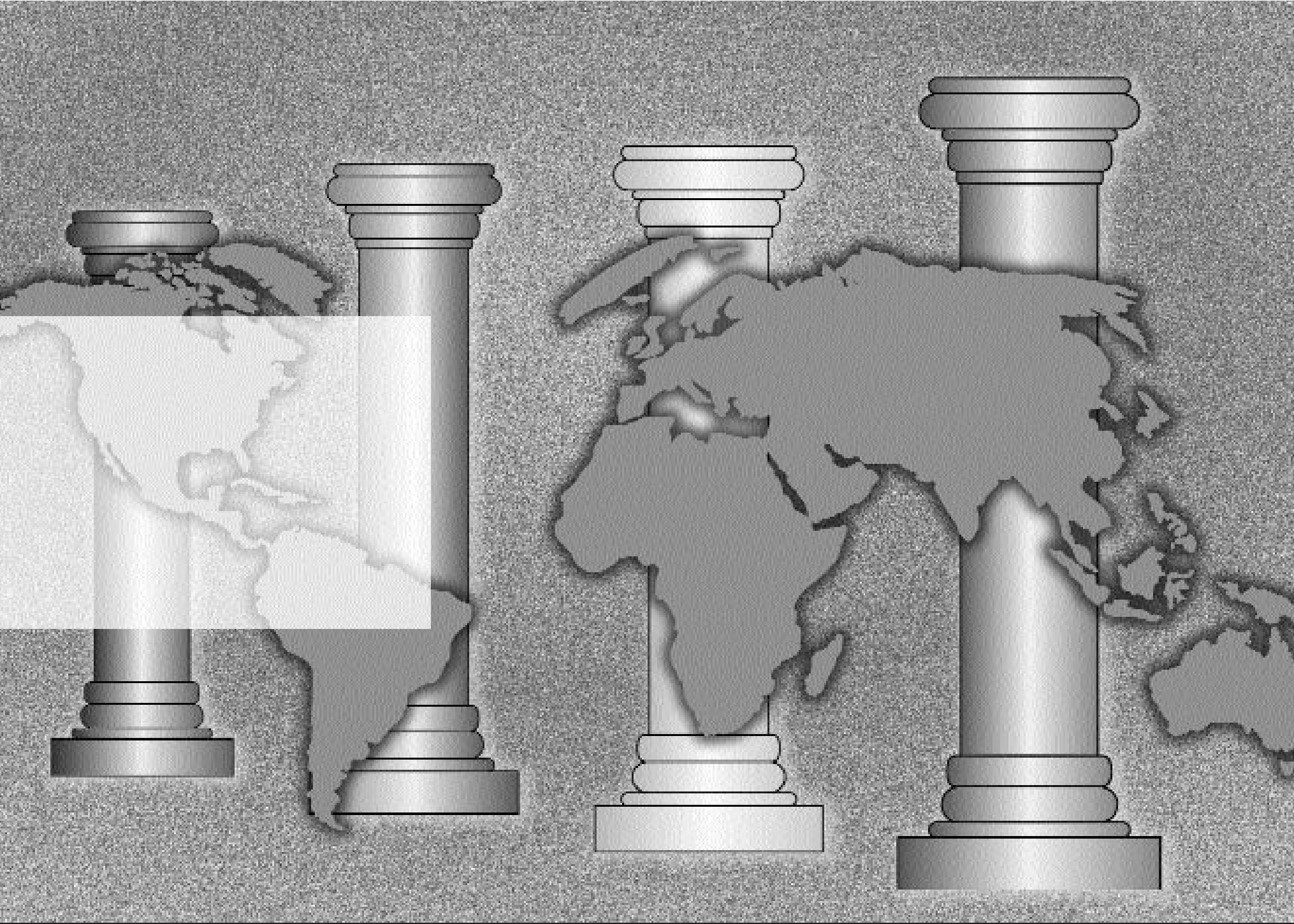
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FOUNDATIONS

9. FOUNDATIONS

PROFILE

A foundation is a nonprofit organization established to manage a pool of capital and distribute grants for purposes consistent with the mission or philosophy of the organization. Foundations thus have two distinct operations, a grant-making side and an investment side, and it is the earnings from the investment side that enable the foundation to continue to give grants over the long run. However, in practice the two sides usually operate independently of each other. Exceptions to this general rule take the form of so-called Program-Related Investments (PRIs), which are low-interest loans allocated by foundation staff in a similar manner to grants, and mission-related venture capital investments. *Figure 9.1* summarizes four key characteristics of foundations of particular importance to the public interest community.

Size and Leaders

Worldwide, there are nearly 40,000 foundations. However, 20 percent of these foundations control 96 percent of all foundation assets. The Council on Foundations in the United States estimates the collective assets of U.S.-based foundations to total some US\$189.2 billion. These foundations disbursed more than US\$10 billion in grants in 1996. That same year, more than US\$100 million in PRIs were made by ten foundations. Some of the largest foundations include the Lilly Endowment, with US\$13 billion in assets, the Ford Foundation, the Robert Wood Johnson Foundation, and the David and Lucile Packard Foundation in the United States; the Fondation de France; and the Sasakawa Peace Foundation in Japan.

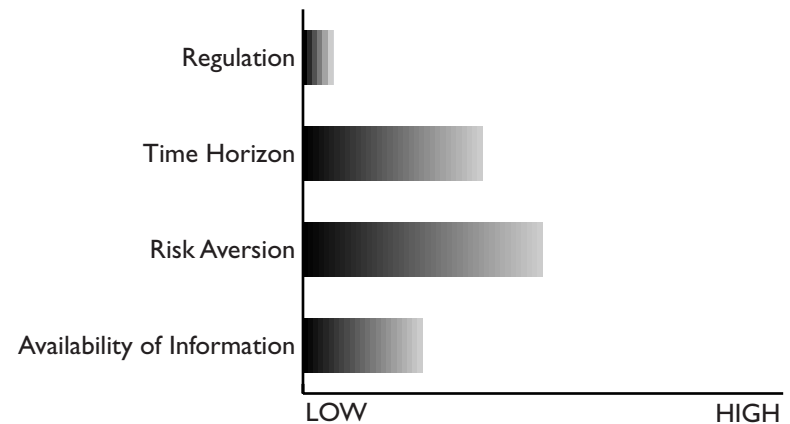
Key Features

Traditionally more conservative in their investment strategies, foundations have become more aggressive, investing in various higher growth (and higher risk) foreign stocks and “emerging market” funds. Large foundations are more likely to invest some assets in foreign investments, ranging up to 25 percent of total holdings. According to a survey by the Council on Foundations, 69 percent of U.S. grantmakers utilize external investment managers (1).

Regulation

In the United States, the principal regulatory framework for foundations is provided by tax legislation, which requires a foundation to pay out a rolling average of 5 percent annually of its total assets and administrative expenses in grants in order to maintain its tax-exempt status. A current U.S. Internal Revenue Service (IRS) proposal seeks to enforce greater disclosure on grantmaking activities by making the Form 990 tax returns filed by foundations more easily available to the public (2). The investment operations within foundations face virtually no regulation.

Figure 9.1 Key Characteristics of Foundations



Attention to Environmental Issues

Frequently, a foundation's portfolio of investments appears to be in conflict with its mission. For example, a foundation making grants to an environmental nongovernmental organization (NGO) for research on climate change and alternative energy might also be investing in carbon-intensive industry stocks (3). Until the 1990s, no mainstream foundation appeared to be integrating its grantmaking philosophy into its investment management strategy. Traditionally, the investment side was delegated to external asset managers solely to maximize profit. Although some foundations are now considering how to integrate social and environmental goals into their investment strategies, foundation financial managers and board members have resisted adopting "socially responsible" investment guidelines because they consider this step financially imprudent. It is often argued that the foundation's mission is best served by maximizing capital available for disbursement as grants.

