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BANKING ON SUSTAINABILITY

Financing Environmental and Social Opportunities in Emerging Markets

"As many financial institutions remain in a reactive mode to sustainability, it is likely that we will see a growing divide between the leaders and laggards, with environmental, social, and governance risks becoming ever more concentrated in the loan books of the laggards. Meanwhile, proactive financial institutions will have the potential to tap into new consumer and product-driven market niches."

David St. Maur Sheil, Director and Co-Founder, The Association for Sustainable & Responsible Investment in Asia (ASrIA)

"The role of companies in a society is currently going through a transition that presents important opportunities and, in many ways, is being felt most strongly in developing economies. Expectations are highest in the developing world for the private sector to go beyond core business lines to help improve education and health systems, address poverty, protect the environment and reinforce human rights. By responding effectively to these expectations, local companies can not only protect and enhance their reputations, but also ensure that they are on equal footing with multinational corporations entering their markets."

Chris Coulter, Vice-president, GlobeScan Inc. (international public opinion researchers)

"Prosperity, environmental protection, and social justice are considered to be the core of every economy. Developing the human resources of banking and financial institutions in order to create sound, efficient, and responsive financial institutions that are environmentally and socially sustainable can help achieve substantial business benefits."

Khaled Bassiouny, Director, Business Development Department Arab Academy for Banking and Financial Sciences

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Manufactured in the United States of America
First printing, January 2007

TABLE OF CONTENTS

BEST BANKING PRACTICE CASES

CASE NUMBER	BANK/COUNTRY	BUSINESS CASE (STORY HIGHLIGHT)	CHAPTER/PAGE
Asia and the Pacific			
12	ACLEDA, Cambodia	Promoting sustainable microfinance	Chapter 4, p. 70
Central and Eastern Europe			
10	ACBA Leasing, Republic of Armenia	Attracting new business by strengthening capacity in renewable energy projects	Chapter 4, p. 62
9	Bank Aval (Raiffeisen), Ukraine	Increasing the bank's value for international investors	Chapter 3, p. 57
14	Banca Comerciala Romana (BCR), Romania	Increasing the bank's marketability in the privatization process and facilitating Romania's banking reform through strong social and environmental management	Chapter 5, p. 76
8	Bank of Georgia, Republic of Georgia	Attaining first mover advantage by offering affordable housing finance	Chapter 3, p. 54
6	"Center-invest," Russian Federation	Sustaining market share through lending to SMEs and energy efficiency projects	Chapter 3, p. 46
1	Česká Spořitelna, Czech Republic	Leading the way in financing sustainable energy projects	Chapter 1, p. 18
11	UralTransBank, Russian Federation	Offering financing for cleaner production and energy efficient technologies	Chapter 4, p. 66
Latin America			
4	Itaú-BBA, Brazil	Setting sustainability benchmarks for the banking industry	Chapter 2, p. 34
7	Unibanco, Brazil	Attaining a stronger market position through sustainability management	Chapter 3, p. 52
5	Banco Cuscatlán, Central America	Reducing risk and offering innovative financial products	Chapter 2, p. 38
Sub-Saharan Africa			
2	Afriland First Bank, Cameroon	Supporting African socio-cultural values by investing in sustainable development	Chapter 1, p. 22
13	FirstRand Bank, South Africa	Promoting Black Economic Empowerment through the financial sector	Chapter 4, p. 72
3	Nedbank, Southern Africa region	Embracing global sustainability standards and broadening community involvement	Chapter 2, p. 29

FOREWORD

Sustainability is now increasingly recognized as central to the growth of emerging market economies. For the private sector, this represents both a demand for greater social and environmental responsibility as well as a new landscape of business opportunity.

The financial sector has been late to respond to this trend but is emerging as an important driver across all sectors in an economy. In the banking sector, new standards and codes of conduct promote corporate accountability, transparency, and consideration of impacts on environment and society. One clear example is the Equator Principles, based on IFC's social and environmental performance standards and adopted by an increasing number of banks that operate in developing countries.

IFC is proud of its leadership in creating and applying high social and environmental standards in private sector investments, as well as in supporting innovative business models in areas such as sustainable energy and access to finance for women. Our work in emerging markets has shown us that effectively managing these risks and leveraging opportunities associated with sustainable development can add value for our clients and, as a consequence, for us. The financial sector has become a priority area for IFC and today accounts for approximately 40 percent of IFC's total portfolio. We believe we are ideally positioned not only to provide financial resources but also to share knowledge to help financial institutions meet and create demand for products and services with a sustainability focus.

The research presented in this report shows a very positive move among banks from trying to avoid risks to proactively looking for ways to tap the business opportunities offered by sustainable development. The resulting benefits for banks range from increased profitability and market value to a stronger reputation and improved image in the community.

We hope this report will be useful to emerging market banks that want to increase their competitive advantage by pursuing a sustainability strategy – and in the process create long-term value for themselves and their clients. We also hope that a wider community of banks will be motivated by the successes of their colleagues from Africa, Central and Eastern Europe, and Latin America featured here and will be encouraged to adopt the Equator Principles. The Principles provide the ideal risk-management framework for banks, whether they invest in their own country or abroad.

Jyrki I. Koskelo
Director, Global Financial Markets Department, IFC

Rachel Kyte
Director, Environment and Social Development Department, IFC

ABOUT THIS REPORT

A New Look at a Fast-changing Sector

This report is an outcome of work done by IFC's Sustainable Financial Markets Facility (SFMF), a capacity-building and technical assistance program focusing on the social and environmental aspects of finance and investment in emerging markets. With the support of the donor governments of Italy, Luxembourg, the Netherlands, Norway, Switzerland, and the United Kingdom, and relying on a global network of partners, IFC has delivered Competitive Business Advantage (CBA) workshops for managers of financial institutions around the world since 1997.

In 2002, IFC conducted a survey of participants in the CBA workshops to better understand the sustainability challenges and opportunities faced by banks in emerging markets, and to find out how they were responding. The results were published in a 2003 report, *Beyond Risk*. Since then, the global financial industry has experienced a significant transformation in which social and environmental responsibility has become increasingly central to business performance. This trend is expanding to include emerging markets, which are quickly becoming an integral part of international capital flows. When IFC conducted a second survey of banks in 2005, the responses showed greater awareness of the importance of sustainability and better management of both risk and opportunity.

Responding to the 2005 Survey of Financial Institutions

The data for the 2005 survey came from 120 financial institutions that had participated in the Competitive Business Advantage workshops between October 2002 and September 2005, covering 43 countries. We asked them what they considered to be key social and environmental risks and opportunities for them and their clients; their motivation and constraints in considering these issues in their operations; what steps they have taken to implement appropriate management procedures/systems; and what kind of impact integrating sustainability has had on their business.

The new survey and additional feedback received from a number of financial institutions have revealed a demand for information, both to raise awareness and to aid in building institutional capacity. The most immediate needs expressed by the respondents were for

- more information on sustainability issues specific to particular regions
- guidance on investment opportunities in specific industries and ways to involve local expertise
- practical examples that demonstrate successful implementation practices

With these needs in mind, this report builds and expands on our previous research and provides greater insight into the specific issues and drivers within the banking sector. The survey results as well as more detailed, practical experiences of 14 financial institutions help to strengthen the business case for sustainable banking and show how progress has been made in the implementation of formal social and environmental management procedures.

