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Environmental and Social Responsibilities of Banks : Global Perspective

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Abstract

The main objective of this paper is to examine the environmental and social responsibility practices of corporate firms from the global perspectives for the promotion of environmentally and socially responsible business activities by banks in global economies. Topics reviewed in this paper include environmental and social responsibility (ESR) models; economies and importance of adopting ESR in banking business; existing global standards and principles on ESR of banks and practices by banks in global economies. Finally, the authors attempted to suggest a guiding framework for introducing and improving ESR activities by banks in the light of available literature on ESR standards.

Keywords: Environmental and Social Responsibility, ESR Models, Global ESR Standards

1. Introduction

It is known that the definition of Corporate Social Responsibility (CSR) has widely varied from scholars to scholars and peoples to peoples, as well as

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managers to managers, although it has indeed contained some persuasive and appropriate issues, subjects or notions in it. The viewpoint of environmental affairs is just such one of items in this line included in rather synthetic meaning of social responsibility.

Here in this article we would like to discuss CSR activities in banking business with emphasis on this topical item of environmental issues together with some specific or general interpretations of CSR.

The essence of the social and environmental responsibilities of businesses is that the corporate entities should treat their stakeholders ethically and in a socially and environmentally responsible manner. Environmental and social responsible banking practices are clearly linked with corporate governance, which is concerned with holding the balance between economic and social goals to encourage the efficient use of resources. It is not just philanthropy and obeying the laws (compliance) rather is an attempt to respond to the stakeholders more efficiently and in a responsible manner.

A number of norms and guidelines that are voluntary in nature have emerged during the last two decades[1]. In most developed countries, multinational enterprises or banks are encouraged to follow various guidelines and work with unions and NGOs towards improvement of the social, environmental and labour conditions related to their operation. The corporate entities in those countries are now to operate under various legislative, fiscal and other regulatory bindings; and there are adequate incentives in those countries to promote good corporate citizenship. In contrast, the status of labour rights practices, environmental management and transparency in corporate governance are not satisfactory in developing and least developed world,

[1] Such as UNEP-FI, UPI-FINANCE 2000, Equator Principle etc.

largely due to poor enforcement of existing laws and inadequate pressure from civil society and interest groups. As corporate responsibility activities have gradually being integrated into global business practices and hence are becoming one of the determining factors for market access. Such practcies by corporate entities serve useful purposes not only for improving corporate governance, labour rights, work place safety, community development and environment management, but also for attaining global market access.

Social and environmental responsibility practices by banks do not only improve their own standards but also affect socially responsible behaviours of other businesses. The nexus between financial services and sustainable development through investment has become evident and evidence also exists showing that the financial industry could play a pivotal role in making businesses more socially and environmentally responsible through its operations: by raising, allocating and pricing capital. Financial industry may have a major influence on the entity who in society gets access to financing; how financial services benefit the people and how a financed project cause environmental destruction. The adoption of different world standards, guidelines or principles by the major global financial institutions and banks reflects a growing awareness of this nexus, and could lead to investments/projects that are good not only for financial institutions, but also for the environment and society. In the developing and least developed world, financial institutions may play vital roles in saving the environment, promoting human rights within the work place, and providing welfare through their financing policies. Such influence can extend a hand of cooperation to the government in enforcing regulations and protecting the fragile environment of many of these countries.

This paper aims at a review of environmental and social responsibility practices of corporate firms from global perspectives for the promotion of environmentally and socially responsible business activities by banks in global economies. The paper reviews available ESR models; discusses economies and importance of adopting ESR in banking practices; identifies existing global standards and principles on ESR of banks and their practices by banks in global economies; and formulates a guiding framework for adopting and improving ESR practices by banks in the light of available literature on ESR standards.

2. Models of Environmentally and Socially Responsible Business Practices and the Relevant Issues

A study on corporate responsibility in the Indian context presented four different models of corporate social responsibility, which were: the Ethical model, the Statist model, the Liberal model and the Stakeholder model (Kumar et al., 2001). The *Ethical* model is based on the corporate philanthropy of Cadbury Brothers in England and the TATA Family in India initiated in the 19th century, which in the ultimate analysis, made important contributions towards social development in the respective countries. The *Statist* model is related to 'state leadership' in corporate responsibility, and emerged in countries with a socialist ideology and in the welfare states, where the state assumes responsibility for the well-being of workers in the workplace and beyond. The *Liberal* model encapsulates the philosophy, which argues that it is sufficient for business to obey the law and generate wealth, which through taxation and private charitable choices, can be directed to social ends. The emergence of the *Stakeholder* model is largely related

to the growing concern regarding the current phase of globalisation, which has in part been criticised on the ground that globalisation results in lower environmental and labour standards (Raihan, 2005).