The New York-based Jessie Smith Noyes Foundation has attempted to "reduce the dissonance" between asset management and grantmaking values through a three-pronged strategy of screening its portfolio to exclude companies with particularly troublesome environmental impacts, engaging in shareholder activities to support the work of grantees (*see Box 9.1*), and including mission-related venture capital investments in its investment portfolio (4).

Relevance to Developing and Transition Economies

Although several foundations based in industrialized countries have significant international grantmaking programs, an indigenous, Western-style foundation sector is not well established in most developing and transition countries. The limited size of the foundation sector in some countries is attributed to a variety of factors, including the lack of tax incentives for charitable contributions, or the absence of a philanthropic tradition. In other cases, foundation-like activities take different forms from the ones familiar in the United States and Asia.

FOUNDATION DIAGRAM

Figure 9.2 illustrates the operation of a foundation. A **foundation** is established in order to direct funds from an **aggregate asset pool** towards **grants** that advance the organization's mission or philosophy. The original and subsequent assets may come from **donations, endowments, and bequests**. This asset pool is utilized by the foundation's **program staff** and **mission-related consultants** to provide **grants** and **PRIs**. Organizations such as the **Foundation Center** and the **Council on Foundations** serve as information **resources** to the foundations as well as to organizations seeking funding. In regards to **tax laws**, foundations do not pay any federal income tax, but they do pay an excise tax on investments.

Grantees, such as NGOs, may have an ongoing relationship with the grantmaking staff and may communicate with **foundation** staff about grantmaking and investing priorities. Although it is the **grants** side of the foundation that interacts with **grantees**, the **finance** side of the foundation manages the foundation's portfolio of **investments**. Many of the individuals managing the finances of foundations are likely to be external to the organization. The **treasurer** and **finance committee** are the link between the **board** and the **asset managers/financial advisors**. The **Board of Directors** is the fiduciary of the foundation and, along with the **Executive Director**, can determine the strategy of the portfolio's investment. Usually, however, this responsibility is left to the **Chief Financial Officer (CFO)** and external **financial advisors**, while the **assets managers** work to diversify the foundation's **investments**. The income generated from the **return on investments** replenishes the **aggregate asset pool** for another cycle of grants.

Many foundations do not exercise their **proxy power**, via shareholder resolutions or other shareholder activities, to influence corporations in which they hold **stock**, abdicating their rights and responsibilities on proxy issues to the external **asset managers** who vote proxies as they deem appropriate. A few foundations have begun to make mission-related venture capital investments in high-risk, high-return commercial ventures related to their grantmaking portfolios.

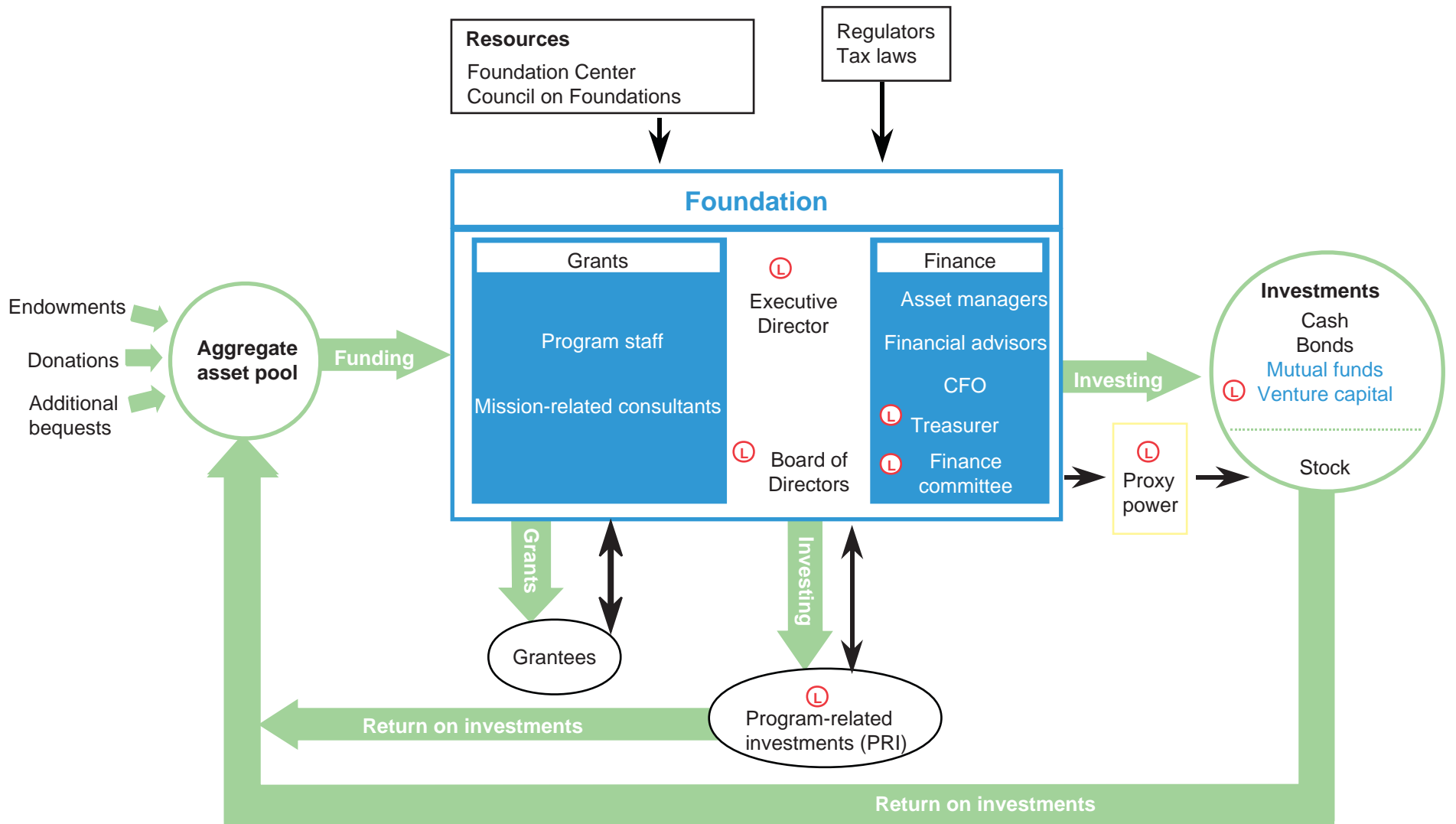


FIGURE 9.2
FOUNDATION

LEVERAGE POINTS

Executive Director/Board Members—*Values-based/Reputational leverage.* Foundation board members are obligated to direct the organization's investment strategy. An individual or group of board members with sufficient knowledge and commitment can lead an initiative to internalize the foundation's mission into its investment strategy, for example, by applying social or environmental screens, or by engaging asset managers with an expertise in socially responsible investing.

Treasurer/Finance Committee—*Bottom-line/Values-based leverage.* Unless the treasurer or members of the finance committee are receptive to internalizing the foundation's mission into its investment strategy, an initiative for change within the foundation is unlikely to be successful. Demonstrating the correlation between environmental issues and financial performance is critical.

Proxy Power—*Values-based/Reputational leverage.* Because many foundation boards fail to exercise proxy power over stock held in the

Box 9.1 A Foundation Speaks with Its Endowments as well as Its Grants

Background: In 1994, the Intel Corporation came under scrutiny for its environmental and hiring practices at a US\$1.7 billion manufacturing plant in New Mexico, based on a report prepared by the Southwest Organizing Project (SWOP), an organization that promotes economic and environmental justice in that state. Intel did not acknowledge or respond to SWOP's report. One of SWOP's funders, the Jessie Smith Noyes Foundation, realized that it held 100 shares—then worth about \$6,000—of Intel stock and asked, in the words of Noyes' President Stephen Viederman, "What we could do, in our capacity as a shareholder, to help."