Going a step further, the report also analyzes current global and regional trends and presents an overall picture of where we stand today with regard to social and environmental sustainability for financial institutions in emerging markets. The report demonstrates how all these elements contribute to a continuous process in which improvements in social and environmental management lead to greater business benefits.

Scope of the Report

We have focused our analysis on financial intermediaries in emerging markets: commercial banks, investment banks, leasing companies, microfinance institutions, and other related financial institutions. Development banks and insurance companies can also benefit from our findings. However, they are largely outside of the scope of the discussion, as they have more specific and somewhat different needs with regard to managing social and environmental sustainability issues.

The survey results presented in the report summarize results for commercial banks, the largest and the most diversified group of financial intermediaries in emerging markets. Commercial banks also comprise the biggest group of the survey respondents and provide the most representative sample for analysis. Results for microfinance institutions, leasing institutions, and investment banks are in line with the results obtained from commercial banks.

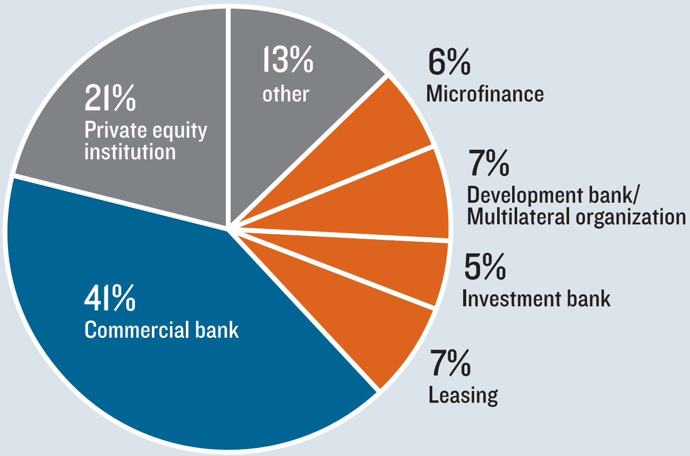
More information on the methodology and results of the *2005 IFC Sustainability Survey of Financial Institutions* can be found at http://www.ifc.org/SFMF

Good Practice Examples

The report provides practical examples of 14 financial institutions in 12 countries that have taken concrete steps to integrate social and environmental sustainability into their policies, practices, products, and services. They include 12 commercial banks, a leasing company, and a microfinance institution. These examples serve to

- Share expertise in implementing social and environmental management systems
- Describe innovative financial products that can help banks expand their business in areas related to social and environmental sustainability
- Demonstrate positive business impact from integrating social and environmental considerations in banks' operations

TYPES OF FINANCIAL INSTITUTIONS SURVEYED (PERCENT OF RESPONDENTS)



Source: *IFC Sustainability Survey of Financial Institutions (2005).*

More than 120 financial institutions in 43 emerging market countries were surveyed. These included:

Financial institutions that make up the banking sector in emerging markets, together with commercial banks. They are linked by their function in the economy, the intermediation of financial flows: that is, borrowing funds from depositors or organizations and channeling these funds to individual and corporate borrowers in the form of business and commercial lending.

Commercial banks

Private equity institutions and other organizations—such as research and consulting organizations, government agencies, stock exchanges, and NGOs—specializing in social and environmental issues in the financial sector or interested in those issues. Responses from these institutions are outside the scope of this report but are included in the aggregated survey results.

EXECUTIVE SUMMARY

What are the major social and environmental risks that banks face in emerging markets? How can these risks be transformed into opportunities and ways to access new markets and clients?

This report serves as a guide for strategic planning for financial institutions that want to improve their competitive advantage by integrating social and environmental sustainability concepts, management systems, products, and services into their businesses. It is particularly targeted to commercial and investment banks, leasing companies, and microfinance institutions that together comprise the banking sector in emerging markets.

The report presents the business case for sustainable banking by drawing on responses to a **2005 Sustainability Survey of Financial Institutions** conducted by IFC as well as 14 case studies from pioneering financial institutions. The survey collected and analyzed data from more than 120 financial institutions in 43 emerging market countries that had participated in IFC's Competitive Business Advantage training workshops. The results reveal drivers, opportunities, and trends in the banking sector's response to sustainability.

Capturing the Business Case

One of the key findings in this report is that **individual banks must devise their own unique business case for sustainable banking**. This is determined by their business goals combined with the sustainability trends and factors in the markets and sectors in which they operate.

According to the 2005 IFC survey, **reputation and branding** has become the top reason for many banks to integrate sustainability considerations into their management practices. 68 percent identified the need to increase their credibility and reputation as the main reason to consider social and environmental issues. 64 percent of respondents identified **investor demand** as a critical factor.

Compliance with government regulations, although important, is no longer the top driver. Instead, other incentives include increased value to shareholders, lower risk and better returns, and client demand.

For financial institutions, the process of continual improvement means integrating better standards as well as expanding the view of what generates long-term value for themselves, for their clients, and for society. The report provides insight into some of the most prominent business opportunities in **four fast-growing areas**: sustainable energy, cleaner production, biodiversity conservation, and banking services to low-income, underserved groups. It also looks at an opportunity to benefit from financing improvements in corporate governance of client companies.

This move to achieve greater long-term value is expected to be driven from both inside and outside financial institutions. Banks that use these strategies will gain a competitive edge. They will also strengthen their positions by contributing to the macroeconomic development of the countries or regions in which they operate, facilitating their integration into the international financial community, and serving as models of best sustainability practice that others can follow.

Understanding Unique Drivers for Sustainable Banking in Emerging Markets

What motivates banks in emerging markets to reassess their business practices and engage in sustainability-oriented risk management and product development? Pressing environmental issues as well as the need to alleviate poverty and protect human rights remain priorities in emerging markets. Local communities that live around large projects financed by banks have their own priorities, and are emerging as new regulators as well.

The scope of responsibility for financial institutions in emerging markets is therefore widening – from environmental protection to social inclusion of underprivileged groups and consideration of other social issues, such as labor practices, protection of indigenous populations, and preservation of cultural heritage.

> *The financial sector is a critical channel through which price signals, regulation, and civil society pressure can direct financial capital to more or less sustainable economic activity.*
>
> Financing the Future, The London Principles

As global players rapidly increase their presence in the banking sector in emerging markets, it will make the sector more complex and thus more vulnerable to financial and non-financial risks, as well as increased competition. To build customer loyalty and meet new market demands to sustain their market share, emerging market banks are increasingly adopting global standards in risk management, international standards of openness in reporting and accountability, and more effective strategies for product development.

The 14 best practice examples in this report illustrate how different financial organizations have pursued different goals tailored to their specific markets. They include a major Czech bank that is leading the way in commercial financing for SME sustainable energy projects, and an African bank providing loans for environmental improvements in waste collection and treatment as well as microfinance to rural communities and women. Other banks in this report are adopting best practice measures to assess social and environmental risk in their projects, and another became the first African bank to publish a sustainability report.

Creating Business Value through Environmental and Social Management

Only by effectively managing social and environmental opportunities alongside risks can banks create long-term value for their businesses. Considering risk alone will not be enough to generate new markets and profits. However, pursuing sustainability-related, market opportunities does not automatically mean that a bank will reduce its social and environmental risks.

To manage both risks and opportunities strategically and comprehensively, banks need to integrate a systematic approach—a social and environmental management system (SEMS)—into their processes and operations. Building and operating an effective SEMS entails several processes that must occur in parallel.

