THE LONDON PRINCIPLES OF SUSTAINABLE FINANCE

The contribution of UK-based financial institutions to sustainable development

INTERIM REPORT

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INTRODUCTION

This interim report sets out the current position of a project to develop a set of broad principles and recommendations for better practice in 'sustainable finance'. The project is based on detailed examples of best practice and the recent experiences of UK financial institutions, and was commissioned and chaired by the Corporation of London in partnership with DEFRA Environmental Protection International.

The recommendations arising from this project will inform the UK Government's proposals at the Rio+10 World Summit on Sustainable Development (WSSD) in 2002.

An initial set of recommendations has been developed from interviews with over 40 UK-based experts, practitioners and NGOs on financing and insuring sustainable development. This consultation was followed by a workshop at Chatham House on 13th December 2001 that sought responses to these recommendations from a wider group of stakeholders. These draft principles and best practice implementation case studies will be further refined and put to a task force of senior representatives of UK-based financial institutions, chaired by Judith Mayhew of the Corporation of London's

This project is not about the environmental performance of financial institutions. It has not examined the operational activities of individual financial institutions in terms of, for example, recycling and energy management. Instead the focus of the project has been on the role of financial institutions in allocating capital funds and risk management instruments to different economic activities, both at home and abroad.

Since investment in assets, particularly long-term ones such as transport and communications infrastructure, will constrain nations’ development for many years to come, it is important to get the allocation of financial capital right. This role as an intermediary means that financial institutions are critical channels through which pricing, regulation and their interaction with society, can direct financial capital to more or less sustainable economic activity.

To this end, it is hoped that these 'principles' will raise awareness among mainstream financial institutions and help to facilitate the financing of the transition path to a sustainable economy.
2. THE LONDON PRINCIPLES OF SUSTAINABLE FINANCE

The aim of the London Principles of Sustainable Finance is to demonstrate good practice, through case studies of a number of UK-based financial institutions, in responding to the challenges and opportunities of sustainable development and its financing. It is hoped that this will raise awareness and provide an incentive for the adoption of these Principles by other financial institutions, at home and abroad.

The London Principles of Sustainable Finance is a voluntary code for financial institutions that demonstrates their commitment to the financing of sustainable development. It focuses on the role of financial institutions in providing financial services that facilitate economic prosperity, while ensuring that the projects and business activities financed protect or enhance the environment and social development. This applies to all aspects of finance and not just values-based investment and banking niches. However, not all of the Principles will be relevant to each financial institution. Financial institutions endorsing these Principles will specify which are relevant to their business operations, and explain which are not.

**Economic Prosperity**

Principle 1: Provide access to finance and risk management products for investment, innovation and the most efficient use of existing assets;

Principle 2: Promote transparency and high standards of corporate governance in themselves and in the activities being financed;

**Environmental Protection**

Principle 3: Reflect the cost of environmental and social risks in the pricing of financial and risk management products;

Principle 4: Exercise equity ownership to promote efficient and sustainable asset use;

Principle 5: Provide access to finance for the development of environmentally beneficial technologies;

**Social Development**

Principle 6: Exercise equity ownership to promote high standards of corporate social responsibility by the activities being financed;

Principle 7: Provide access to market finance and risk management products to businesses in disadvantaged communities and developing economies.

The London Principles are aspirational and seek to encourage continuous improvement. To make this process transparent signatories of the London Principles will report annually on progress towards their implementation.
3. FREQUENTLY ASKED QUESTIONS

This section aims to provide the background information required for financial institutions to assess the applicability of the London Principles of Sustainable Finance to their businesses.

3.1 WHAT IS SUSTAINABLE FINANCE?

Sustainable finance is defined here as the provision of financial capital and risk management products to projects and businesses that promote, or do not harm, economic prosperity, environmental protection and social justice. This is not aid or concessional finance, which is the role of government and the International Financial Institutions, but is the provision of access to market finance. It is recognised that 'win-win-win' economic activities will not always be feasible and that trade-offs are sustainable\(^1\) if there is a net benefit to the balance of all three objectives. The draft principles are based on a positive approach of seeking to facilitate the financing of the transition path to a sustainable economy. The risk management requirements and the opportunities that this path is opening, for both growth and value, make the 'London Principles' relevant to all mainstream financial institutions.

3.2 WHICH PRINCIPLES APPLY TO WHICH BUSINESS AREA?

**Principles 1 and 2** apply to all aspects of financial services. Economic prosperity is advanced either by using a country's existing stocks of capital more efficiently, or by adding to those stocks by investment and innovation. Transparency and high standards of corporate governance are integral parts of this process.

**Principle 3** applies to the pricing of equity or debt finance and the price of risk management products, and includes any requirements on the business or project to improve environmental or social performance as a condition of the deal. The key point is that the financial service itself provides an appropriate incentive for improved environmental or social performance.

**Principle 4** applies to equity investors and their asset managers. Investor engagement through the corporate governance process should provide a direct mechanism to encourage appropriate management of non-financial risks, such as environmental performance.

**Principle 5** applies to banks and some investment institutions including, bank credit, other debt finance, asset finance, venture capital or investment funds buying IPOs. This calls not for the funding of projects unlikely to become commercially viable, but for access to market finance to be made available for technology start-up, expansion and later stage development.

**Principle 6**, like principle 4, applies to equity investors and their asset managers. In fact principles 4 and 6 are just extensions of the corporate governance process

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\(^1\) This corresponds to the definition of 'weak sustainability'. See for example Pearce, D.W., 1988, *Sustainable Development and Cost Benefit Analysis* in Environmental Valuation, Theory, Techniques and Practices, UCL.
covered by principle 2. In this case the non-financial risk that the business should be seen to manage appropriately is corporate social responsibility.

**Principle 7** does not require financial services to provide aid or concessional finance. It does call for the financial institution to provide appropriate access to market finance to commercially viable businesses in disadvantaged communities and in the developing economies. This will not apply to financial institutions with no business operations in developing economies or investment institutions in secondary markets.