Action: After consulting with SWOP, Viederman appeared at an Intel stockholder meeting in 1994 to ask Intel to respond to SWOP's report. He was told that Intel does not deal with "vocal minorities." Next, working with SWOP, Noyes filed a shareholder resolution asking Intel to improve its environmental, health, and safety (EHS) policy and to commit to sharing nonproprietary information with local communities. It noted that Intel "jeopardizes stockholder investments by picking environmentally risky sites" for its plants. The 1995 resolution, with nine co-filers, was supported by 5 percent of the vote (8 percent abstaining). Shortly thereafter, Intel and SWOP began meeting to discuss SWOP's concerns. With little tangible progress toward policy change, Noyes re-filed the resolution with several co-filers, this time including four other philanthropic foundations with whom it had shared its concerns.

Outcome: Before the resolution could come to a vote at the 1996 stockholders' meeting, Intel drafted a new and improved EHS policy. After consulting

with SWOP and the other co-filers, Noyes agreed to withdraw the resolution.

Analysis: The Noyes Foundation supported its grantee, SWOP, not only with grant funds but with the leverage of its endowment holdings. The combination of SWOP's community organizing and shareholder activism facilitated by Noyes, brought Intel to the bargaining table. The shareholder resolution raised bottom-line concerns about the plant, but also carried with it the possibility of costs to Intel's reputation. Although Intel claims the new EHS policy simply codified existing procedures, local organizations that monitor high-tech companies suggest that the shareholder resolution accelerated change at Intel. At Noyes and the four supporting foundations, the decision to link the investment and grantmaking sides of their work sparked internal discussion and, in some cases, internal guidelines for such actions. Thus, action resulted not only in a policy change at Intel, but has also provoked the broader philanthropic community to explore links between grantmaking and investment.

Sources: Stephen G. Greene. "Foundations' Shareholder Activism." *The Chronicle of Philanthropy*. January 25, 1996. p. 25; and Stephen Viederman. "Adding Value to Your Grants." *Foundation News and Commentary*. January/February 1997.

organization's portfolio or otherwise engage in shareholder activities, it often falls upon a single board member who has sufficient knowledge and commitment and is willing to take the initiative to begin to ensure that the foundation's shareholder resolution record and corporations in which it owns stock are consistent with its mission or grantmaking philosophy.

Program Related-Investments (PRIs)—Values-based leverage. PRIs are often an underutilized part of a foundation's financing capability. PRIs can be used to support progressive entrepreneurial activities by for-profit or nonprofit organizations and still count toward the foundation's 5 percent annual payout requirement.

Venture Capital—Bottom-line leverage. Some foundations have begun to utilize their investment portfolios to finance high-risk, high-return commercial ventures related to their missions.

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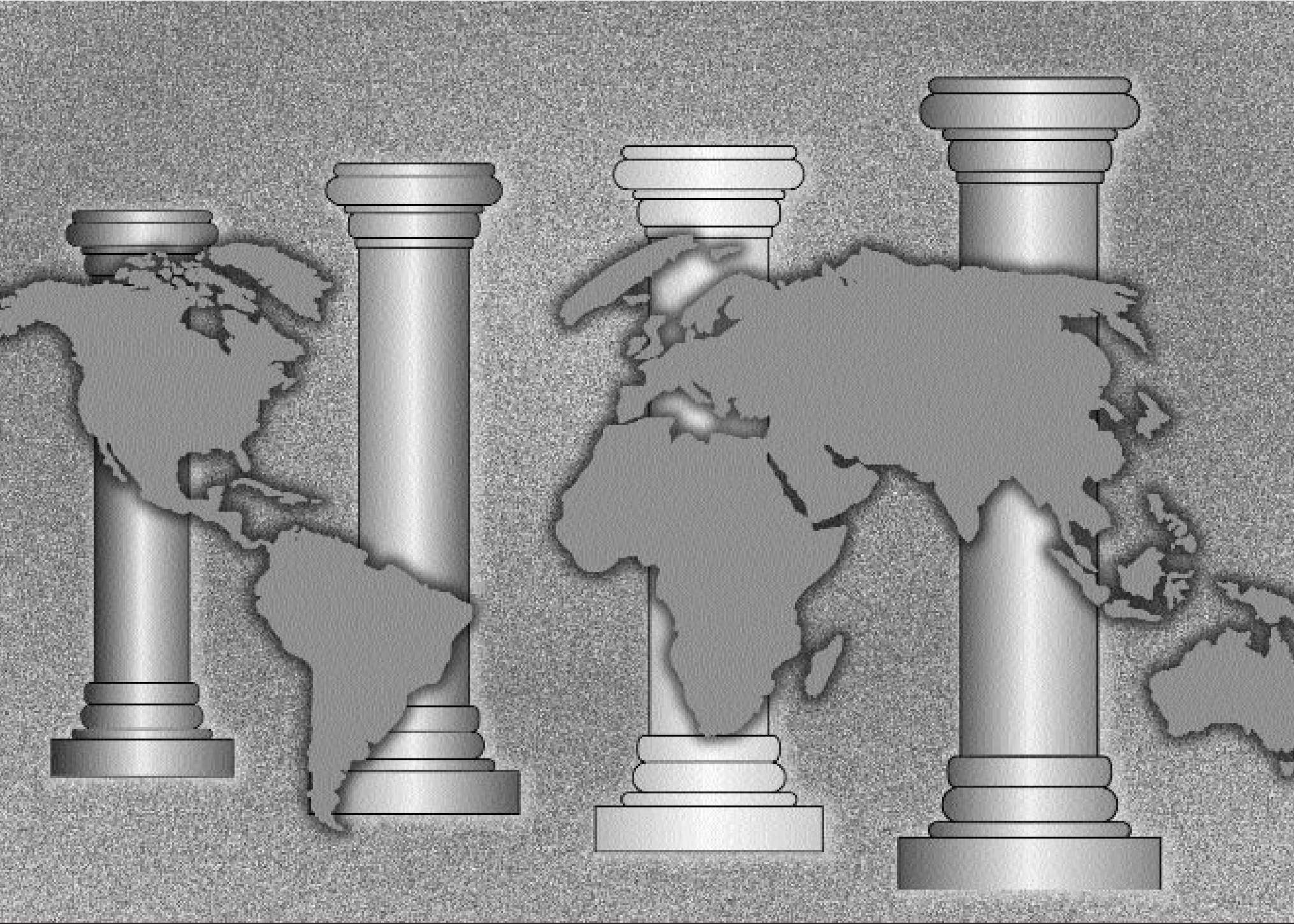
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CONCLUSION

10. CONCLUSION

This concluding chapter takes a broader comparative view of the eight industry segments described in preceding chapters and assesses their significance for the public interest community seeking to influence the environmental character of private financial flows to developing and transition economies. The chapter first compares the eight segments based on their sensitivity to various types of leverage. It then summarizes cross-cutting issues and opportunities relevant to the financial services industry as a whole. Finally, this chapter assesses the opportunity offered by engagement with the private financial services industry compared to that offered by engagement with public sector agencies and operating companies and identifies opportunities for change.

COMPARATIVE OPPORTUNITY ACROSS INDUSTRY SEGMENTS

Size

A first approximation of the relative opportunity offered by the eight segments is determined by the magnitude of assets they control or manage and the extent to which they are active in the sectors or geographic regions of interest. As mentioned in the introduction, the eight segments featured in this guide are presented in order of relative size. Commercial banks collectively represent the world's largest single pool of private capital, with assets in the tens of trillions of dollars, while private foundations collectively control assets in the range of hundreds of billions of dollars. Total assets controlled by the financial sector have been increasing at double-digit rates overall in the 1990s, with mutual

funds posting the highest rate of growth and the property and casualty insurance industry lagging behind the rest (1).

In terms of their relative significance for environmental sustainability in developing and transition economies, commercial banks were responsible for approximately 14 percent of North-South financial flows in 1996, and are often involved in the finance of large infrastructure projects with significant environmental footprints. With the increasing securitization of financial flows to developing and transition economies, the activities of investment banks, mutual funds, and pension funds based in industrialized countries have become increasingly international. In 1996, some 38 percent of total North-South financial flows were in the form of bonds or portfolio equity (2), but data on the sectoral composition of those flows are scarce.