To succeed, banks need to bring their written policies into action through a strategy for **creating long-term value through sustainable banking**. This entails capacity building and training, as well as setting measurement and evaluation standards. Effective reporting is just as important to ensure that results are communicated back to banks' shareholders and a wider group of stakeholders. These processes should be tailored to fit banks' own business goals and organizational culture.

SUSTAINABLE FINANCE AND SUSTAINABLE BANKING

Sustainable finance is defined 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.[a]

Sustainable banking can be defined as a decision by banks to provide products and services only to customers who take into consideration the environmental and social impacts of their activities.[b]

a Forum for the Future (2002, p. 3).
b Bouma, Jeucken, and Klinkers (2001, p. 101).

Although implementing an SEMS is not without costs, banks overwhelmingly report that the benefits outweigh the costs. 86 percent of the commercial banks in the survey reported positive changes as a result of steps taken to integrate social and environmental issues in their business. 19 percent perceived these changes as significant. Not a single respondent reported a negative change.

Social and environmental risk management improves the quality of a bank's portfolio and lowers insurance liabilities and compensation claims. Pursuing innovative financial solutions and products generates direct profits in new markets with new clients. All these elements contribute to improving a bank's brand value. Banks in the survey noted reduced risk (74 percent), improved access to international financing (48 percent), improved brand value and reputation (39 percent), and improved community relations (26 percent) among the most significant benefits.

INTRODUCTION

The Link Between Sustainability and Finance

Sustainability in the private sector is increasingly understood as the creation of not just financial and economic value but also long-term environmental and social value for a wide range of stakeholders – including shareholders, employees, customers, suppliers, communities, and public-sector partners – with particular consideration for the needs of future generations.

The global importance of sustainability is reflected in changing consumer expectations and emerging national and international legislation. Companies' chances of operating successfully and engaging in international trade depend more and more on their ability to mitigate social and environmental risks and to capitalize on opportunities for innovation. Sustainability has become an essential element of competitive advantage and something businesses can no longer ignore.

Recognizing this trend, many companies are looking to integrate sustainability into their businesses. For many, the first challenge is knowing where and how to start. The next is getting the necessary inflows of capital to begin transforming their operations.

Financial institutions, as the providers of finance for businesses of all shapes and sizes, have a pivotal role to play in promoting sustainability across industries, sectors, and communities. Sustainability also offers vast potential for financial institutions to improve their own products and services.

For financial institutions, sustainability has two components. One component is **managing social and environmental risks** in strategic decision-making and lending. Financial institutions can strengthen their portfolio by systematically evaluating these risks in the loan or investment appraisal process. In this way, they can focus investments on those companies and projects with high environmental, social, and financial performance. Doing so can help protect their asset portfolio by decreasing nonperforming loans, thereby increasing financial stability and protecting the bank's reputation.

The other component is **identifying opportunities for innovative product development** in new areas related to sustainability. This entails creating financial products and services that support commercial development of products or activities with social and environmental benefits. A growing cluster of these opportunities has evolved and includes renewable energy, energy efficiency, cleaner production processes and technologies, biodiversity conservation, microfinance, financial services targeted to women, and low-income housing. Business models that address these dimensions are yielding new clients and markets. They are also helping financial institutions differentiate themselves from competitors, improve their reputation among key customers and stakeholders, attract new capital, and generate goodwill and support from stakeholders.

A Changing Landscape for Banking

In its broadest definition, the **banking sector** includes commercial and investment banks, leasing companies, microfinance institutions, and other related institutions. All these forms of financial institutions are united by the fact that they intermediate financial flows by borrowing funds from individual depositors or a wide range of organizations and channel these financial resources to individual and corporate borrowers, mainly in the form of business and commercial lending.

Compared to institutions that *invest* in the equity of companies (private or listed equity institutions), institutions that *lend* usually offer financial services to their customers on a shorter-term basis and charge fees for providing their financial resources. For deposit-taking financial institutions, minimizing risk and finding new ways to attract customers are major business goals that guide the entire flow of their operations.

Commercial banks are the most important financial intermediaries in the economy in most countries, as they link savings and investments. In recent years, commercial banks have converged with the functions of other financial service providers, such as investment banks, leasing companies (see case, ACBA Leasing), and microfinance institutions (see case, ACLEDA bank), and have broadened their lines of business to become more competitive. Commercial banks now engage in money market operations, project finance, insurance business, leasing operations, mortgage finance (see case, Bank of Georgia), securities trading, and financial advisory work.

>> *Banks are moving from defensive banking—where management of social and environmental impacts is seen as an additional cost—to sustainable banking—where sustainable development is seen as an advantage and an opportunity for growth.* <<

DEFINING SUSTAINABILITY

Sustainability is about ensuring long-term business success while contributing toward economic and social development, a healthy environment, and a stable society. IFC's definition of sustainability, used in this report as applied to financial institutions, encompasses four dimensions of good business performance.[a]

- The financial sustainability of the financial institution and its client-companies, so that they can continue to make a long-term contribution to development
- The economic sustainability of the projects and companies the financial institution finances, through their contribution to host economies
- Environmental sustainability through the preservation of natural resources
- Social sustainability through improved living standards, poverty reduction, concern for the welfare of communities, and respect for key human rights.

These considerations, taken together, aim to capture a fuller range of factors that influence the decisions, activities, products, and services of financial institutions, including the social and environmental impacts of their work.

a. IFC. (2005, p. 19).

Through the portfolios of their customers, banks are exposed to a more diverse set of social and environmental issues than the average business and, to a certain extent, than other financial institutions. Accordingly, banks and other financial institutions are shifting their focus and reorienting their activities. They are increasingly moving from avoiding risks to creating opportunities: from *defensive* banking—where environmental management is seen as an additional cost—to *sustainable banking*—where sustainable development is seen as an advantage and an opportunity for growth.[1]

Such a shift requires a fundamental change in perspective: a focus on creating long-term value. The new approach stands in contrast to earlier and narrower management systems that deal with social and environmental risk. For instance, systems such as ISO 14001 focus on process *conformance*[2], where the main target is compliance with necessary regulations imposed by relevant authorities. By contrast, a comprehensive approach to sustainability focuses on process *performance*, where the focus is on creating value in the process of achieving the financial institution's business goals.

Capitalizing on Industry Trends

Banks in industrialized countries have recognized that sustainable banking can bring sizable business benefits. In emerging markets, the following **global trends and factors** are strengthening the case for sustainable banking as a means of differentiating banks in increasingly competitive markets:

- *The private sector is using innovation to play a role in addressing global concerns.* Significant environmental threats and growing demand for action on social issues are causing both the industrial and the financial sector to seek new ways of doing business. Notable examples include extreme pollution in China, the energy efficiency crisis in Central and Eastern Europe, and the HIV/AIDS epidemic in Sub-Saharan Africa. Supported by governments and international organizations, many companies are producing innovative products, services, and business models to respond to such challeges.