### 3.3 WHY ANOTHER SET OF PRINCIPLES?

The **London Principles of Sustainable Finance** are not intended to substitute for any of the international initiatives in this area, such as the UNEP Bank Declaration or the UN Global Compact. Nor are they intended to substitute for local UK initiatives, such as FORGE.

Instead they aim to complement these initiatives with a set of principles on economic prosperity, environmental protection and social justice aiming to underpin financial and risk management services. The focus is on the financial sector's vital role as allocator of financial capital between economic activities, and this initiative forms part of the UK Government's contributions to the World Summit on Sustainable Development later this year.

The **UNEP Bank Declaration** sets out a commitment by financial institutions to comply with environmental regulations, introduce environmental management systems and report on policies and procedures.

The **UN Global Compact** aims to underpin markets with a set of fundamental principles on human rights, labour standards and the environment.

The **FORGE** Group is a set of UK-based financial institutions that have put together guidelines on environmental management and reporting for the financial services sector. The second stage of this project is now working on wider CSR issues.

### 3.4 THE APPROACH TAKEN BY THIS PROJECT

The objective of the project is to put together case studies illustrating good practice by UK-based financial institutions in the development of financial products that encourage sustainable development. In addition a set of principles has been derived to underpin future advances in the provision of financial products that promote sustainable development.

This interim report sets out the case studies and principles developed after interviews with over 40 UK-based experts, practitioners and NGOs on financing and insuring sustainable development and a Chatham House workshop attended by a further 80 financial institutions and stakeholders.

This project is not about 'sustainable financial institutions'. It has not examined the ecological or social 'footprints' of financial institutions' own operations. Instead the focus has been on the role of financial services in allocating capital and risk
management instruments to different economic activities, both at home and abroad. Since investment in assets, particularly long-lived network assets such as transport and communications infrastructure, will constrain the development path for many years to come it is important to get the allocation of financial capital right. This role as an intermediary implies that the sector is a critical channel through which price signals, regulation and civil society action can direct financial capital to more or less sustainable economic activity.

The approach taken has not been to concentrate on values-driven financial products, such as ethical or retail SRI funds or institutions like the Cooperative Bank. They are an important and growing lever for sustainable development, but still small. Rather the focus has been on how the market is failing, on why mainstream financial activities do not integrate environmental, social or ethical considerations into many investment, lending or insurance decisions. And how financial and insurance products have started to emerge to fill these gaps in the following financial services functions:

1. Pricing equity and debt for sustainability and exercising responsible ownership;
2. Supplying new finance for sustainable technologies, communities and businesses;
3. Providing risk management products to manage sustainability risks.

The structure and thinking behind this approach is summarised in the table below:

The links between sustainable development and mainstream financial services

<table>
<thead>
<tr>
<th>Functions</th>
<th>Business area</th>
<th>Sustainability problems</th>
<th>Solutions</th>
<th>UK strengths</th>
</tr>
</thead>
<tbody>
<tr>
<td>Providing new finance</td>
<td>Commercial banking - credit - leasing Investment banking - project finance - new issues - private equity</td>
<td>Sustainability risks not integrated into credit risk assessment/due diligence. Access to finance difficulties for new technologies/processes.</td>
<td>Assess and integrate sustainability risks into credit risk assessment/ due diligence. Include sustainability impacts (to project viability and bank's reputation) in project finance cost-benefit analysis.</td>
<td>Specialist banks in credit, micro-credit and leasing for sustainable businesses (Triodos-UK, Coop) Bank credit environmental risk management</td>
</tr>
<tr>
<td>Risk management</td>
<td>Insurance - reinsurance - non-life</td>
<td></td>
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<tr>
<td>Access to finance difficulties for the poor.</td>
<td>Threat to solvency of reinsurers and lack of insurance cover for business and households as a result of climate change. Contaminated-land brownfield redevelopment hindered by risks of unforeseen liabilities and clean-up cost overruns.</td>
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<tr>
<td>Easier listing requirements for small sustainable venture IPOs. Set up private equity/VC funds to invest in environmental technologies/ sustainable new businesses.</td>
<td>Transfer weather risk to capital markets through new weather hedging instruments. Encourage mitigation and adaptation by the companies and households seeking insurance for extreme weather events. Cost-cap, liability and other insurance instruments to mitigate risks and facilitate brownfield redevelopment transactions.</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Investment bank due diligence (UBS Warburg's environmental risk management system). IPO capacity. Private equity/VC funds (biggest in EU, 2nd only to the US).</td>
<td>Environmental liability insurance. Lobbying on planning regulations and education programmes to mitigate climate risks, especially flooding. LIFFE and derivatives capacity</td>
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The response to these sustainability problems and good practice in mainstream finance has taken a number of different routes, which are illustrated in the table above and in the case studies described in section 3:

1. Where Government can provide better signals through a stable regulatory framework, market-based instruments or disclosure requirements. There is also a partnership role for Government to set up new markets, share risk, transactions cost and provide an enabling environment for financial services to play a part;
2. Where new or better financial products and services are needed to supply a demand from valued-driven individual or institutional investors (or depositors) to reflect those values in investment funds, through engagement or other financial products;
3. Where the market is failing and there are material risks and hidden shareholder value that are not being reflected in market prices for equity and debt, or there is a lack of access to finance for commercially viable environmental technologies, or sustainable businesses and communities.
4. GOOD PRACTICE SUSTAINABLE FINANCE IN THE UK

The following examples of good practice were derived from a series of consultations with over 40 UK-based financial institutions during September-December 2001. These were amended and added to by a workshop for 80 additional financial institutions and other stakeholders was held by DEFRA and the Corporation of London on the 13th December at Chatham House.

They are arranged in four sections. The first three covering the three main functions played by financial services, as set out in the table above. The final covering the regulatory framework and government. It is intended to expand these case studies in the final report.

4.1 PRICING ASSETS AND EXERCISING RESPONSIBILITY

Investors have recognised sustainability as a factor in business success by identifying key environmental and social risks to short and long-term business value, and taking account of this in the investment and corporate governance processes.