There are various schools of thoughts on the mechanism of socially and environmentally responsible practices and their impacts on businesses. There are arguments that an emphasis on environmentally and socially responsible business practices may lead to price increases that may not allow the specific markets for a company's goods and services to clear. If these costs are then transferred to pricing the company's products, all other things being equal, the non-ESR company will eventually drive its ESR counterparts or force it to reduce ESR related costs. On the other hand, it is also argued that quality aspects may not allow price increases and markets to clear. There is an ESR premium or an additional benefit earned by ESR practising firms that can be earned on the factors like product quality, employee productivity, consumer satisfaction and appreciation etc. Therefore, the additional ESR related costs could well be cancelled out by consumers accepting to pay for this additional premium. The third argument is that generally, the ESR cost is unaccounted for, and society is paying on behalf of businesses through various channels as tax for environmental rehabilitation, draining of government resources for rehabilitation and compensation. Once the businesses internalise the externalities they are responsible for, environmental protection and socially responsible business practices are automatically ensured.

Today the widely acceptable model or framework of ESR addresses the following broad issues: how banks operate in-house; how banks' policies,

services and products affect society; how banks promote sustainable business development; and how community activities affect stakeholders. Connected with the above-mentioned four issues the ESR areas include: (1) the social and environmental aspects of the banks' own operations such as labour and work conditions, recycling, and energy consumption; (2) the environmental and social impacts of, for instance, projects financed by the banks or bonds issued by the investment banks; (3) banks can be pro-active and support social and environment friendly developments, e.g. by designing new products that favour better environmental and social practices; (4) community investments and activities that target underprivileged, low income clients or other stakeholders such as setting up of hospital, schools, free medical treatment for low-income people reside in the location of a bank branch.

3. Economies of ESR and Roles of Banks in Developing ESR Practices in Businesses

Evidence for the positive ESR premium is growing with time. The Co-operative Bank in England sought to distinguish itself from rival banks by stressing its socially responsible credentials as it announced record profits for the seventh year running. It is proven that with a well-managed ESR premium, consumers could be willing to pay extra in the knowledge that the products they bought had not been produced by child labour, had respected the environment, that the technology to produce them had been acquired without corruption payments, and that the human rights of its employees and the local community had been protected etc. An ESR premium is also earned from increased productivity through sound human resource policies

of employees and managers. Product quality is also likely to be much improved when employees are treated as part of the company.

Practically, many businesses see ESR as investment. The benefits of such investment are not always immediately apparent. Training is an obvious social investment that is accepted as essential for future growth and profits. Reputation, a key ingredient of social capital, is known to be an important force in the market place that can not be gained in a day. However, it is not clear whether reputation for an ESR company is stronger than a non-ESR company. Certainly, the more companies and institutions that adopt CSR policies, the less particular companies will be picked upon, and the more resilient they will be to attacks on their reputation (Hopkins, 2001).

It is argued that intermediation of financial flows to business enterprises affects people's lives and the choices available to society. By generating, allocating and pricing capital, financial institutions may seriously influence business practices. There is also an increasing concern of the impact of financial lending to companies and for projects on the environment and human rights. Project financing by banks or bonds issued by investment banks should focus on how ESR principles are managed. ESR practices by banks should also ensure that financial firms actively promote sustainable development through proactive support of social and environmental developments, e.g. by designing new products that favour better social or environmental practices. Such products might be, for example, loans with lower interest rates for companies with a proven social and environmental record. Current project lending across the globe often results in unsustainable practices, because financiers do not produce reasonable environmental and social impact

assessments of the projects they are financing. The lack of sustainability criteria and regulation, combined with the lack of transparency for those individual depositors (who are interested in knowing how banks are using their money) and channels for those depositors to voice their concerns, also led to unsustainable practices.

4. Standards, Guidelines and Global ESR Practices by Banks

In a good ESR framework processes and systems should be there to ensure that banks can be responsive to their shareholders, regulators, customers, employees and communities. The ESR strategy is to pursue a balanced approach with all the stakeholders as banks build trusted relationships with them. We aspire to ensure that the impact of business decisions on all stakeholders is a factor that is considered from the outset. The practice should incorporate a set of community, environment and business initiatives consistent with delivering the ESR strategy.