- *Market-based mechanisms are gaining more power to stimulate investments in sustainability.* Rising oil and gas prices are stimulating a move to new sources of energy. The Kyoto Protocol, which came into force in 2005, is creating commercial value from energy efficiency and renewable energy initiatives (see chapter 4). Consumer demand for more sustainable products and services, as well as tighter restrictions on imports by developed markets, such as the European Union (EU), are driving improvements in the

>> *Social and environmental considerations are becoming vital in ensuring competitiveness and differentiating banks in increasingly competitive markets.* <<

technologies and business models used by producers in the developing world.[3]

- *Concerned NGOs are turning more attention to banks.* Rather than simply criticize, NGOs are increasingly seeking to collaborate and advocate change in banks' social and environmental policies and practices. For example, over 100 advocacy groups signed the Colleveccio Declaration at the World Economic Forum in 2003, calling upon financial institutions to implement more socially and environmentally responsible lending policies. [4]

- *Leading international financial institutions are setting higher standards.* IFC was one of the first multilateral finance institutions to commit to high standards for managing social and environmental risk in its private sector investments. IFC's standards, updated in 2006, have in turn been used as the basis for the Equator Principles, a voluntary set of principles adopted by ten international banks in 2003 and now applied by 43 financial institutions, covering 80% of global project finance (see http://www.ifc.org/sustainability). In April 2006, leading institutional investors from 16 countries, and representing more than $2 trillion in assets, signed up to the Principles for Responsible Investment, an initiative of the United Nations Environment Programme Finance Initiative (UNEP FI) and the UN Global Compact (see http://www.unpri.org).

In addition, a variety of **industry trends and factors** are leading to greater integration of the world's financial markets and intensifying the move toward sustainable banking.

- *Consolidation.* A number of cross-border mergers and acquisitions have taken place as a way to respond to financial crises.[5]

- *Liberalization of banking sectors and heightened competition in traditional markets has increased pressure on major international banks* to find new areas for growth. The result has been a rapid increase in external capital flows and acquisition of emerging market banks by large international banks.[6]

- *Rapid credit growth and higher risk exposure.* Since 2002, credit has grown by about 50 percent in many countries in Europe and Central Asia, as well as in several countries in Africa.[7] Such rapid growth may cause deterioration in credit quality. It signals a need for tighter risk management in general and more diligent credit risk assessment and stronger supervision in particular.

- *Technology transfers and innovations* in banking products and processes. Such improvements often accompany the entry of foreign banks and result in more competitive pricing and a more efficient allocation of credit in the financial sector as a whole.[8]

As global players increase their presence in the banking sector in emerging markets, the sector will become more complex and competitive and thus more vulnerable to financial as well as nonfinancial risks. As competitive pressure from large foreign banks intensifies, banks in emerging markets are reassessing business practices, including local lending and risk assessment practices.[9]

Finally, **the scope of responsibility for financial institutions in emerging markets is widening**: from environmental to social inclusion. Alleviating poverty and protecting human rights remain top priorities in emerging markets. As a result, local financial institutions are being called upon to help address a variety of social concerns through their core services, such as labor practices, protection of indigenous populations, and preservation of cultural heritage.

The Dynamic Business Case for Sustainable Banking in Emerging Markets

To achieve the greatest long-term benefit, individual banks must devise their own unique approach and business case for sustainability. This is determined by how they want to align their business goals with trends in the markets and sectors in which they operate. The case studies in this report illustrate how different financial organizations have pursued specific goals in different markets. The last part of this introduction summarizes major lessons learned by banks that have undertaken initiatives in sustainable banking.

As the evidence in this report shows, the business case for financial institutions is a dynamic process of continuous change. One step flows into the next and further strengthens the case for sustainability (see figure).

DEVELOPING AN APPROACH

Banks can start devising their own business case by identifying the risks as well as the opportunities offered by their markets and lines of business, and assessing how these can support growth for their clients as well as themselves.

Examples of new markets and areas of business include energy efficiency and renewable energy, cleaner production finance, biodiversity conservation, developing sustainable supply chains, and providing financial resources to underserved groups (see chapters 3 and 4).

INTEGRATING ENVIRONMENTAL AND SOCIAL MANAGEMENT SYSTEMS

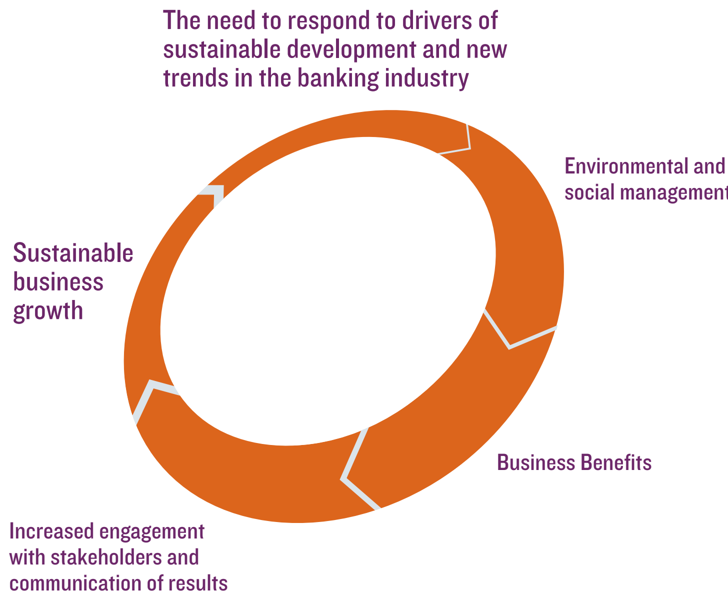
The next step is to implement changes to more systematically minimize risks and capture opportunities. This may mean adopting a series of organizational innovations, including formal social and environmental management systems and improvements in corporate governance. Resources will need to be allocated to support these innovations and train and hire staff as required.

Good corporate governance, both for financial institutions and companies in which they invest, is a requisite for sustainability (see chapters 2 and 4). Innovations in this area will include a greater emphasis on openness, transparency, and accountability, and engagement with a wider range of stakeholders.

MEASURING THE BENEFITS

The best approaches to sustainability are ones that meet the needs of stakeholders while strengthening a business' own operations and bottom line. Recognizing and measuring the benefits of sustainability as a competitiveness strategy is an important part of ensuring long-term buy-in from shareholders and stakeholders alike.

THE DYNAMIC BUSINESS CASE FOR SUSTAINABLE BANKING IN EMERGING MARKETS



There is growing evidence that innovative approaches to sustainability can bring substantial benefits to a bank's overall business performance. Examples include

- Greater and higher long-term returns by financing more sustainable projects and businesses
- Reduced risk
- New business development through new products and services
- Increased market share in sustainability-driven sectors
- Enhanced reputation and better brand value
- Better access to capital from international financial organizations
- Increased value to shareholders

STIMULATING WIDER CHANGE

Encouraged by the success of pioneers, the uptake of sustainability by a much wider range of banks is strengthening and reinforcing the business case. This is particularly true for risk management. In recent years, voluntary industry frameworks such as the Equator Principles have helped build an international consensus around the need for and benefits of social and environmental standards. Adherence to such standards is gradually becoming standard banking practice. To maximize the competitive advantage of sustainability, banks are now turning to the new frontier of innovation in products and services.

>> *The results of the IFC 2005 survey indicate that the business case for sustainable banking is strong.* <<

Evidence of the Business Case

Are banks in emerging markets actually strengthening their ability and undertaking more initiatives to manage risk and pursue opportunities through sustainability? The 2005 IFC Sustainability Survey of Financial Institutions found the following trends among 120 financial institutions in 43 emerging markets:

- *Banks in emerging markets have increased their awareness about the risks and potential benefits associated with social and environmental issues.*

  Virtually all the commercial banks that responded (98 percent) reported they consider social and environmental issues, either by managing risks, developing business opportunities, or both. 58 percent said their banks consider social and environmental opportunities.