- The ABI guidelines and associated research make an explicit link between corporate environmental and social performance and risks to business success, and call for companies to identify these risks and manage them effectively. This is an initiative by mainstream returns-driven investors. The risks will vary between sector and company and over time, but they are relevant for every investor.

Investors have collaborated nationally and internationally in order to engage on specific issues with companies and policy-makers.

- The SRI Forum of major UK investors and asset managers collaborated in putting together a set of business risk-related SRI engagement guidelines, which were the model on which the ABI guidelines have been based.
- The Universities Superannuation Scheme ‘Climate Change Project’ has commissioned a report and set up several collaborations with other UK investors to engage with companies, policy-makers and also property managers. Engagement with policy-makers is explicitly not to lobby on behalf of specific companies or sectors, but recognises that overall economic and social performance of the economy is vital for pension funds as ‘universal investors’.
- The Carbon Disclosure Project is a UK-led collaboration with major institutional investors in Europe, America and Asia to bring a substantial weight of funds behind pressure on Fortune 500 companies to disclose their carbon emissions. This project aims to make engagement successful with MNEs, to remove the need for lots of questionnaires and to focus on the risk to business success by providing a carbon analysis from Innovest.

Fund managers have made their engagement process transparent by disclosing details of dialogue with companies and voting policies, and provided evidence of its effectiveness.
- There is a concern that some claims of investor engagement on environmental and social issues are little more than 'greenwash'. Even when significant resources are devoted to engagement there is a need to assess whether anything is being achieved. Causality is impossible to prove but it should be possible to demonstrate that the investors was part of the process that brought about change.
- Morley Fund Management require FTSE100 companies to publish an environmental report to avoid a vote against them at the company's AGM.
- The Central Finance Board of the Methodist Church have a transparent process of disclosure on their engagement with companies.

**Investment bank sell-side analysts have integrated corporate environmental and social performance into their financial analysis of companies, and provided such research for their asset manager and institutional investor clients.**

- Since brokers' analysts are the main interface between investor and company, their acknowledgement of the importance of environmental and social performance as a factor in business success would dramatically increase the effectiveness of SRI. HSBC has recently set up a small SRI team to provide research for mainstream analysts and SRI clients.

**Index-tracking or quasi-index-tracking investment funds have extended their corporate governance activities to include engagement on environmental and social performance.**

- Engagement by equity investors with investee companies on environmental, social and other corporate governance issues is necessary to exercise responsible ownership. Many funds are under pressure to match benchmark index performance and have become in effect quasi index tracking funds to add to the growing proportion of explicit index funds. As a result many investors have become permanent owners of the top 20-30 or so companies in the benchmark index, and so do not have the option of disinvestment if the company underperforms on environmental or social criteria. Engagement to improve performance as an overlay to the index-tracking investment process is the only option. Friends, Ivory & Sime have just entered into a collaboration with State Street Global Advisers to offer index-tracking funds with an engagement overlay.

**Values-based institutional investors with a fiduciary duty to maximise financial returns within an ethical or sustainable development framework, such as churches, charities and public sector pension funds, have done this by using risk management techniques to offset the impact of screening on active risk exposures, or through their corporate governance process.**

- The Central Finance Board of the Methodist Church has been a 'modern SRI' investor for many years, and has an excellent investment returns performance. One factor behind this success has been to ensure that the SRI fund has a similar beta to the market, by replacing excluded stocks with those having a
similar correlation with market movements; tobacco with food retailing for example.
- An alternative approach has been taken by USS who follow a standard investment process but have put significant resources behind an SRI team to engage on environmental and social performance with their major investments.

**Fund managers have set up specialist environmental technology funds to invest in listed stocks in sustainable energy, water, waste and resource management.**

- These funds focus on the long-term growth sectors, generated by the sustainable development agenda. Funds such as the Merrill Lynch New Energy Technology Fund or the Impax Capital Environmental Technologies Fund understand the nuances of the technologies, the regulatory environment and provide an important role for these new technology companies. They perform a stabilising role by buying low-valued sustainable technology stocks when other general technology funds sell them along with other small caps. They also provide an important exit for venture capitalists and so encourage financing at the key start-up stage.
- Environmental technology funds were set up, and failed, in the early 1980s. These new funds have a more promising future as energy and water markets are being liberalised, environmental regulations are tightening. Moreover whereas the 1980s 'end-of-pipe' technologies offered just a cleaner environment, the new technologies also add shareholder value.

**Banks have provided project finance and trading capacity in London to facilitate the development of the UK Emissions Trading Scheme in 2002, which is likely to be the first active market in carbon emission allowances and credits.**

- The industry-led UK Emissions Trading Scheme has the potential to be a key stage in the development of a carbon-constrained economy. Individual carbon trades have taken place elsewhere on a case-by-case basis but the UK market could offer the first transparent price for carbon and a place for Annex 1 countries to cash in carbon credits. Arguably, the UK scheme is lent credibility and liquidity by the introduction of the mandatory EU scheme from 2005.
- The UK market could also facilitate the transfer of resources to developing economies by offering, once rules are established, a place for non-Annex 1 countries to cash there CDM carbon credits. Barriers that need to be overcome include the cost of verification and a concern that developing country projects will become skewed to carbon and away from poverty alleviation.

**Banks have facilitated the trade in Green Certificates**

- Eco-Securities recently advised on the first trans-Atlantic Green Certificate trade between Holland and a Guatamalan hydro-electricity project.
4.2 SUPPLYING NEW FINANCE

Listed equity investors have provided a clear exit opportunity for sustainable venture capital investors through a liquid and mature Socially Responsible Investment market.

- A prerequisite for a strong flow of venture capital finance into sustainable environmental and community ventures is a clear exit several years later by investors who will buy listed equities in these new companies. The UK’s maturing SRI market will provide this. This is also an argument for funds such as the Merrill Lynch New Energy Technology fund that invests in small unlisted ventures as well as listed equities, providing support and finance for new energy ventures throughout their development life-cycle.

Investors and banks have provided finance and capacity building support to small-scale financial intermediaries supplying innovative finance, such as micro-credit and private equity to community and environmental ventures.