Although many insurance companies based in industrialized countries have also diversified their asset portfolios to include emerging market securities to some degree (although industry guidelines propose a limit on such exposure), only the reinsurance industry has diversified its underwriting activities internationally to a significant extent.

The underwriting activities of most primary insurance issuers continue to be primarily or exclusively domestic. Similarly, although many private foundations based in the United States have diversified their asset portfolios to include emerging market securities, only a few foundations fund projects overseas because it is difficult to monitor an international grants portfolio with limited U.S.-based staff (3).

Thus, the opportunities offered by the eight segments vary by overall size, degree of activity in developing and transition economies, and even by the variation in the extent of that activity across different parts of the same segment.

Accessibility and Receptivity

A second approximation of the relative opportunity offered by the eight segments is determined by the accessibility of each segment to the pub-

lic—through regulation and information disclosure—and by how receptive each segment will be to an environmental message, which may be at least in part a function of the segment’s risk aversion and time horizon for realizing return on investment. A more fully elaborated regulatory framework and a higher degree of information disclosure provide the public interest community with more openings for engagement. More risk-averse segments may be more sensitive to potential liabilities related to the environment, while those investing for the long run may have more reason to care about the environmental sustainability of the enterprises in which they are investing.

Figure 10.1 captures these four key characteristics (degree of regulation, availability of information, risk aversion, and time horizon) in a single diagram, and places the eight industry segments side by side for ease of comparison. (The four parameters have been subjectively estimated relative to each other based on expert opinion, and are intended only for comparison across the segments in the context of strategic planning.) As a first approximation, the relative size of the area outlined by the four parameters provides an indication of the current potential for leverage that each segment presents.

According to these measures, commercial banks and pension funds present opportunities due to their high degree of regulation, while life insurance should offer opportunity based on a high degree of risk aversion and long time horizon. Mutual funds and P&C insurance occupy a middle position, while foundations, investment banks, and venture capital score low because of their more limited information disclosure and degree of regulation.

SENSITIVITY TO DIFFERENT TYPES OF LEVERAGE

Sensitivity to Values-Based Leverage

Certain subsegments of the financial services industry not bound by fiduciary responsibility to seek maximum financial return may be relatively more sensitive to values-based leverage translated through indi-

vidual or private institutional investors. The recent proliferation of socially and environmentally screened mutual funds in industrialized countries is one indication of the industry’s responsiveness to investor preferences. Although pension funds often resist pressure to make investment decisions on social or environmental grounds citing fiduciary responsibility, the CalSTRS/CalPERS case described in *Box 5.1* illustrates how values-based leverage mobilized members of public employees’ unions and called attention to a stock eventually deemed questionable on bottom-line grounds.

Private foundations may also be particularly receptive to values-based leverage because of the apparent inconsistency between values promoted by a foundation’s grantmaking activity on the one hand, and its investment activity on the other. The example of the Noyes Foundation described in *Box 9.1* illustrates the potential power of linking these two activities.

Sensitivity to Reputational Leverage

In general, the financial services industry is somewhat less exposed to reputational leverage than more consumer-oriented businesses: international investment banks and insurance companies, for example, tend to have low “brand name” recognition among the general public. Commercial banks, however, because of their large customer base of depositors, may be somewhat more sensitive to reputational leverage, as illustrated by the example of the Dresdner Bank, described in *Box 2.1*. In addition, the role of commercial banks in project finance in developing and transition economies renders them particularly vulnerable to project-specific advocacy.

Most segments of the financial services industry can be expected to respond to reputational leverage targeted at the operating companies or projects that they invest in, if adverse publicity is sufficient to damage either the profitability of the enterprise or its attractiveness to investors. For example, as described in *Box 3.1*, the reluctance of the financial services industry to participate in new international bond offerings by the State Development Bank of China may in part be due to environmental advocates’ having linked such bonds to the financing of the controversial Three Gorges Dam.

Currently, however, in the context of rapidly increasing foreign direct investment, information on the activism against alleged corporate irresponsibility abroad is not readily available to investors. Making sure that analysts on Wall Street are aware of public interest campaigns against individual companies is an important leveraging opportunity in its own right.

Sensitivity to Bottom-Line Leverage

Bottom-line leverage should be a potent method for focusing the attention of all segments of the financial services industry on environmental considerations. Not only should creditors, investors, and underwriters respond to opportunities to increase returns to improve their own profitability; many financial intermediaries such as pension funds are legally obligated to take into account any information that would materially affect the risk and return characteristics of their portfolios. Thus, if environmental factors can be demonstrated to have positive impacts, financial intermediaries could be considered negligent if they do *not* take them into account (4). Because of the herd-like behavior typical of the financial industry—in other words, once the “conventional wisdom” is successfully challenged, most market participants shift from the old way of doing things to the new way very quickly—a change in perception about the relationship between environmental and financial performance could have dramatic results (5).

Until very recently, the bottom-line interests of the financial services industry related to the environment have focused on the downside risks and potential liabilities associated with failure to perform adequate due diligence on environmental factors. As described in previous chapters, the commercial banking and P&C insurance industries in the United States woke up to the salience of environmental concerns to their businesses only after facing significant losses when they became liable for the costs of cleaning up contamination caused by borrowers or casualty claims related to contamination-related harm.

In the context of developing and transition economies, however, lower environmental standards, inconsistent enforcement, and weak judiciary