- *The business case for sustainable banking is strong.*

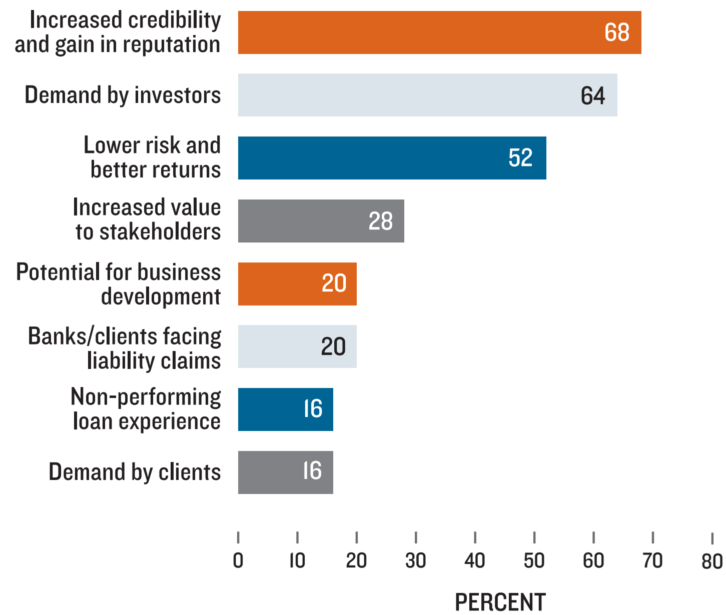
  86 percent of respondents reported positive changes as a result of steps to integrate social and environmental issues in their business. 19 percent perceived these changes as significant. None of the respondents reported a negative change from considering social and environmental issues.

- *The integration of sustainability into management systems and practices brings tangible benefits, including new lines of business, new clients, greater access to financing, greater shareholder value, and improved reputation and goodwill.*

  74 percent of the commercial banks in the survey reported a reduction in risk as a result of considering social and environmental issues. 48 percent noted improved access to international capital, 39 percent benefited from improved brand value and reputation, 35 percent developed new business, and 26 percent benefited from improved community relations.[10]

- *Reputation and branding is the top reason that banks in emerging markets integrate social and environmental considerations into their management practices.*

KEY REASONS WHY BANKS CONSIDER SUSTAINABILITY ISSUES (percent of respondents)



Source: IFC Sustainability Survey of Financial Institutions (2005).

  Compliance with government regulations, although important, is no longer the top driver.

  68 percent identified the need to increase their credibility and reputation as the main reason to consider social and environmental issues. 64 percent identified investor demand as a critical factor.

- *Banks increasingly see the potential for lending in areas such as sustainable energy, cleaner production, biodiversity conservation, and good corporate governance.*

  A number of respondents saw opportunities to strengthen their portfolios by providing loans for environmental projects (74 percent), getting access to new markets (59 percent), developing new business in sustainability-driven sectors (52 percent), and providing loans/advisory services for eco-efficiency and cleaner production (44 percent).

- *There is a demand for guidance and support.*

  86 percent of the banks surveyed expressed the need for further assistance. This included sustainability learning (73 percent), information (70 percent), and technical assistance and advisory services (68 percent).

LESSONS LEARNED

>> *Strong outcomes are most likely when banks and their client companies can incorporate sustainability measures and practices into their own management systems.* <<

The case studies in this report show examples of commercial banks, a leasing company, and a microfinance institution that have taken concrete steps to integrate sustainability into their policies, practices, products, and services. The following are **10 lessons for effective integration** drawn from their experiences:

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1 *Design a social and environmental management system (SEMS) that goes beyond written policies into action,* such as allocating human and financial resources for implementation, and training employees. The policy is a necessary but not sufficient step for implementing a strong management system. Other elements should reflect institutional structures and operations.

2 *Bring on board and support dedicated managers and/or social and environmental departments*, staffed by experts with appropriate academic background and experience, and responsible for implementing social and environmental controls.

3 *Adopt an organization-wide approach to capacity building*, and reinforce it with training and the support of senior management.

4 *Systematically integrate social and environmental procedures for risk management* into overall risk management systems for all projects. Sustainability risks vary by project size and industry, but are potentially present in any project.

5 *Transform the assessment of sustainability risks into the creation of business benefits*. Work with clients to improve their social and environmental performance rather than simply rejecting potentially risky investments.

6 *Make social and environmental considerations part of overall market assessment and project appraisal*. In choosing their approach, banks should define priority areas and focus on them. Avenues for engagement can include
- market research into sustainability-driven sectors
- partnerships with communities, NGOs, and related organizations
- identifying demand among existing customers for products with social and environmental components, such as affinity credit cards and "green" or social trusts

7 *Cooperate with international financial organizations*, tapping both financial resources and technical assistance.

8 *Join voluntary industry frameworks*, such as the Equator Principles, to benefit from shared knowledge and expertise.

9 *Communicate improvements to stakeholders* in a clear and transparent manner. Improved reputation and relationships with stakeholders is one of the immediate benefits of adopting sustainability as a business approach. Getting the message out can be done through a variety of channels, such as sustainability reports, Web sites, and the media.

10 *Undertake continual improvements* to ensure that the institution's commitment to sustainability goes beyond compliance with legal requirements and remains effective as a tool for gaining competitive advantage.