- Small-scale intermediaries in community micro-credit such as StreetUK and in environmental finance such as Triodos-UK have the cost structure and expertise to successfully deliver innovative finance at the small scale often required by these sustainable ventures.

Investors have demonstrated that venture capital can work in the poorest countries to generate commercial returns on projects that are also providing development, environmental and community benefits.

- CDC Group are transforming themselves from a provider of concessional debt finance to a venture capitalist seeking commercial returns on projects in the low-income economies of Sub-Saharan Africa and elsewhere in the world. This has meant their exit from sectors such as agriculture, where returns are below hurdle IRRs, but they are supplying an important and growing demand for access to market finance from emerging market entrepreneurs. The CDC business model uses local knowledge to get deals and assess political risk, private equity skills to increase the chances of success during the life of the project, and a set of Business Principles to ensure a sustainable and ethical approach by the company in which they are invested.

Investors and banks have financed sustainable development in emerging markets through partnership with International Financial Institutions, Development Agencies and local financial intermediaries.

- CDC Group and Impax Capital (in their solar energy VC fund) have partnered with the IFC to share risk and access to cheaper, long-term, finance. This partnership to share the much higher risk involved in emerging markets is a key to attracting private finance into sustainable development in these economies.
- CDC Group and others have invested in local financial intermediaries as a means of effectively delivering finance in developing economies. The generation of sustainable livelihoods in developing economies generally
requires small-scale finance such as micro-credit or mini-enterprise lending. This is most effectively delivered through low-cost, local, financial intermediaries which require access to finance and capacity building from Northern financial institutions.

**Banks have established risk-based screens for mainstream credit and project finance business, and exclusionary loan screens, based on environmental, social and ethical criteria, for value-based depositors.**

- UBS Warburg have introduced an environmental risk management system to assess and manage credit risk and risks to reputation and the viability of a loan or project finance. The clearing banks, such as Barclays and LloydsTSB, have similar screens to manage those risks on their commercial loan books.
- Cooperative Bank screens its loans on the basis of an Ethical Policy based on extensive consultations with its depositors and other stakeholders. They report on the number of loan applications rejected on grounds of harming environmental, social or ethical objectives.

**Banks have provided finance instruments, such as asset finance and development bank bond issues, that matches the payback period of sustainable projects.**

- One of the difficulties experienced by preferential loan instruments, such as the EIF's Growth and Environment Scheme is that the payback period of sustainable projects, such as a combined heat and power plant or a wind farm is 5-9 years compared to the typical business loan of 1-3 years.
- Cooperative Bank has a successful asset finance business which provides longer-term finance that matches the payback period of the typical environmental venture. Projects such as a local authority waste to energy district heating scheme will have an even longer payback period of 15 years or more. There are opportunities for local financial institutions, such as the Coop Bank who can place funds in these sorts of projects, to partner with development banks to get access to their low-cost, long-term bond finance.

**Banks have provided finance to credit unions and disclose against community lending standards such as the Bank of England’s, the extent of lending to the poorest communities as compared with deposit-taking.**

- Credit unions have proved very effective financial intermediaries in underdeveloped communities, driving out loan sharks, and increasing financial literacy and incentives to save through linking loans to individual deposits. UK banks are farming a number of these institutions.

**Banks have disclosed and produced an externally-verified report on indicators showing the delivery of sustainable value to all partners, including shareholders, customers, workforce and local communities.**

- Cooperative Bank’s sustainability report provides a useful model for external verification and measuring sustainability impact. For each part of their business they report a sustainability cost-benefit analysis. Overall, it is
estimated that 15-18% of their profitability can be attributed to sustainability policies.

4.3 PROVIDING RISK MANAGEMENT PRODUCTS

Providers of financial derivative products have supplied tools to enable investors and businesses to manage a number of the risks arising from sustainable development issues.

- LIFFE have introduced a number of weather indices to allow investors, agricultual and entertainment businesses and others to hedge against extreme weather events. Since climate change is, arguably, already leading to more unstable weather patterns, these risk management tools are increasingly valuable and allow a higher level of economic activity than otherwise.

- UBS Warburg have introduced a number of derivative products based on the FTSE4Good equity indices, allowing ethical and SRI investors to take on or reduce their risk to this style of investing.

Insurers have provided reinsurance and insurance for low-latitude forests against the risk of fire and storm damage, by requiring the adoption of sustainable forestry management techniques.

- Partner Re have introduced a reinsurance product for a pool of local insurers in Indonesia that requires insured forestry companies to undergo sustainable forestry management (SFM) training and/or certification. It has been found SFM, through simple measures such as fire breaks and good relationships with local communities, can reduce the risk of forest loss by 75% and premiums from 2% to around 0.6%. Daily satellite imaging allows the monitoring of forest risks. This provides a market-based incentive for sustainable forestry.

Insurers have provided agricultural yield guarantee products to developing economies, helping to manage climate risks and alleviate poverty.

- High discount rates in rural developing economies are partly due to crop losses following extreme weather events or variability. Insurers are able to understand, model and measure these risks, at least for irrigated cash crops, if not yet for rain fed subsistence agriculture. This makes it possible for the insurer to offer a guarantee for the crop yield - not necessarily the full potential yield but sufficient to repay the loan that has financed the crop. This may be a good opportunity for the introduction of micro-insurance, provided via local insurers, or for villages to pool risks (as with micro-credit) until a critical threshold is reached that makes it commercially viable for insurers to reinsure the pool.

Insurers have improved the flow of private finance into sustainable development in the South by insurance products that reduce the rate of discount or risk premium required.

- One of the big problems with privately financing sustainable development in the South is that the payback period is often too long to make the project
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commercially viable, given very high discount rates and risk premiums. Reducing risk through insurance lengthens the payback period, allowing time for sustainable development criteria to be met.