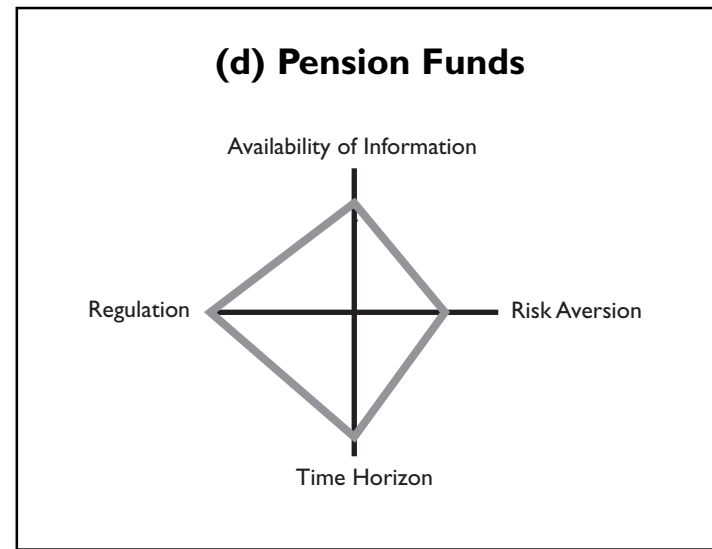
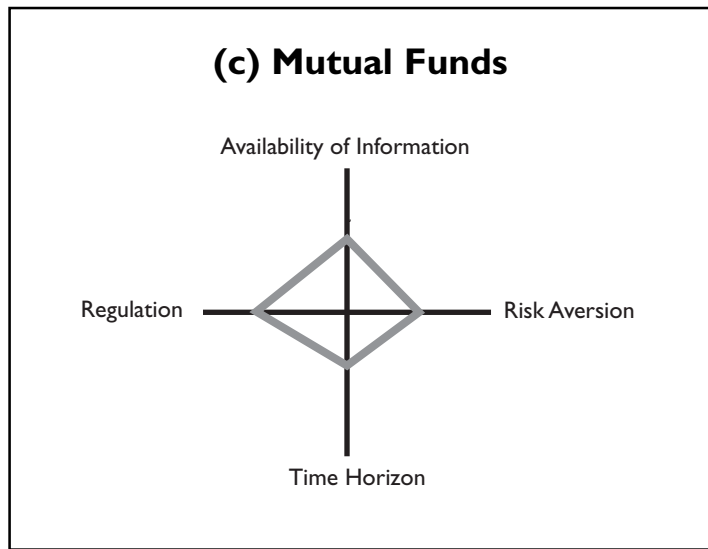
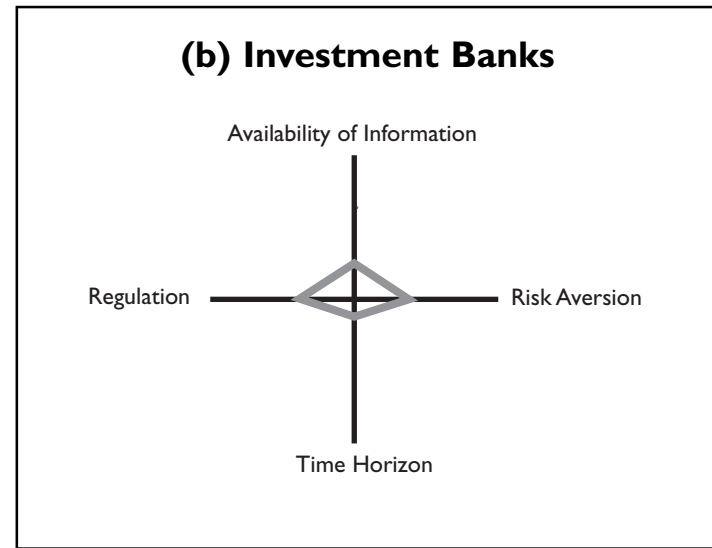
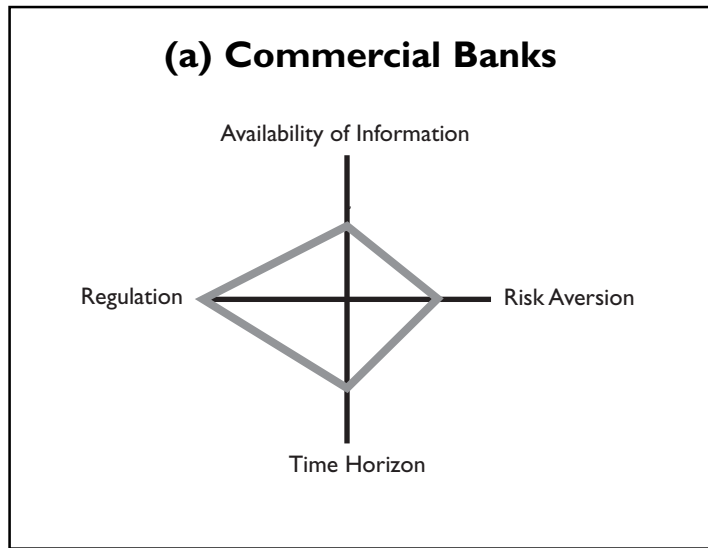
systems lessen the threat of financiers being held liable for environmental harm. Instead, threats to a firm’s so-called “social license to operate,” which can be generated by local community resistance to environmentally destructive activity, can impose delays in completing projects or disruptions to operations that can have severe financial consequences, for example to those involved in project finance.

As described in *Box 6.1*, the P&C insurance industry has begun to take seriously the bottom-line implications of climate change for the profitability of its underwriting business, in light of mounting claims for storm-related damages in recent years. If the linkages among greenhouse gas emissions, climate change, and casualty losses become more accepted, the P&C insurance industry could become a powerful political force in support of national and international climate protection policies. Moreover, at least one firm has begun to take steps toward integrating these concerns into its investment portfolio.

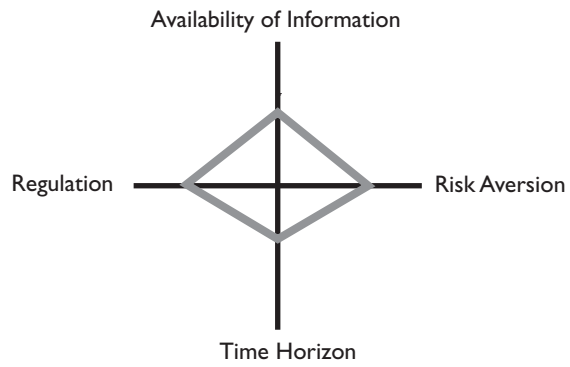
Over the past two years, attention has begun to shift to the positive opportunities offered by taking environmental factors into account in financial decisionmaking. As described in *Box 4.1*, an emerging body of literature demonstrates a small but statistically significant positive correlation between a firm’s environmental performance and its financial performance (6). This finding should be of interest to mutual funds, pension funds, and asset managers for insurance companies and foundations, which may be able to increase their overall returns by overweighting environmentally proactive companies in their portfolios.

Finally, venture capitalists should be interested in financing new environmentally driven products and services that offer a competitive advantage due to changing public policies and preferences for environmental sustainability. As described in *Box 8.1*, the identification and packaging of such opportunities, particularly in developing and transition countries, is an important leveraging opportunity for the public interest community and for public institutions such as the International Finance Corporation.

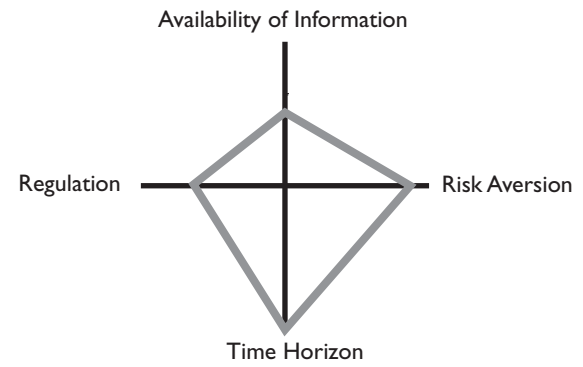
Figure 10.1 Snapshot of the Eight Industry Segments



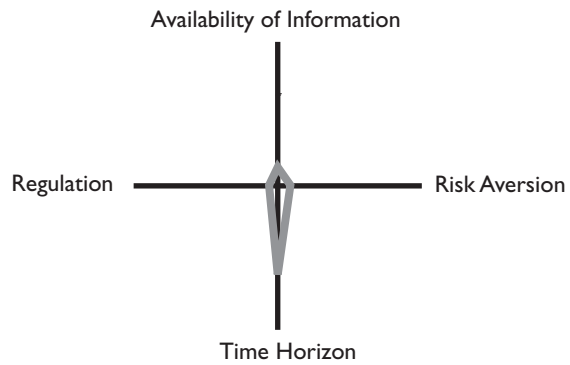
(e) P&C Insurance



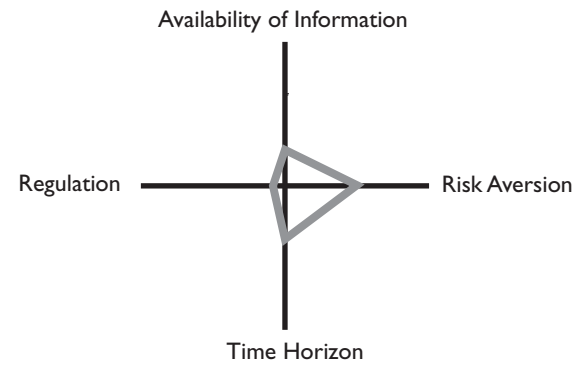
(f) Life Insurance



(g) Venture Capital



(h) Foundations



Sensitivity to Policy Leverage

Policy leverage is potentially the most potent type of leverage to be brought to bear across all segments of the financial services industry, harnessing the power of the government to regulate corporate activity and to create incentives through fiscal policies. Policy change in turn creates new opportunities for bottom-line leverage, by altering the relative profitability of environmentally friendly corporate performance.

In the first instance, the financial services industry can often be relied upon to amplify the effect of policy change imposed on the operating companies that are the industry's clients. For example, the U.S. stock market reacted negatively when firms were first required to disclose Toxic Release Inventory (TRI) data in 1989, reflecting a change in investor expectations about the likely pollution abatement costs faced by those firms (7).

There is also opportunity for policy leverage directly toward segments of the financial industry itself. With the exception of venture capital and private foundations, the financial services industry is rather highly regulated, but current regulatory frameworks and institutions—particularly those at the international level—rarely address environmental concerns explicitly. Requiring banks, insurance companies, and investment managers to put into place and to disclose information about their environmental risk management systems would be one opportunity to remedy this deficit (8).