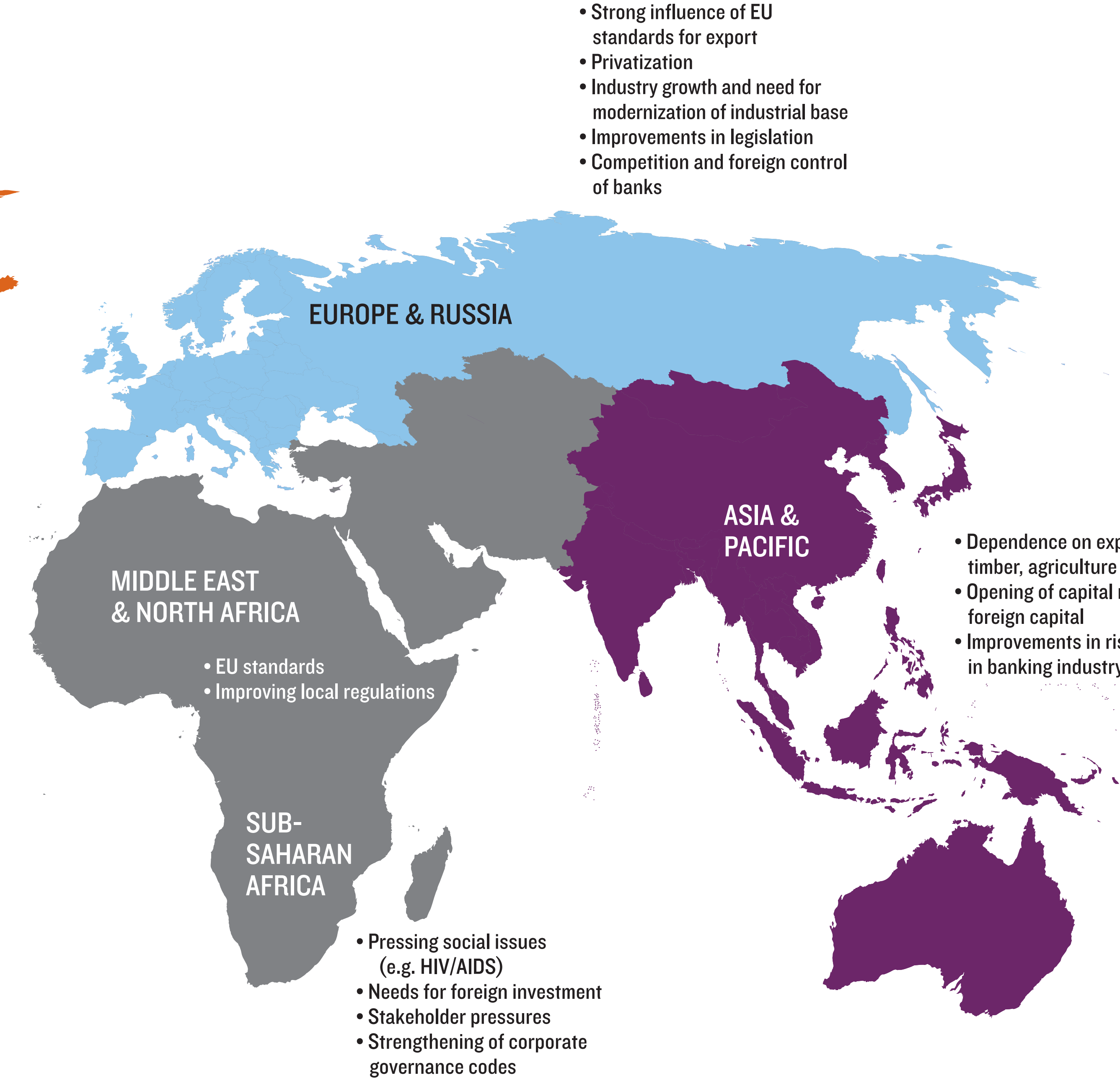
REGIONAL TRENDS AND FACTORS DRIVING SUSTAINABLE BANKING

Along with international trends and factors, region-specific and country-specific drivers for sustainable banking come into play in particular emerging markets. Prevailing social and environmental problems, countries' macroeconomic development, and the availability of natural resources may be factors, as well as cultural and religious perceptions (see map 1.1). Local communities that live around large projects financed by banks have their own priorities, and are emerging as new regulators as well.

The discussion that follows considers sustainability drivers for the banking sector in five emerging market regions: Asia and the Pacific, Central and Eastern Europe and the Former Soviet Union, Latin America, the Middle East and North Africa, and Sub-Saharan Africa. It also presents two cases to illustrate regional trends: Ceská Sporitelna, which built a new line of business in response to regulatory changes in the Czech Republic; and Afriland First Bank, based in Cameroon, which supports African socio-cultural and economic values through its business ventures.

>> *In general in emerging markets, risks are greater, but so are opportunities.* <<

>> The scope of responsibility for financial institutions in emerging markets is widening: from environmental protection to consideration of social issues and social inclusion of underprivileged groups by providing access to finance. <<



The banking sector in emerging markets is becoming more complex—and thus more vulnerable to financial and nonfinancial risks, as well as increased competition. This serves as a strong incentive to banks to adopt international practices and standards in social and environmental sustainability.

Asia and the Pacific

In the aftermath of the Asian financial crisis of the late 1990s, economic restructuring and market reforms have been at the forefront of the Asian banking sector. Before the crisis, sustainability was not on the radar of Asian banks, since performance was driven by rapid economic growth and market liberalization, propelled by massive capital inflows.[1]

Government intervention has helped rebuild confidence in the market through the establishment of a risk-based approach to lending and investment and credit risk analysis. Governments in the regions have the opportunity to encourage and even provide incentives for banks to incorporate systematic procedures for assessing social and environmental risks. Many Asian countries have also updated their environmental legislation in the past decade. Weak regulatory implementation and an absence of strict enforcement severely impede improved environmental performance.[2] There is a limited litigation culture in many countries in Asia,[3] varying from fairly uncommon in Thailand to an absence of a functioning judicial system in Cambodia. As a result, many Asian banks perceive environmental legislative risks to be low.[4]

Thus for the next decade, sustainable banking in Asia is likely to be driven mainly by market mechanisms, such as privatization and consolidation, and the importance of Asian exports in global supply chains, including textiles and fishery, forestry, and agriculture products, as well as electronics, appliances, automobiles, and consumer goods.

As market barriers that have historically inhibited foreign banks from operating in many Asian countries have fallen, competition has intensified. Foreign banks are taking equity stakes in domestic banks and are competing with domestic banks for market share. The infusion of corporate sustainability policies and procedures by foreign banks into their Asian subsidiaries may encourage leading domestic banks to adopt sustainable lending practices.

With the accession of a number of Asian countries into the World Trade Organization (WTO) and other nations about to get their membership, Asian countries must consider the implications of domestic environmental policies and labor standards on trade. As Asia's dependence on exports continues, the region's exporters will be forced to invest in technology upgrades to meet growing requirements from foreign buyers. This will present Asian banks with an opportunity to develop sustainability products such as green credit lines and cleaner production loans to enable the region's exporting companies to meet these demands (see chapter 4). South Asia has many opportunities in the renewable energy segment, especially solar energy. This sector is strongly supported by the government, and banks have developed significant experience in developing models of financing (see chapter 4).

Central and Eastern Europe and the Former Soviet Union

The collapse of communism and decline of planned economic systems in Central and Eastern Europe and the Former Soviet Union in the 1990s led to massive privatization, corporate growth, and increased global capital flows into the region. These efforts have been undermined by economic instability and disruptions, such as the Russian financial default in 1998. The region's outdated industrial base has generated severe energy efficiency problems and numerous social and environmental hazards. Lack of funding as well as problems with defining property rights for many industrial and municipal projects make it difficult to tackle air and water pollution, or repair or replace deteriorating infrastructure, such as sewage systems and street lighting.

Many Eastern European countries have strong social and environmental legislation. However, the laws are only weakly enforced because of problems with corporate governance and corruption. The influence of civil society groups and NGOs is still rather weak in the transitional economies. On the positive side, governments are taking steps to enforce regulatory mechanisms to mitigate social and environmental impacts.

© Texterno | *Texterno, in Ternopol, Ukraine, produces premium quality textiles, utilizing some of the newest production technologies in the world. The plant is very energy-efficient and places a premium on worker safety. It was financed by Bank Aval (Raiffeisen) and exports have proven very successful in the international market (see story, p. 57).*

For example, the new Energy Security Policy, adopted in 2005 by Ukraine emphasizes attention to energy efficiency and alternative sources of energy. The launch of a National Agency for Energy Conservation is also expected.

Sustainability considerations for banks in the region are largely affected by the proximity to the European Union (EU). This proximity strongly influences manufacturing and trade in such sectors as textiles and other light industrial manufacturing, food, forestry, and agriculture In addition, penetration by major EU banks into the banking sector in the region is extremely high [see story, Bank Aval (Raiffeisen), p. 57].

Maturing capital markets in Western Europe have squeezed margins in the corporate banking sector. After facing declining revenues in corporate banking, and an unsatisfactory attempt to penetrate the domestic retail segment, Western European banks were forced to move east, where they are mostly interested in the investment banking segment. For example, in Romania the almost simultaneous privatization of two major banks in 2006, Banca Commerciala Romana (see story, p. 76) and Casa de Economii si Consemnatiuni, put as much as 90 percent of banking assets under the control of foreign banks—one of the highest percentages in Europe.