**Insurers have worked with policy-makers to design appropriate policy and encourage the direct mitigation of sustainability-related risks.**

- Insurers as CGNU, Prudential and Henderson and others and a number of individuals from the industry have worked with policy-makers through institutions such as the UNEP Insurance Industry Initiative to, in particular, promote appropriate climate policies. This initiative is sponsoring research on the framework required after the Kyoto Protocol's first commitment period (2008-2012), which is necessary to be understood for infrastructure projects with economic lives of 25 years or more.
- In the UK insurers have also been involved in lobbying the local government planners to prevent new development taking place in low-lying areas vulnerable to flooding and other extreme weather events. Similar policy discussions and research have been supported by the industry on, for example, the design of buildings and building codes in the face of increased rates of subsidence.

**Insurers have linked insurance premiums more closely with sustainability-related risks that the insured individual or company can have some control over.**

- There are some discounts for low mileage offered on motor insurance policies. A more explicit link to mileage would both reduce the risk of insured loss and produce a market-based incentive for fuel economy and reduced greenhouse gas emissions.

### 4.4 REGULATORY FRAMEWORK

This section sets out the regulatory context for financial institutions to participate in financing sustainable development. It is recognised that governments are the democratic agents through which society's preferences should be set. Financial institutions must operate within this framework. In order for the London Principles of Sustainable Finance to be effective Government needs to set an enabling framework or, in other words, create the business case where necessary for the financing of sustainable development. The UK Government has led in a number of areas where this has been achieved, the disclosure legislation for pension funds being one. This and a number of other recommendations are set out below:

**Government could require the disclosure by institutional investors of the extent to which they take environmental, social and ethical matters into account in their investment decisions and voting policies. Extend the UK model [amendments in July 2000 to the Pensions Act 1995] to apply to all pooled investment assets under management and require these investment funds to report annually on implementation.**

- Institutional investors may not be reflecting the wishes of their fund members if they do not take into account the environmental, social and ethical impact of
their investments. The shift in pension provision from state to individuals in most OECD economies requires this disclosure in all countries to allow individuals to take responsibility for their pension investments. Policy-makers generally prefer the option of disclosure to allow effective stakeholder action, if necessary, rather than prescription. Without a requirement to report the disclosure requirement may not result in any significant change. Another view is that this is enabling legislation that will encourage voluntary leaders and peer pressure for change.

**Regulators could include a core training module on finance and sustainable development in financial services professional training and examinations.**

- There is a perceived need to ensure the competency of SRI analysts and fund managers. Environmental and social analysis, in particular the link with shareholder value, is not a subject most financial analysts and fund managers are familiar with. There is certainly the need for considerable capacity building to cope with the demand for SRI. Requirements for proof of competence may vary between retail SRI funds, which aim to produce environmental, social or ethical results for investors, and those investors looking to identify hidden shareholder value from ‘management quality’ - which is more an art than science.
- Forum for the Future and the Cambridge Programme for Industry run a senior executives learning network to build capacity in understanding the links between sustainable development and business success.

**Government could provide tax incentives for sustainable and socially responsible investment funds, particularly in emerging markets.**

- The evidence shows that SRI at the least has no cost and may enable portfolio out-performance. However, returns-driven rather than cause-based investors will require an incentive to provide the social and environmental benefits of sustainable and socially responsible investment that may not be reflected in financial returns. Polluter-pays taxation, if implemented, should ensure corporate environmental impacts are reflected in financial returns. This will not be so for investments in some overseas markets and in social or community development, where a tax incentive is justified. The Dutch have a similar scheme.
- The risk premium for investing in the emerging markets can easily make most investment opportunities there unprofitable. The development/social/environmental benefit can be obtained by Governments/International Financial Institutions taking on some of the risk through guarantees or a tax incentive. The Dutch have a similar scheme.

**Government could convene a task force with emerging market and SRI fund managers and analysts to examine ways of making portfolio flows to developing countries more sustainable.**

- The emerging markets, particularly in Asia, are where sustainable development will be won or lost given prospective population growth, fossil fuel and biodiversity reserves. SRI investors and other have some influence
through the FDI and supply-chains of MNEs. Hendersons also run an Asia Pacific SRI fund and Calvert Group in the US have a number of emerging market funds and joint ventures. However, the bulk of portfolio flows into the developing world arguably support unsustainable economic activity.

**Government could make a link with the Rio Conventions and listing requirements on the Stock Exchange.** Listed companies to be required to file, for example, an appropriate carbon or forestry management plan.

- The SEC in the US materiality requirement implies, for example, an oil company should file details of how the Kyoto Protocol will affect their business model. This sort of listing requirement could be linked to the Rio Conventions which would allow investors to assess whether their investments are at risk from these sustainability issues.

**Government could partner with private sector institutions in providing venture capital for sustainable technology start-ups and businesses in developed and developing economies.**

- Impax Capital is managing just such a public-private venture capital fund, financed by IFC, GEF and private investors, to invest in photo-voltaic solar power ventures in Kenya, Morocco and India. The role of IFC and GEF is to shoulder some of the political risk and ensure that private investors can achieve acceptable IRRs.

**Government could provide concessional finance in the form of debt or guarantees to reduce the transactions costs of financing new sustainable ventures in developing economies and could facilitate learning, until commercial returns are possible.**

- The experience of Impax Capital and others shows that there are substantial initial barriers to the private financing of new environmental or community ventures due to start-up difficulties and learning, to add to the political and market risk. The social and environmental benefits justify the use of concessional finance to enable companies like Impax Capital bring these emerging sustainable sectors to the point where they offer commercial returns to attract market finance.

**Government could provide an enabling environment in developing economies to allow private investors to supply venture capital, by funding necessary infrastructure and institutions, and providing training in business management.**

- Country risk is often very high and makes even a 20% IRR unattractive. This risk can be reduce by Government aid or IFI concessional finance to establish the infrastructure and institutions required to ensure the success of venture and allow eventual exit.
Government could improve the tax incentives for venture capital finance of sustainable technologies and companies with sustainable business models.