There are several international efforts to draw up ESR guidelines that may apply to all financial services, and specific initiatives that aim at setting voluntary ESR standards for the banks/financial institutions. These guidelines are generally voluntary in nature for the financial institutions, and only apply to those in the industry that sign up for such initiatives. However, there is a severe dearth of information as regards the actual implementation of guidelines, as there is no standard disclosure norm for ESR practices. Generally, external verification is missing, as there is little scope to get information from the financial institutions

One of the initiatives, directly related to environmentally responsible business practices, is UNEP (United Nations Environment Programme) Finance Initiative (UNEP FI). The initiative, established in 1992, attempts to work with financial companies and institutions to identify, define and promote good and best environmental practices in their internal and external operations. In collaboration with over 260 commercial and investment banks, fund managers, and insurance companies, the initiative is based on a statement of commitment in regard to environmental and sustainable development in three areas of their activities: incorporating environmental and social aspects in internal operations; identifying and quantifying environmental risk as part of the normal process of risk management, and the development of products and services that actively promote environmental protection. The initiative promotes information sharing with customers and other stakeholders, research, dialogue with other financial corporations and the sharing of best practices, and working with UNEP to review their success in implementing the statement. The statement and UNEP FI are not very far reaching with their shortcomings with regard to the verification of implementation by the signatory financial firms (SOMO Report, 2004).

In 2002, the World Business Council on Sustainable Development (WBCSD) released a position paper (in response to the approach of a group of financial institutions) on the impact of sustainable development on the financial industry, and the criteria on which a sustainability strategy for the financial industry should be based. The paper argued for integrating sustainable development, outlined major issues of sustainable development[2] in

[2] Sustainable development is generally understood as development taking care of protection of environment and preservation of bio-diversity.

relationship with different stakeholders, recognised the influence and responsibility of financial companies as drivers for change towards sustainable development, and encouraged the sector to be more transparent in its financial reporting.

Another initiative *EPI-Finance 2000*, aims at developing environmental measurement indicators, and was launched by 11 financial corporations in Germany and Switzerland. The set of *Environmental Performance Indicators* (EPI) for the financial industry incorporated the environmental evaluation standard ISO14031 as a guideline. The *EPI-Finance 2000* proposed indicators covering four categories of financial services-commercial banking; investment banking and project financing; asset management; and insurance-relating to integrating environmental issues into core business, and development of environmental products for financing.

A declaration was released in January 2003 on "Financial Institutions and Sustainability", which was endorsed by 100 civil society groups by the beginning of 2004 (SOMO Report, 2004). The declaration states six key guiding principles that NGOs are calling on for banks and other financial firms to adopt at all levels of their activities and transactions. These guiding principles include commitment to sustainability at the level of core business (lending, investing etc.); commitment to adopt a 'Do No Harm' approach (impact on environmental and social levels); commitment to responsibility; commitment to accountability to their stakeholders; commitment to transparency; and commitment to sustainable markets and governance. This *Collevecchio Declaration* on Financial Institutions and Sustainability is concerned with the damaging environmental and social results of projects financed by

banks and other financial firms. The declaration outlines civil society's expectations from the financial sector in order to advance sustainability. The expectations go far beyond current practice and thinking of banks' ESR initiatives. It aims for real improvements of the impact that financial activities have on societies and the environment.

NGOs have been undertaking campaigns against financial firms for their role in financing risky projects[3] where ESR problems are most likely to occur. In response, some financial firms developed sector specific guidelines for project financing[4]. However, independent, external verification of the implementation of these guidelines is still not in place.

Among the existing guidelines, the Equator Principles received prominence in recent years. The Equator Principles are based on the environmental and social policies and guidelines of the International Finance Corporation (IFC), the private sector development arm of the World Bank Group. In the area of project financing, the *Equator Principles* are a set of voluntary commitments, designed by a group of banks for assessing, managing and monitoring environmental and social risk. Committing to abide by the Equator Principles, a bank agrees to apply guidelines based on the International Finance Corporation's policies for assessing projects' environmental and social impacts. These principles apply to all project financing, in all sectors globally, where the size of the deal exceeds US$50 million. Each project is categorized into one of three groups: High-impact 'Category A' projects, which require a full environmental impact assessment (EIA); 'Category B'

[3] For example financing projects that harm tropical rainforests, mining operations, gas operations, financing investments that violate human rights etc.