The expansion of the European market opens up export opportunities for companies in both EU-accession and non-EU countries. As European export regulations and market-based mechanisms, such as labeling and certification, have a strong social and environmental component, they generate high demand for cleaner production and energy efficiency finance, especially for countries that have already joined or are striving to join the Union in the near future (see stories, UralTrans-Bank, p. 66; Bank "Center-invest," p. 46; ACBA Leasing, p. 62; Česká Spořitelna, p. 18).

Latin America

Among today's emerging markets, Latin America has significant ecological, economic, and social advantages, exemplified by its enormously rich natural resources and biodiversity, as well as its cultural diversity and innovative approaches to multilateral integration in subregions such as Central America.[5] As Latin American countries seek to position themselves more advantageously in international arenas, the need for major investments in services, technologies, and environmental management systems has been growing.

The banking sector in Latin America has been exposed to global financial sector trends for perhaps the longest period of time of any other emerging market. Many Latin American countries experienced exchange rate and banking crises as well as severe fluctuations in their macroeconomies in the 1990s.[6] Latin American countries have privatized many of their banks and have encouraged foreign banks to enter their domestic markets (see story, Banco Cuscatlán, p. 38).

continued on page 20...

ČESKÁ SPOŘITELNA, A.S. (member of the Erste Group)

Leading the Way in Financing Sustainable Energy Projects

At A Glance

Česká Spořitelna is a major bank in the Czech retail and municipal market. Geared toward small-scale clients, SMEs, towns, and municipalities, it also plays a key role in the financing of large companies and corporations and ranks among the leading securities dealers in the Czech capital market. Česká Spořitelna Financial Group, with almost 5.4 million clients, is the largest bank in the Czech Republic, as measured by number of clients. In 2000, Česká Spořitelna became a member of Erste Bank, a powerful Central European financial group with more than 15 million clients. Within the following 18 months, Česká Spořitelna had successfully completed its transformation, aimed at improving all key areas of the bank. It continues in the improvement of its products and services and the modernization of technology, while making work processes more effective. | **www.csas.cz**

Recent legislative changes in the Czech Republic introduced long-term tariffs favorable for the generation of renewable energy electricity, making the renewable energy sector more attractive for project development and related financing. Česká Spořitelna began exploring these opportunities and financing such projects, in cooperation with IFC and other investors.

Launching Innovative Financial Products

The bank has developed an investment loan especially designed for SMEs to finance energy-saving investments and investments in renewable energy sources, the Financing Energy Saving Applications product (FINESA). This was made possible by an IFC guarantee for up to half of the loan, accompanied by an extensive technical assistance program. The guarantee significantly facilitates the availability of capital for the bank's clients and reduces administrative costs pertaining to the estimation and possible acquisition of other hedging instruments.

Financing Renewable Energy

MICRO-HYDRO. IFC issued a partial credit guarantee and provided technical assistance to Česká Spořitelna in 2005 to support construction of a small hydropower plant in Eastern Bohemia. This was done through IFC's Commercializing Energy Efficiency Finance (CEEF) program, which supports financing for sustainable energy projects in emerging and transition economies. With a maximum power output of 380 kW, the plant is expected to reduce greenhouse gas emissions by 1,559 tons annually. The plant became operational in May 2006.

WIND POWER. In 2005 Česká Spořitelna invested in the first fully commercially financed wind power project in the Czech Republic, a 2-MW wind power plant in North Bohemia. Favorable local wind conditions combined with a supportive regulatory framework for renewable energy projects pave the way for the economic viability of wind power generation that relies solely on commercial financing, without any direct

>> *Sustainable energy finance has increased our bank's visibility and market differentiation in a highly competitive domestic market.* <<

Ladislav Dvorák, Head, Special Products for SMEs, Česká Spořitelna

subsidies. The plant is now operational. With expected annual electricity production of approximately 5,000 MWh, it is estimated to reduce greenhouse gas emissions by 5,600 tons annually. Operational results to date have exceeded original expectations. The sponsor is now planning to install another two 2-MW turbines at the same location.

Bottom Line Impact

Today Česká Spořitelna is leading the way for commercial financing for energy efficiency and renewable project finance for SMEs in the Czech Republic. Just 18 months after the program started, by March 2005, these projects had generated $8 million in loans. The project pipeline is now over $50 million.

By building good relationships with international financial organizations such as IFC on sustainable energy initiatives, the bank has benefited from capacity building, technical assistance, and risk-sharing tools, while strengthening its ability to provide technical assistance to its client companies. As first-mover and innovator, Česká Spořitelna is enjoying the benefits of increased visibility and market differentiation in a highly competitive local market.

© Olga Kordova, Česká Spořitelna | *Weir on the Upa River in Czech Republic, the future site of a small hydro power station. The project is being financed by Česká Spořitelna, a.s. (member of the Erste Group).*

>> *The business case for sustainable banking is strongest when a bank can focus on a business line where it can take advantage of scale, become a first mover, or find a niche market.* <<

... Latin America continued

International as well as regional development banks have been active in advancing the agenda of sustainable banking. The 1992 Rio Summit brought a number of new stakeholders into the discussion on sustainable development in the region. The development of the local microfinance industry, the intense activity of civil society organizations in the promotion of corporate social responsibility and environmental standards, and the new set of practices being introduced by global institutions are opening new fronts. NGO focus on the financial industry is a very recent movement. Pioneers were Ecuador's Fundación Futuro Latinoamericano (FFLA) and Friends of the Earth Brazilian Amazon, through its EcoFinance Project.[7] All these drivers explain why Latin America has some of the most progressive banks in emerging markets. Some joined such global initiatives as UNEP FI Statement and Equator Principles at the early stage (see stories, Unibanco, p. 52; Banco Itaú-BBA, p. 34).

Sustainability-oriented efforts at Brazilian banks began with social reporting in the early 1990s, when Banespa (Banco do Estado de Sao Paulo) published Brazil's first financial sector social report. In 1993, the Brazilian Banking Federation issued the first social report for the financial industry. As of 2004, five of the largest banks in Brazil have made nonfinancial information publicly available, either in the form of a separate social report or in their annual reports. The world-renowned leader in sustainability banking, Banco Real, began formally incorporating assessments of social and environmental aspects of transactions into its overall funding approval process in 2001.[8] In 2000, Banco BBA Creditanstalt (today Banco Itaú-BBA) became the first bank to establish a set of formal procedures to manage social and environmental risks, and to require the explicit consideration of environmental issues in project financings. In 2002, Unibanco launched its own social and environmental risk management system.

Latin America has been an active player in carbon finance since the mid-1990s. It played a major role in the forerunner to the Clean Development Mechanism (CDM). When the CDM became operational in 2003, six of the nine first project methodologies approved by the Executive Board were from Latin America.[9] Brazil and Peru are leaders in carbon finance, while Chile, Honduras, Mexico, and Nicaragua have a growing project pipeline. Project finance is concentrated in the areas of renewable energy, gas capture, and large hydro projects; other sizable areas are forestry, energy efficiency, and fuel switching.

The Middle East and North Africa

Among the most pressing environmental issues in the Middle East and North Africa are water availability and quality, as well as desertification. Water scarcity and land degradation reduce the quality of both farmland and agricultural products. Maintaining quality is increasingly important because exports of agricultural products to the European Union are a major source of income. Exporters in the region are under pressure to comply with the EU's environmental, health, and safety requirements. The free trade agreement between Morocco and the United States also incorporates environmental standards.