- In the UK there could be higher rate tax relief under the VCT scheme for venture capital investments in sustainable companies. This tax credit is necessary for getting this sort of risk capital into the organic agriculture sector, where returns often fail to meet hurdles IRRs. It has the advantage that the fiscal instrument and legislation is already in place. In addition there could be accelerated depreciation allowances for sustainable start-ups, a simplification of the tax regime for SMEs and a reduction of tax levels on share options.
- Another good example is provided by the tax credit for community finance introduced this year under the UK’s Community Finance Initiative.
5. WORKSHOP COMMENTS

5.1 PRICING ASSETS AND EXERCISING RESPONSIBILITY

- The recommendation that SRI funds should hold 5% of assets in high impact areas should be applied universally, especially in the stakeholder pensions area. On access to SRI funds, there is action required by the FSA on the issue of client fact-finding, where the issue of values are excluded from, the traditional process of financial needs and risk assessment. Voluntary codes will not address either of the two action points above. There is clearly a need for values-based SRI funds to demonstrate that they are contributing to environmental and social improvements, or at least avoiding harm as they claim. A greater proportion of the portfolio in high social impact assets such as property, venture capital or PFI projects would be a way forward, but it is not the aim of this project to prescribe how SRI should be implemented.

- Could the government do more to create a demand for SRI by putting across the government’s point of view more clearly and regulating that financial services advice should include information on SRI products and values investing, so as to raise awareness. And to perhaps have compulsory questions on whether investors want some of their money put into SRI/values products, so investments are not just sold on the basis of financial returns. Given that SRI is the fastest growing area of retail investment it is hard to understand why financial services providers will not respond appropriately.

- The government should encourage active fund management, and moves away from simply tracking mainstream industry benchmarks. It is not the role of government in a liberal market economy to prescribe how investment should be implemented. Moreover, this would only be a sensible move if active funds routinely beat the index, which they don’t.

- All funds should report against SD indicators such as the ones some SRI funds use, and move those indicators in a direction that is more sustainable. The role governments can play in this should be outlined in a broad way so as to make it applicable to many governments. It is not clear that any SRI funds are able to report the impact of their investments on sustainable development. This would be desirable but at present is not done. Mainstream funds are more likely to integrate SRI as an investment style alongside or incorporated in e.g. growth and value investing. The relevant indicator would be an improved version of existing SRI equity indices.

- Suggestion of a kite mark scheme, like with stakeholder pensions, to allow people to differentiate between SRI products with expert environmental and social research supporting it. Endorsement of the London Principles of Sustainable Finance would be one such kite mark.

- There are inadequate benchmarks of companies SD progress which will hamper the effectiveness of SRI due to inadequate information. Effective SRI will certainly depend upon adequate information about corporate environmental and social performance. However, the situation is improving with additional research from financial institutions, various reporting initiatives and data from private environmental and social risk rating agencies.

- Suggest to look at the OECD export credit agency guidelines and ask for SD measures in decisions. The UK’s ECGD guidelines offer a good model for
encouraging project finance and other funding instruments to take social and environmental impacts into account.

- IFAs should be made to learn about SRI in their required training to qualify as an IFA. Capacity building across the financial services is important and one of the recommendations made in the section of this report addressing government actions.

- The pensions disclosure regulations should be expanded to corporate and retail finance. Certainly increased transparency and disclosure is an effective means of getting society's preferences taken into account without restricting the decision-making of free market institutions. This will be considered as a recommendation for government action.

- Need to recognise market failures to take SD into account in buying decisions and look at how to rectify these. It is the role of government rather than financial institutions to rectify market failures, except to the extent that actions by other stakeholders, such as consumer boycotts, lead to the internalisation of these external costs. Both of these actions are already integral to this report.

- Need the analyst to engage with policy makers to assess how to get the market to value SD issues/performance. This is recommended in regard to portfolio flows to the developing countries, and the insurance industry's involvement in the policy making process on climate change is one of the case studies.

- Most UK financial institutions have a VC investment group, and they should be encouraged to include SRI in their work. The pressures for sustainable development are already causing new industries to emerge in renewable energy, water, waste and sustainable food. These are turning into the growth sectors of the future which should naturally attract VC. The challenge is to raise awareness and expertise.

5.2 SUPPLYING NEW FINANCE

- If there is no incentive for SD action at the moment the document needs to look at whatever tax/regulation is required to incentivise the action. Some of the recommendations for government action look at the issue of leveling the playing field or providing tax incentive or risk sharing where the business case is not sufficiently strong for private finance, but where the social benefits are large.

- Currently there are few repercussions to non-sustainable investing beyond reputation risk, there is government action required to extend the impacts on companies of non-sustainable investment. The position taken by this project is to emphasise the positive aspects of managing risks and taking advantage of opportunities to invest in the growth industries being created by sustainable development. Financial institutions, as intermediaries, will lend and invest in line with the preferences of their depositors and investors. Greater transparency by financial institutions themselves is the mechanism that should ensure this.

- Changes in the export credit guarantee regulations would be a good starting place for governments to send clear messages about SD and investment. The UK's ECGD is already a good model for other export credit agencies with its sustainable development screening procedures.

- The widening of access to capital needs to be emphasised as a corner stone of sustainable development in the developing world. DfID has experience in this field that could be of use in this project. One of the principles emphasises just this point.
- The project should look at the community reinvestment and anti-corruption regulations around the world for suggestions of principles. *A close look has been taken at these issues and these played a part in shaping the principles.*
- Financial institutions need to reward sell side analysis providers that include SRI analysis by using them to broker for them. *This appears to be starting to happen with a number of brokers looking into starting SRI research services.*
- Need longer term capital available to fund SD, as many projects have a long payback period. *That is an observation made in one of the case studies describing the successful application of asset finance to a number of energy projects.*
- There is a need for more transparency in environmental lending guidelines. *The need for transparency in all financial services activities is emphasised in one of the principles.*
- Need to expand credit risk assessments from environmental to sustainability. *This point is implicitly made in one of the principles calling for social risks to be integrated into risk assessment.*
- Need to look at UK financial exclusion, and internationally. *Certainly. To the extent that commercial business opportunities in disadvantaged communities are being denied access to market finance, this is catered for by one of the principles. The UK Community Finance Initiative has already considered this in detail.*
- Need to look at what is required to motivate private sector investment in emerging sustainable technologies. *This project has already consulted fairly widely on this issue and the principles and case studies make a number of recommendations based on this.*