Finally, fiscal incentives can be offered to investors that create new bottom-line opportunities for the financial services industry. Following a parliamentary initiative, in 1995 the Dutch Ministry of Finance declared interest and dividend income from investment in certain “green” investment funds to be tax-free. The purpose of the tax break is to encourage investment in designated categories of approved environmental projects, including developing and maintaining forests, sustainable energy, environmentally friendly housing, and organic farming. The policy has created a sudden surge in demand for such new investment products, leading to almost 2 billion Dutch guilders in finance for green projects in 1997 (9).

CROSS-CUTTING ISSUES AND OPPORTUNITIES

The segment-by-segment descriptions of the financial services industry provided in this guide reveal several cross-cutting issues and opportunities characteristic of the industry as a whole. These include the importance of information disclosure and standard performance indicators, the role of providers of information and analysis to the industry, the potential to connect “both sides of the house”—or bridge separate parts of the same industry segment—and the continuing importance of shareholder activism. In addition, ongoing structural and regulatory changes in the industry, related to financial globalization, raise a new set of issues and opportunities.

Importance of Information Disclosure and Standard Performance Indicators

All four types of leverage described in this guide depend on information disclosure and performance indicators in order to most effectively influence the behavior of the financial services industry. Values-based investors must be able to screen out bad actors and screen in environmental performers, requiring both firm-specific information and information related to the composition of investment portfolios. Reputational leverage depends on the ability to link specific investors to the environmental performance of specific firms or projects. Financial markets require consistent and comparable information regarding environmental performance to be able to discern and reward superior environmental performance. The enforcement of policy leverage is similarly constrained. In particular, the ability to award incentives for environmentally friendly investment—such as the tax breaks offered in the Netherlands described above—depends on the existence of agreed-upon criteria for “green” certification.

The private financial services industry and the public interest community thus share an interest in enhanced corporate transparency and disclosure of information, especially by firms in developing and transition economies. A 1997 study by the Investor Responsibility Research Center found that of 97 S&P 500 corporations with foreign operations that were examined, approximately 75 percent included no data in their publicly available documents regarding their environmental performance

overseas (10). Strengthening the disclosure requirements faced by transnational corporations is thus an important leveraging opportunity, and engagement with the SEC in the United States, its analogues in other countries, and the International Organization of Securities Commissions is an important next step for the environmental community.

However, information alone is not useful if it is not presented in a consistent and comparable manner. The development of standard indicators and formats for reporting on environmental performance is thus a critical challenge, and one that presents an opportunity for collabora-

tion between the environmental and financial communities (11). One example of such collaboration is the Global Reporting Initiative of the Coalition for Environmentally Responsible Economies (CERES), which is seeking to standardize corporate environmental reporting worldwide (12).

Adaptation of such standards to be used and applied to the financial services industry is a complementary challenge. Efforts are currently underway under the auspices of the European Commission to modify the European Eco-Management and Audit Scheme (EMAS) to meet the needs of the financial services sector and to enable the sector to participate in the scheme (13).

Box 10.1 The UNEP Financial Services Initiatives on the Environment

Background: Since 1991, the United Nations Environment Programme (UNEP) has been instrumental in drawing the attention of the financial services industry to environmental concerns. In 1992, UNEP brokered the “Statement by Banks on the Environment and Sustainable Development” (later revised and renamed the “Statement by Financial Institutions”), and in 1995 followed with a “Statement of Environmental Commitment by the Insurance Industry.” Both statements include commitments to mainstream environmental considerations into core business practices, such as risk assessment and management.

Action: By July 1998, 115 financial institutions and 78 insurance companies were signatories to the statements, and thereby committed to incorporate environmental considerations into internal and external business activities. In an ongoing effort to translate those commitments into practical actions, UNEP organizes outreach meetings and collaborations with regional and national banking associations, holds an annual roundtable meeting with the international financial community, and fosters the sharing of best practices and effective environmental management tools through a quarterly newsletter, an online clearinghouse of resources, “how-to” materials, and topic-specific seminars.

Outcome: UNEP’s principal accomplishment has been to facilitate dialogue within the financial services and insurance industries and between the financial and environmental communities on how to meet the goals of the statements. An outcome of the intra-industry dialogue is that 50 companies from the insurance and financial services industries have agreed to support the market

for photovoltaic cells through a combination of direct investments in technology and installation of solar panels on their buildings. The dialogue has also encouraged financial and environmental professionals to engage each others’ policy arenas. The number of environmentalists participating in events sponsored by the UNEP Financial Services Initiatives has been steadily increasing, while members of the Insurance Initiative presented a position statement on climate change at the Conference of Parties to the Framework Convention on Climate Change in Kyoto in 1997.

Analysis: While the bottom-line arguments that link environmental concerns and the financial services industry have always been powerful, they have existed in an institutional vacuum. The contribution of the UNEP initiatives has been to articulate these arguments clearly, provide a forum in which they can be fully developed and disseminated, and provide vehicles through which they can be integrated into the internal activities and external policy frameworks of the financial institutions.

Sources: UNEP Insurance Industry Initiative information packet and background papers. “UNEP’s Financial Services Initiative.” *UNEP Financial Services Initiative Newsletter*, Issue 1 (December 1996), Issue 2 (August 1997), and Issue 3 (January 1998); and Vorhies, Deborah. “UNEP’s Effort to Increase Environmental Responsibility in Banking, Investment Sectors.” *International Environmental Reporter*. April 3, 1996.

The Role of Providers of Information and Analysis

Among the most influential actors in the financial services industry are purveyors of information and analysis regarding the value of various investment opportunities: ratings agencies, “sell-side” analysts, and investment advisory services. In addition, regulators, industry associations, and the financial press all play a role in “agenda-setting,” and developing norms of industry practice.

Particularly in the realm of bottom-line leverage, ensuring knowledge and understanding among these actors of the potential relevance of environmental information to financial analysis is crucial. Currently, most professionals in the industry at best lack awareness of the relevance of environmental factors to their work, and often are even actively skeptical.

The implication for the public interest community is that financial industry professionals must be made aware of the emerging literature linking environmental and financial performance. Although the United Nations Environment Programme (UNEP) Financial Services and Insurance Initiatives described in *Box 10.1* are an important step toward that goal, more effort is needed to penetrate the mainstream investment community. Once they become convinced of the relevance of environmental issues to their industry, regulators, industry associations, and the financial press all provide potential vehicles for getting the message out.

Connecting “Both Sides of the House”

A feature common to several financial industry segments is that environmental sensitivity occurs in different degrees in different parts of the same organization. For example, the underwriting side of the insurance industry as a whole has developed significant environmental expertise to deal with claims related to toxic contamination, and the P&C insurance industry has become increasingly concerned about how climate change may contribute to the increased incidence of catastrophic loss. However, this expertise has not yet been brought to bear on the investment activities of the same firms. Similarly, the public interest

values expressed in the grantmaking and program-related investments of private foundations are seldom reflected in the investment portfolios of those same foundations. Illuminating these inconsistencies may offer a promising strategy to begin connecting “both sides of the house.”

Importance of Shareholder Activism

The examples in *Boxes 2.1, 5.1, and 9.1* highlight the continuing utility of shareholder activism in putting environmental concerns on the agendas of operating companies and financial entities. The financial services industry can itself have leverage over the environmental performance of operating companies through exercising shareholder rights, as illustrated by the CalPERS/CalSTRS and Noyes Foundation examples. Such resolutions can alert the broader investment community to concerns about a corporation’s environmental performance. At the same time, shareholder resolutions directed at the financial entities themselves—such as the one presented by Urgewald at the Dresdner Bank shareholders’ meeting—can be an effective way to generate a response to environmental concerns related to a particular project and can induce an institution to adopt stronger environmental policies overall.