[4] For example, ABM Amro developed "Risk Policies on Forestry and Tree Plantations".

projects with lower likely impacts, which require a less-extensive EIA; and 'Category C' projects with minimal or no adverse impacts. The projects under category C do not require an EIA. The principles also require borrowers in high impact projects to carry out appropriate local stakeholder consultation. In addition, the borrower or a third-party expert must put an environmental management programme in place to address project compliance, mitigation, action plans and monitoring procedures. From a humble beginning, the Equator Principles have indeed altered the project finance market. As of 2005, 28 major banks[5] committed to using the Equator Principles to manage environmental and social risk in their project finance businesses. The Equator banks represented about 75% of the project finance market in 2003 (Lazarus, 2004).

UN Global Compact is an ESR initiative applicable to all business sectors expressed in 10 voluntary principles on human rights, labour rights, environment and anti-corruption. It includes recommendation to all sorts of financial market participants, ranging from stock exchanges, pension funds, financial institutions and regulators. One of the problems with UN Global Compact is that it is not a regulatory instrument and relies on the self-interests of the company. There is criticism that by promoting the instrument the UN effectively undermines the ability of the national governments to put forward a different approach.

Though some banks are very slow to take interest and are absent from the

[5] Major banks include ABN Amro Bank and Rabobank of the Netherlands; Barclays PLC and Royal Bank of Scotland of Britain; US-based Citigroup, Inc. ; French-based Credit Lyonnais; Credit Suisse Group of Switzerland; HVB Group and West LB AG of Germany; and Westpac Banking Corporation of Australia, etc.

scene where the world's major financial institutions are taking the initiative in establishing environment-friendly standards for project finance (PF) for developing countries. The adoption of the Equator Principles by a number of big banks confirms that the role of global financial institutions is changing. More than ever, people at the local level know that the environmental and social aspects of an investment can have profound consequences on their lives and communities — particularly in the emerging markets where regulatory regimes are often weak. On the adoption of Equator, IFC President (in 2003) noted that one extremely important development is finding something common in banks of different regions i.e. adoption of equator principles which is absolutely vital to the long-term economic performance, environmental status, and social health of all countries. The fate of the rich economies is directly linked to the fate of responsible growth in the poorer economies, and the Equator Principles make that link explicit.

5. Formulating a Guiding Framework for ESR Practices in Banks: Critical Issues

It might generally be agreed that ESR practices could enhance banks' reputation and profitability, and that customer satisfaction and community investment would have positive impacts on their financial sustainability. It could also widely be accepted that banks/financial institutions can play a vital role in incorporating and improving ESR practices in businesses. However a wider adoption of ESR practices in many countries, mainly in developing and least developed countries, is still missing. Even in many cases specific policy guidelines and directions from the central banks or concerned monetary authorities are non-existent or inadequate.

5.1 Broad Policy Guidelines for Banks and Basic Principles

Generally global rules of business are dictated by the norms set by developed countries. It is obvious that applying the same yardstick of compliance in terms of responsible behaviour to banks both in the developing and least developed countries would be premature and unjust. A broad set of voluntary principles should be offered on the current practice of ESR elements considering current business environment, domestic reality and global practices. The basic principles could be commitments in connection with the following aspects:

ESR Commitments at the Level of Core Activities

ESR commitments should be on: the incorporation and improvement of evaluation mechanism of social and environmental impact of the activities, including lending and investing etc. ; incorporation of mechanism for identification and quantification of environmental risk as part of the normal process of risk assessment and management; introduction and development of financial products for promoting protection of the environment and sustainable society through price differentiation; implementation of steps for capacity building through providing education and training, and ensuring health, safety and other benefits to the staff.

ESR Commitments in Lending Operations ensuring no Harm to the Environment and Society

ESR Commitments should be on: development of methods to screen the level of environmental and social risk in the projects and assigning a risk categorization; introduction of a lending mechanism under which higher risk projects require the borrower to prepare an environmental assessment and

develop an environmental management plan; incorporation of a mechanism which ensures that environmental assessment evaluates the project against environmental guidelines and a baseline set of policy requirements, set by domestic agencies, including consultation with local communities.