### 5.3 PROVIDING RISK MANAGEMENT PRODUCTS

- Need to clarify what is meant by risk in each of the sections of the report. *There are many different types of risk. A major category of risk for investors is systematic risk or correlation with the fluctuations in the market. One of the case studies describes offsetting the active risks taken by using modern risk management tools. Derivative and insurance products can offset event risks.*
- Environmental impairment liability capacity in the UK, mentioned in the report, is not that big. Most of the market capacity is in the US, but the UK does have a lot of knowledge in this field. *Noted.*

### 5.4 GENERAL COMMENTS

- There needs to be explicit recognition of the need for government action to make the changes in the document happen. *The objective of this report is to examine what has been done and what could be done by financial services themselves. However, recommendations for enabling regulatory and other government measures are being considered.*
- Need to split the document in to general principals and actions, including which stakeholder groups the actions are aimed at. *This has now been done.*
- Need to distinguish between principals and actions in the final report. *This has now been done.*
- The report should split UK, EU, and world recommendations. It should also suggest legislative change. *This process should produce two documents. One for the UK/EU audience and another for the WSSD. This was felt to be beyond the scope of a UK-based initiative.*
- The report should look at how to provide micro finance to developing countries. *This is a key financial instrument in developing countries but it proved difficult to find extensive UK private sector experience.*

- More prominence should be given to micro finance in the report. *Note point above.*

- The role of private finance companies in micro credit should be mentioned, as this will be key to the future sustainability of the field. *Note point above.*

- Make the points less Anglo-centric by, for instance changing recommendations on engagement to ones on governance which has a broader international appeal. *The principles have been made universal but the case studies remain Anglo-centric by virtue of source.*

- Need to think of the actions in terms of governments and not the UK government. *Yes but the focus of this project is on actions by financial services themselves.*

- The discussion needs to be more mainstream and international and less Anglo-centric. *The emphasis has always been on mainstream institutions and their services in global capital markets. However, the whole idea is to capture the experience of UK-base institutions so there is inevitably and Anglo-centric element.*

- The main flows of capital in the developing world are from the developed world. Therefore the principles should focus on developed world institutions and how they can positively affect development in the south. *This is a key point. One of the recommendations for government is to establish a working group to examine this issue as a concrete next step to implement the London Principles.*

- There is interest amongst the more advanced developing countries in the financial services sector. As these develop there is scope to include some SD principals, so these principals should be made with that in mind. *The principles have been designed with this in mind.*

- Attempts should be made to get other countries, both north and south, to agree to support them, rather than try to make them less Anglo-centric. *This is the intention eventually.*

- Pricing of equity will not be of relevance to most of the WSSD attendees, but the section on the provision of capital will be. UK experience in this area could be effectively used to develop such provision in developing countries. *It is hoped that the case studies in this section will perform this role.*

- Will it be a cost, need to make the principles attractive to the industry. *No. The focus is on opportunities for new commercial business and risk management. Financial services are not expected to take on the proper role of government.*

- If you are putting forward principles you need to suggest ways in which the barriers to that principle can be overcome. *There are a number of practical initiatives such as FORGE that already do that.*

- All the recommendations/principles need to have incentives with them to give them a better chance. *The incentives are increased returns or better risk management. Recommendations have been made for Government action to improve the regulatory environment to increase the number of commercial opportunities.*

- We can base the principles on the two facts that investments need to have durable returns, and that they need to be sustainable. *Noted.*

- If these recommendations are to become principles then they need to be broadened out, not honed in on, so as to make them universally applicable. *This has been done to produce the seven principles.*
- The final document should contain specific case studies along side the broad principles to give practical relevance to its readers. Yes.
- Incentives and disincentives should be considered as ways of encouraging sustainable finance. Since we are considering mainstream finance this is true throughout.
- Shouldn’t take SRI as a starting point for the report as this document should be aimed at the mainstream financial community. Of course not. This project from the beginning was explicitly designed to consider mainstream financial services and their contribution to sustainable development.
- The document shouldn’t say SRI is not returns driven; this needs to be re-phrased. The report shouldn’t suggest tax breaks for SRI products as it suggests that they are inferior to mainstream product. SRI can mean all things to all men (and women). This report explicitly distinguishes between ‘values-drive’ ethical investment and ‘returns-driven’ SRI. Since this report is focused on mainstream finance the principles apply to commercial investment and finance opportunities.
- In order to make SRI type products more popular, you need to let people know about them. Yes but that is probably not the function of this report.
- The report should be focused on convincing fund managers to take SRI seriously as a profit making issue. It is hoped that it will.
- The suggestion of High Impact Investment needs to be emphasised in the report as the target audience for this report is the international community. Yes but the target audience are mainstream financial institutions also. The emphasis is on commercial opportunities that have high environmental and social impacts. Aid and concessional finance needs are not covered here.
- The report needs to look at how do you support access to capital in the least developed countries where the financial sector poor. Additionally it needs to look at which sectors are a priority for investment, in development terms. One of the key next steps is to put together a working group to examine portfolio investment flows to the developing countries.
- The knowledge gathered in the ACBE process should be reflected in the submissions to the summit so as to make some use of the findings. Yes, this will be done.
- Should be the London and New York principals as they are the major sources of FDI. We are starting with the experience of UK-based institutions. FDI is not the subject of this report.
- Recognise that investment looks at global sectors, and focus recommendations at those global sectors. Yes that will be an important next step. However, the principles apply across global sectors. They will of course vary in their applications to different sectors.
- The broader macro economic question of financial disclosure is not discussed. The involvement of financial services in issues of macro policy would be an important next step.
- You should take the principles to the finance and development conference in March 2002 in Mexico where the audience be more suited. Noted.
- Need to recognise cultural differences in different countries in the application of the principles/ recommendations. Quite true when considering implementation. However, the principles themselves may not be so relative to cultural differences.
- Need to recognise the need for financial sustainability in the products and services provided in developing countries. That goes without saying as these principles and case studies have been put together with mainstream institutions in mind.
- How would these principals fit in with other guidelines such as those of the IMF and world bank. *This has been explained in section 2 above.*
6. **WORKSHOP ACCEPTANCES LIST**