Context of Financial Globalization

The financial services industry is experiencing significant change globally. In industrialized countries, a trend is occurring toward increasing consolidation, illustrated by several “megamergers” that have taken place in 1997 and 1998. Consolidation is also blurring the boundaries among previously distinct industry segments. This situation will require regulatory innovation, and perhaps provide opportunities for upward harmonization of information disclosure and other policies to support and encourage organizations to improve environmental performance. Consolidation is also creating a small group of well-known global companies, which may be more vulnerable to reputational leverage than their smaller, less widely known, premerger components. However, consolidation could also have the effect of reducing competition, rendering companies more impervious to public interest pressure.

In many developing and transition economies, the “rules of the game” for the financial sector are being written—or rewritten—in the context of financial globalization. In the wake of the Asian financial crisis, banking sector regulation is undergoing reform in several countries, providing an opportunity to increase transparency overall and potentially to include new disclosure requirements related to environmental management and risk. Domestic capital markets are being created in emerging markets, providing an opportunity to impose environmental criteria on newly publicly listed companies. Prior to the financial crisis, for example, the Stock Exchange of Thailand required manufacturing and industrial listing applicants to undergo an environmental audit and to submit an environmental impact assessment report for new manufacturing plants (14).

At the same time, there is concern that the emergence of ever-larger transnational corporations and new international investment rules—such as those proposed under the Multilateral Agreement on Investment (MAI)—will further constrain the ability of governments to condition the welcome afforded to foreign investment on its environmental character (15). As trade in financial services is itself liberalized, the need for global standards and international cooperation for financial sector regulation has become apparent (16). Placing environmental issues on the agenda in relevant policy arenas is an important opportunity for the public interest community.

OVERALL INDUSTRY SIGNIFICANCE FOR PROMOTING ENVIRONMENTAL SUSTAINABILITY

Because private financial flows to developing and transition economies have dramatically increased, and the degree of securitization of those flows has increased, the private financial services industry has become an important leverage point for the environment. However, the relative opportunity presented to the public interest community through direct engagement with the industry, compared to alternative engagements with public sector institutions and private sector operating companies, is not immediately obvious. The international “rules of the game” for

governing transboundary economic relationships are in flux, making it more complicated to identify the most strategic points of engagement.

Compared to Direct Engagement with Public Institutions

Compared to engagement with public sector institutions—including governments of countries where financial firms are located, governments of countries receiving international investments, and multilateral institutions such as the World Bank Group—engagement of the private financial services industry on environmental issues is more difficult. The number of private financial institutions is far greater than the number of public counterparts, and these institutions are accountable to private shareholders and clients rather than to the general public. Accordingly, compared to strategies aimed at influencing public institutions, engagement with the private financial services industry requires a higher degree of targeting and different strategies to deal with a lesser degree of transparency and public accountability.

In contrast to direct engagement with the private financial services industry, engagement with governments can significantly influence systemic change in how the industry operates through policy leverage. In industrialized countries, there is significant scope for further strengthening requirements and enforcement related to environmental risk management and information disclosure.

However, where the environmental implications of increasing financial flows are concerned, the governments of many countries that receive international financing are characterized by “responsibility vacuums” that are due to limited political legitimacy and institutional capacity (17). Public interest groups in less democratic societies may be less able than their counterparts elsewhere to hold public agencies and private corporations accountable for their environmental performance; at the same time, governments may hesitate to raise or enforce environmental standards for fear of driving away coveted capital flows (18). Influencing the private financial services industry based in industrialized countries may thus be a “second best” strategy for integrating environmental considerations into financial decisions in recipient countries where there

are political or capacity constraints on more direct public sector regulation of corporate activity.

Engagement with multilateral financial institutions may offer indirect policy leverage through advice to borrower governments. Through their cofinancing and guarantee operations, as well as their policy advice on designing the “rules of the game” for both the productive and financial sectors, multilateral institutions are also well positioned to influence a far greater proportion of international financial flows than just their own portfolios.

The International Finance Corporation (IFC), for example, requires its financial sector clients to attend a one-week training seminar in environmental management, and a recent survey of IFC clients revealed that the IFC’s assistance on environmental matters was among the top three most valued services (19). The next frontier is to integrate environmental objectives into the policy advice and technical assistance provided by such multilateral public agencies to client governments in the design of the “rules of the game.” For example, such agencies could encourage governments to address environmental concerns in the listing criteria for stock exchanges and more general financial sector disclosure requirements.

Compared to Direct Engagement with Operating Companies

The direct ecological “footprint” of the financial services industry is small compared to that of the most extractive or pollution-intensive industries. Although there is likely room to make the industry more eco-efficient with respect to savings of paper and lighting, for example, the financial services industry is of interest to the environmental community primarily because of its potential leverage over operating companies through market mechanisms or as a constituency for policy change.

Engagement with the financial services industry is thus a complement to, rather than a substitute for, engagement with operating companies, including transnational corporations as well as domestic firms in devel-

oping and transition economies. Corporations should be at least as sensitive to bottom-line leverage as their financiers: corporate managers and investors alike are interested in opportunities to increase profits through improved environmental performance. However, to the extent that the financial community recognizes such opportunities first, it can have a powerful multiplier effect by communicating an environmental message to a large base of corporate clients.

Creditors, investors, and underwriters can reinforce reputational or bottom-line leverage directed at a particular company: environmentally irresponsible companies may not pay attention to environmental critics until the financial community begins to do so. At the same time, for environmentally responsible companies to be rewarded for their superior performance, financial markets must be able to recognize environmentally sound behavior and value it appropriately. Industry leaders in environmental management are thus an important constituency for change in market perceptions and policy requirements related to environmental factors.

IDENTIFYING OPPORTUNITIES

Precisely because attention to the relationship between environmental issues and the financial services industry is new, it is likely that a significant amount of “low-hanging fruit” remains to be harvested. Most individual and institutional investors are not aware of the environmental profiles of their investment portfolios, and at least some portion of those investors is likely to be sensitive to values-based or reputational leverage. Most financial industry professionals are not aware of the empirical evidence linking environmental and financial performance, and many would be interested in learning more if the value in doing so were more clear. Most financial industry regulators have not considered the possibility of pursuing environmental objectives through disclosure requirements and fiscal incentives, and perhaps would do so if exposed to the idea.

Until recently, the efforts of the public interest community, and particularly environmentalists, to influence the financial services industry have depended on the use of values-based or reputational leverage. A

new generation of strategies employing bottom-line and policy leverage is just getting underway, starting an important debate about which of the two types of leverage is most powerful—or most politically feasible—in the context of financial globalization. Over the next few years, significant experience will be gained as alternative strategies are tested and evaluated.

Although engagement with the private financial services industry is only one of several avenues to be pursued by the public interest community in support of environmentally sustainable development—and is not necessarily the most important—significant leveraging potential remains to be exploited. This activity, however, should complement rather than substitute for direct engagement with public agencies and operating companies. Both environmental groups and industry professionals are on the steep part of the learning curve in identifying opportunities to meet common objectives. Because of yet-to-be-exploited opportunities to influence investors, industry professionals, and regulators, engagement of the financial services industry is an avenue worth pursuing to obtain leverage for the environment.

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GLOSSARY*

acquisition—one company taking over controlling interest in another company. Investors are always looking for companies that are likely to be acquired, because those who want to acquire such companies are often willing to pay more than the market price for the shares they need to complete the acquisition.

actuary—mathematician employed by an insurance company to calculate premiums, reserves, dividends, and insurance, pension, and annuity rates, using risk factors obtained from experience tables. These tables are based on both the company's history of insurance claims and other industry and general statistical data.

American Depositary Receipts (ADR)—receipt for the shares of a foreign-based corporation held in the vault of a U.S. bank and entitling the shareholder to all dividends and capital gains. Instead of buying shares of foreign-based companies in overseas markets, Americans can buy shares in the U.S. in the form of an ADR. ADRs are available for hundreds of stocks from numerous countries.

analyst—person in a brokerage house, bank trust department, or mutual fund group who studies a number of companies and makes buy or sell recommendations on the securities of particular companies and industry groups Some analysts have considerable influence, and can therefore affect the price of a company's stock when they issue a buy or sell recommendation.