ESR Commitment to ensure Wider Accessibility to Financial Services

ESR Commitments should be on: designing savings services and lending products targeting lower income groups and poorer class of the society; ensuring good distribution and balance of urban and rural customers; ensuring better access to finance of the underprivileged through various incentives, including preferential refinancing facilities of the Bangladesh Bank.

ESR Commitment to Accountability to the Stakeholders

ESR Commitments should include: development and implementation of a system of measuring customer satisfaction, or arrangement of regular dialogue between customers and management/directors; engagement of stakeholders through a forum, with representatives from prominent environment experts and activists groups, community service groups and consumer groups, which will ensure effective consumer satisfaction and economic and social returns.

ESR Commitment to Transparency and Independent Verification

ESR Commitments should include: development and implementation of a system of reporting by banks/financial firms on the social, environmental and/or sustainable development aspects of their activities and their implementation; introduction of a system of external verification or independent social audit to ensure compliance of ESR Banks policy guidelines and

commitments.

5.2 Incentive for ESR Practices by the Banks

A set of positive incentives can be useful for encouraging banks to adopt the ESR guideline. There could be refinancing facilities for banks that have and utilizes well-defined environmental and social risk assessment tools. Other fiscal and non-fiscal incentives can also be designed in this regard. One of them may be the introduction of tax incentives for the selected ESR banks.

5.3 ESR Governance in Banks

CSR governance cannot be segregated from overall corporate governance. An ESR Cell or ESR Unit in each bank may be assigned with the responsibility of designing, evaluating, and administering the relevant issues of banks. The cell or unit should be responsible for review of CSR practices and environment management systems, evaluation of achievements, and reporting to the management on an annual basis. Central bank or monetary authorities of respective countries may play a role to encourage the formation of such a cell or unit in all the banks.

5.4 Initial Cost and Awareness Building

Initially, implementations of ESR practices require an investment cost. The awareness building of bank shareholders and management is the precondition for adopting good ESR practices. It is to understand that banks need to have a balance between their economic and social goals for a long run sustainable development. It is important to raise awareness on ESR practices so that CSR does not simply mean community services or philan-

thropy. The awareness programme may include seminar, workshop, staff orientation, campaign etc.

5.5 Product Development for Wider Access

Appropriate product design is an integral part of ESR practices and a crucial challenge to ensure wider access of people of all classes [high incomes to low incomes], communities and areas [urban and rural]. Practically in many instances, rural and farm sector and the poorer class have very limited access to the financial services offered by the banks.

5.6 Incorporating CSR Provisions in Loan Appraisal

Under a broad guideline, banks are expected to adhere to some major principles for all activities/transactions in general, and some principles for project financing specifically to incorporate in the loan proposals to improve ESR practices by their business clients. The methods of risk assessment and grading should be country specific and might be a matter of research.

5.7 Incentive for ESR Practices by the Banks' Clients

Incentives and disincentives should be part of banks lending procedure that could work to encourage banks' clients to adopt and improve ESR practices in businesses. Compliance of national environmental regulation may not be sufficient and banks may charge lower cost of fund for those projects that are socially desirable and have no harmful effect on environment.

5.8 Personal and Professional Development of Human Resources

It is crucial to recognize the importance of developing human resources professionally and personally and providing them with the right skills-not

just for current period, but also for the future. It is important to strengthen the relationship between managers and the staff by encouraging more open and honest conversations. It is required to introduce documented health and safety policy, as these are also the fundamental rights of the employees.

5.9 Multi-Stakeholders Dialogue

Generally, multi-stakeholder dialogue is very limited in banking sector governance. Shareholders, directors, and bank management have a scope for interaction and view sharing. However, banks generally do not have any initiative of measuring customer satisfaction or arrangement of a regular dialogue between customers and management/directors. Stakeholders' forum, with representatives from prominent environment, community services and consumer groups may ensure greater consumer satisfaction, and economic and social returns.

5.10 Environment Management System

Adopting globally accepted environment management systems is a challenge to the banking sector of the country for long-term prospects and sustainability. Banks should be guided by specific principles, and should consider the direct and indirect environmental impacts of any lending decision.

5.11 Independent Monitoring and Social Audit

The loan officials of banks generally have limited experience in monitoring environmental and social compliance of the businesses. Getting high quality, consistent and independent advice from independent experts through outsourcing will be one of the major challenges for the banks and for borrowers.

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