<table>
<thead>
<tr>
<th>Organization/Individual</th>
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<tr>
<td>ACCA</td>
<td>Roger Adams</td>
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<td>Carole Arumaina</td>
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SG Securities John Mayers
Small Business Service Robert Brennan
Social Systems John Robinson
Solar Century Madeleine Lyons
SRI Investment Marketing Manager Mark Campanale
Stratclyde University Dr Andrea Coulson
Sustainability Ltd Alex Cutler
The Blake Project Dr John Hemingway
The centre for Tomorrow's company Mark Goydin
The Co-operative Bank Jayne Beer
The ENDS Report Keith Tyrell
The Environment Council Sarah Holbrook
The Manifest Voting Agency Ltd Adam Rose
Theodore Goddard Claire Sheppard
Traidcraft Fiona Gooch
Traidcraft Michael Gidney
UBS WARBURG John Dean
UK Environment News Nick Paget-Brown
Universities Superannuation Scheme David Russell
University College London Charles Van Oppen
Wessex Environment Public Health Janet Barber
Advisory Panel
Westpac Banking Corporation Martin J Hancock
WSP Environmental Jim Finnamore
WWF Jules Peck
7. INSTITUTIONS AND INDIVIDUALS CONSULTED

- **Weeh Partnership (Raise venture capital and incubate environmental start-ups)**
  Rob Wylie, Director
- **National Association of Pension Funds**
  Peter Thompson, Chairman
- **Henderson Global Investors (SRI asset manager)**
  Nick Robbins, Head of SRI Research
- **CGNU (life insurer and asset manager)**
  Anthony Sampson, Environment Manager
- **Independent SRI consultant and financier**
  Mark Mansley, Claros Consulting
- **Environmental Resource Management (climate change consultants)**
  Lee Solsbury, Head of climate change services
- **Pall Mall Partners (asset managers/ partners in the Carbon Disclosure Project)**
  Jeremy Smith, Director
- **Morley Fund Management (SRI asset manager, part of CGNU)**
  Clare Brook and Toby Belsom, Head of SRI and SRI analyst
- **CDC Group (Venture capital investors in low-income developing economies)**
  Gillian Arthur and Alice Chappell, MD and Fund Manager
- **London Stock Exchange**
  Marc Bailey, Director of Business Development
- **Sustainability (Sustainable development consultancy)**
  Oliver Van Heel, Senior Consultant
- **Hendersons Global Investors (SRI asset manager)**
  Mark Campanale, SRI product development manager
- **Cambridge Programme for Industry (Senior executive education in sustainability)**
  Polly Courtice, Programme Director
- **Friends, Ivory & Sime (SRI asset manager)**
  Craig Mackenzie, Head of SRI
- **International Underwriters Association (Reinsurers trade body)**
  Marie-Louise Rossi, Chief Executive, Nick Lowe, Director
- **UK Social Investment Forum (SRI investment and banking trade body)**
  Penny Shepherd, Executive Director
- **NatWest Bank (commercial and retail banking)**
  Andrew Robinson, Director of Community Banking
- **Merrill Lynch (investment banking)**
  Adair Turner, Vice Chairman
- **Friends, Ivory & Sime (asset management and venture capital)**
  Rachel Crossley and Mark Thompson, Global Environmental Technology
- **Legal & General (Insurer)**
  Nevilel Watson, Director of Corporate Communication
- **Apax Partners (Venture capital)**
  Sir Ronald Cohen, Chairman, Michele Giddens, Community VC fund
- **Anderson (Climate Change consultants)**
  Frank Joshua, Head of Climate Change consultancy, Fiona Gadd
- **Jupiter Asset Management (SRI fund manager)**
  Emma Howard-Boyd, Head of Green Research
- **Impax Capital Group (Environmental technology corporate finance and asset manager)**
  Ian Simm, Managing Director, Bruce Jenkyn-Jones, fund manager
- Central Finance Board of the Methodist Church
  Russell Sparkes, fund manager
- Royal & Sun Alliance (Insurer)
  Paul Pritchard, Environment Manager
- Independent expert on climate change for the Insurance industry
  Dr Andrew Dlugolecki
- EcoSecurities (Climate change-related corporate adviser and financier)
  Lionel Fretz, Director
- Aon (Insurance brokers)
  Charles Crosthwaite Eyr and Justin Mundy, Carbon Risk Management
- Friends of the Earth (Environment NGO)
  Simon McRae
- PartnerRe (Reinsurer)
  Phil Cottle
- Cooperative Bank (Commercial and retail banking)
  Jon Lee, Ecological and Social Business Development Manager
- Universities Superannuation Fund (Pension fund)
  Dr Raj Thamotheram, Senior Adviser
- Department of Social Security
  Peter Askins
- WWF-UK
  Jules Peck, Sustainable Finance Adviser
- Association of Sustainable and Responsible Investment in Asia
  Tessa Tennant, Chair
- Just Pensions project (To get development objectives into pension SRI policies)
  Duncan Green, CAFOD researcher
- Hendersons Global Investors (SRI asset manager)
  Rob Lake, Head of SRI strategy
- FTSE (Financial market index provider)
  Mark Makepeace, Chief Executive
- Swiss Re (Reinsurer)
  Alan Bridgewater, Chairman
8. A VIEW OF FINANCIAL SERVICES AND SUSTAINABLE DEVELOPMENT

- Values-driven ethical funds
- Returns-driven Engagement and SRI funds
- Returns-driven but constrained SRI
- Micro-credit through financial intermediaries
- Community finance
- Venture capital
- Asset finance
- Environmental technology
- Carbon markets
- North/OECD
- South/Emerging markets

- Large-company behaviour
- FDI Supply chain
- Lack of access market
- High political risk/discount rate
- Cash in credit
- CD project
- Biodiversity
- Insurance products
- Project environmental screens
- Community development
- Environmental technologies
- Missing markets
- Public-private ventures/funds