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bond—any interest-bearing or discounted government or corporate security that obligates the issuer to pay the bondholder a specified sum of money, usually at specific intervals, and to repay the principal amount of the loan at maturity. Bondholders have an IOU from the issuer, but no corporate ownership privileges, as stockholders do.

credit—in general: loans, bonds, charge-account obligations, and open-account balances with commercial firms.

debt—1. money, goods, or services that one party is obligated to pay to another in accordance with an expressed or implied agreement. Debt may or may not be secured. 2. general name for bonds, notes, mortgages, and other forms of paper evidencing amounts owed and payable on specified dates or on demand.

derivative—short for derivative instrument, a contract whose value is based on the performance of an underlying financial asset, index, or other investment.

disclosure—release by companies of all information, positive or negative, that might bear on an investment decision, as required by the Securities and Exchange Commission and the stock exchanges.

divestiture—disposition of an asset or investment by outright sale, employee purchase, liquidation, and so on.

due diligence[†]—investigation by an underwriter, credit officer, or analyst into all information relevant to the value and risk of a security or loan to meet regulatory or other disclosure guidelines.

equity—ownership interest possessed by shareholders in a corporation—stock as opposed to bonds.

ERISA—The Employee Retirement Income Security Act, 1974 law

[†]Definition compiled from various sources.

governing the operation of most private pension and benefit plans. The law eased pension eligibility rules . . . and established guidelines for the management of pension funds.

Form 10-K—annual report required by the Securities and Exchange Commission of every issuer of a registered security, every exchange-listed company, and any company with 500 or more shareholders or \$1 million or more in gross assets. The form provides for disclosure of total sales, revenue, and pretax operating income Form 10-K becomes public information when filed with the SEC.

index fund—mutual fund that has a portfolio matching that of a broad-based portfolio. This may include the Standard & Poor's 500 Index, indexes of mid- and small-capitalization stocks, foreign stock indexes, and bond indexes, to name a few.

initial public offering (IPO)—a corporation's first offering of stock to the public. IPOs are almost invariably an opportunity for the existing investors and participating venture capitalists to make big profits, since for the first time their shares will be given a market value reflecting expectations for the company's future growth.

investment—use of capital to create more money, either through income-producing vehicles or through more risk-oriented ventures designed to result in capital gains.

Investment Advisers Act—legislation passed by Congress in 1940 that requires all investment advisers to register with the Securities and Exchange Commission. The Act is designed to protect the public from fraud or misrepresentation by investment advisers.

Investment Company Act of 1940—legislation passed by Congress requiring registration and regulation of investment companies by the Securities and Exchange Commission. The Act sets the standards by which mutual funds and other investment vehicles of investment companies operate, in such areas as promotion, reporting requirements,

pricing of securities for sale to the public, and allocation of investments within a fund portfolio.

investor—party who puts money at risk; may be an individual or an institutional investor.

limited partnership—organization made up of a general partner who manages a project, and limited partners, who invest money but have limited liability, are not involved in day-to-day management, and usually cannot lose more than their capital contribution. Usually limited partners receive income, capital gains, and tax benefits; the general partner collects fees and a percentage of capital gains and income.

Lipper Mutual Fund Industry Average—average performance level of all mutual funds, as reported by Lipper Analytical Services of New York. The performance of all mutual funds is ranked quarterly and annually, by type of fund, such as aggressive growth fund or income fund. Mutual fund managers try to beat the industry average as well as the other funds in their category.

load—sales charge paid by an investor who buys shares in a load mutual fund or annuity. Loads are usually charged when shares or units are purchased; a charge for withdrawing is called a back-end load. A fund that does not charge this fee is called a no-load fund.

mergers—combination of two or more companies, either through a pooling of interests, where the accounts are combined; a purchase where the amount paid over and above the acquired company's book value is carried on the books of the purchaser as goodwill; or a consolidation, where a new company is forced to acquire the net assets of the combining companies.

money market—market for short-term debt instruments—negotiable certificates of deposit, Eurodollar certificates of deposit, commercial paper, banker's acceptances, treasury bills, and discount notes of the Federal Home Loan Bank, Federal National Mortgage Associa-

tion, and Federal Farm Credit System, among others. Federal funds borrowings between banks, bank borrowings from the Federal Reserve . . . and various forms of repurchase agreements are also elements of the money market. What these instruments have in common are safety and liquidity.

Morningstar Rating System^{††}—system for rating open- and closed-end mutual funds and annuities by Morningstar Inc. of Chicago. The system rates funds from one to five stars, using a risk-adjusted performance rating in which performance equals total return of the fund. The system rates funds assessing downside risk, which is linked to the three-month U.S. treasury bill.

net asset value (NAV)—in mutual funds, the market value of a fund share, synonymous with bid price. In the case of no-load mutual funds, the NAV, market price, and offering price are all the same figure, which the public pays to buy shares; load fund market or offer prices are quoted after adding the sales charge to the NAV. The NAV is calculated by most funds after the close of the exchanges each day by taking the closing market value of all securities owned plus all other assets such as cash, subtracting all liabilities, then dividing the result by the total number of shares outstanding.

no-load fund—mutual fund offered by an open-end investment company that imposes no sales charge on its shareholders. Investors buy shares in no-load funds directly from the fund companies, rather than through a broker, as is done in load funds.

private placement—sale of stocks, bonds, or other investments directly to an institutional investor like an insurance company. A private limited partnership is also considered a private placement. A private placement does not have to be registered with the Securities and Exchange Commission, as a public offering does, if the securities are purchased for investment as opposed to resale.

^{††}Definition compiled from various sources.

proxy—1. written power of attorney given by shareholders of a corporation authorizing a specific vote on their behalf at corporate meetings. Such proxies normally pertain to election of the Board of Directors or to various resolutions submitted for shareholders' approval. 2. person authorized to vote on behalf of a stockholder of a corporation.

Prudent-Man (investor) Rule—standard adopted by some U.S. states to guide those with responsibility for investing the money of others. Such fiduciaries must act as a prudent man or woman would be expected to act, with discretion and intelligence, to seek reasonable income, preserve capital, and, in general, avoid speculative investments.

rating—evaluation of securities investment and credit risk by rating services such as Moody's Investors Service and Standard & Poors Corporation.

Safe Harbor—provision in a law that excuses liability if the attempt to comply in good faith can be demonstrated. For example, safe harbor provisions would protect management from liability under Securities and Exchange Commission rules for financial projections made in good faith.

secondary market—exchanges and over-the-counter markets where securities are bought and sold subsequent to original issuance, which took place in the primary market. Proceeds of secondary market sales accrue to the selling dealers and investors, not to the companies that originally issued the securities.

Securities and Exchange Commission (SEC)—federal agency created by the Securities Exchange Act of 1934 to administer that act and the Securities Act of 1933. The SEC is made up of five commissioners, appointed by the President of the United States on a rotating basis for five-year terms. The chairman is designated by the President and, to insure its independence, no more than three members of the commission may be of the same political party. The statutes adminis-

tered by the SEC are designed to promote full public disclosure and protect the investing public against malpractice in the securities markets.

SEC Rule 144—public sale of unregistered securities sets forth the conditions under which a holder of unregistered securities may make a public sale without filing a formal registration statement.

securitization—process of distributing risk by aggregating debt instruments in a pool, then issuing new securities backed by the pool.

security—instrument that signifies an ownership position in a corporation (a stock), a creditor relationship with a corporation or governmental body (a bond), or rights to ownership such as those represented by an option, subscription right, and subscription warrant.

syndicate—(or purchase group) a group of investment bankers that, operating under the agreement among underwriters, agrees to purchase a new issue of securities from the issuer for resale to the investment public; also called the underwriting group.

underwrite—*Investments*: to assume the risk of buying a new issue of securities from the issuing corporation or government entity and reselling them to the public, either directly or through dealers. The underwriter makes a profit on the difference between the price paid to the issuer and the public offering price, called the underwriting spread. *Insurance*: to assume risk in exchange for a premium.

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