Air pollution, carbon emissions, energy consumption, and preservation of coastal areas are serious environmental problems. Given the importance of the tourism industry, preservation of the coastal areas is directly linked to the region's economic development. A number of pressing social issues, including youth unemployment and gender inequality, are undermining the region's potential for economic and financial inclusion of a wider population.

Environmental, health and safety, and labor regulations in the Mediterranean region are being strengthened through a host of donor programs, such as the EU's Neighborhood Policy, designed to improve management of these issues and gradually harmonize the regulatory framework with that of the European Union. The Mediterranean Environmental Technical Assistance Program—an innovative partnership between countries of the Mediterranean region and multilateral donors to enhance capacity to develop and enact sound policies for the environment—has been working effectively since 1990.[10]

IFC and the World Bank are completing joint pilot programs in sustainable finance in Egypt, Morocco, and Tunisia. The programs aim to identify the drivers for sustainable finance in these countries and develop the capacity of central banks and local banking institutions for sustainable finance. In response, banking associations in all three countries, with the support of their central banks, have sponsored capacity-building workshops and issued publications on managing environmental risk.

Although the region does not have an extensive history of environmental law, regulatory policy has gained momentum over the past few years. National governments have also recognized the need to upgrade many of their production systems. Tunisia has emerged as the regional leader in creating a regulatory environment for sustainable development and has created the Ministry for the Environment and Land Use Planning to address the issues. For example, while Tunisia is the world's fourth largest producer of olive oil, it has no nationally branded product. The Tunisian government has identified significant opportunity to upgrade the entire production system and establish a branded product. Egypt has enacted a National Energy Efficiency Strategy, which focuses on three goals: accelerating the use of natural gas instead of oil; developing national energy efficiency codes and standards; and promoting private investment in energy efficiency activities.[11] Parallel programs are endeavoring to strengthen enforcement. As regulatory enforcement improves in the region, environmental and related liabilities will become significant risks to lenders.

The banking sector is becoming increasingly aware of environmental and social risks and opportunities in the region and is taking steps to manage them. For example, CIB (International Commercial Bank), which operates in Egypt, Qatar, and Saudi Arabia, has recently joined the Global Banking Alliance for Women (GBA), a worldwide group of banks that are sharing best practices to accelerate the global growth and development of women's businesses and women's wealth creation.[12]

Sub-Saharan Africa

The African approach to sustainability is distinguished by the importance placed on social issues, such as HIV/AIDS, inclusion and empowerment of disadvantaged groups, and protection of local societies (see story, Afriland First Bank, p. 22).[13] Notably, post-apartheid South Africa is responding to the long-standing economic marginalization of black South Africans by transforming its economy through a concept known as Black Economic Empowerment (BEE) (see story, First Rand Bank, p. 72). The Financial Sector Charter is a unique industry-led framework that establishes the principles upon which BEE will be implemented in the sector, establishes targets to implement the principles, and outlines mechanisms to monitor and report on progress.[14] Overall, the agenda of the African banking sector broadened considerably following the World Summit on Sustainable Development (WSSD) in Johannesburg in 2002.

© Courtesy of Nedbank | *The Mayebuye Wetlands project, sponsored by the Nedbank Green Trust (see story, p. 29). Students from a local environmental education club help the project coordinators clean up a portion of the Klip River, which flows through Soweto, Johannesburg.*

Africa is facing a severe shortage of energy resources, having to rely mostly on traditional sources, such as wood fuel. The shortage is largely due to uneven distribution of energy resources that calls for integration of energy development throughout the continent.[15]

African social and environmental regulations have been steadily improving over the past decade. For example, under South Africa's National Environmental Management Act (NEMA), financial institutions can be found liable for environmental pollution and risks of a social nature. Corporate governance standards have also expanded significantly in Sub-Saharan Africa. A good example is the standards developed by the Institute of Directors in Southern Africa and its King Committee on Corporate Governance.[16] Increasing stakeholder pressure is gaining momentum, such as NGO attention to the Chad-Cameroon pipeline.

These improvements are vital for Africa, as it faces strong competition for international investments from other emerging markets. International private banks are active in Africa and have been introducing social and environmental standards into the region's lending practices. In 2005, Nedbank became the first bank in Africa to adopt the Equator Principles (see story, p. 29).

AFRILAND FIRST BANK

Supporting African Socio-cultural Values by Investing in Sustainable Development

At A Glance

Afriland First Bank (First Bank) was created in 1987. Its philosophy is inspired by the need to promote African socio-cultural and economic values as well as provide expertise and support for the integration of the African culture into modern management practices and sustainable development. The Bank's portfolio consists of individuals and corporate and private institutions, with special emphasis on individuals and small businesses. Afriland First Bank operates through a network of 13 branches in Cameroon as well as affiliates in the Democratic Republic of Congo, Equatorial Guinea, and São Tomé and Principe; and offices in Congo Brazaville, China, and France. Along with providing traditional banking services, it also has a leasing division, ALC (Africa Leasing Company); and operates venture capital funds, Central Africa Investment (CENAINVEST) and MicroTrust Fund (MITFUND), for micro and small enterprises. As of December 31, 2005, Afriland First Bank had 310 employees, of which 67.5 percent were men and 32.6 percent were women. Total assets rose 23 percent from 2004 to 2005, from FCFA 181.1 billion ($362.2 million) to FCFA 223.6 billion ($447.3 million). | **www.afrilandfirstbank.com**

Afriland First Bank's Sustainability Vision and Policy is to become the leading financial institution in Central Africa, with a focus on the medium- and long-term quality of its investment portfolio and with value added that comes from greater social and environmental awareness and management.

In 2000, Afriland First Bank developed an environmental policy framework, which it updates regularly. Within the Department of Research and Corporate Banking, the bank created an Environmental Division which develops, updates, and oversees the environmental policies. The bank also carries out social due diligence that is focused on the internal governance structure of client companies, including workers' organization, their working conditions, and their social amenities such as health security, to avoid social, economic, and political tensions and to enhance workers' performance.

Afriland First Bank participates actively in national sustainable development activities, such as promoting renewable energy, waste treatment, and access to finance for the poor. For example, the bank has provided a loan to Afrigaz, a company that distributes cooking gas. With its innovative approach of providing gas refill services on-site through a network of mini-stations, Afrigaz enjoys market advantages as compared to its competitors, which must transport gas cylinders as far as 200 to 500 km to be refilled. However, the mini-stations were not constructed according to environmental norms and were perceived as dangerous by the surrounding neighborhoods. To reduce the risks and increase users' perception of safety, Afriland First's loan to Afrigaz included the cost of constructing a firewall around its mini-stations and putting appropriate security measures in place (13 percent of the total cost).

In 2006, the bank plans to finance a garbage collection company, making sure the loan is used to collect and treat garbage in a way that reduces its impact on the environment. Due diligence was carried out on-site to verify social as well as technical parameters, including the distance of the dump site to inhabited areas, the buffer perimeter, and treatment of special waste, such as waste from hospitals.

Rural development activities are fundamental to sustainability in Africa but are often neglected because of major hurdles to making them financially self-sustaining. Afriland First Bank promotes rural development through its network of rural microbanks, the MC², which provides financing to rural communities, and MUFFA, which specializes in providing financing to women in urban and suburban areas. The Department of Microbank of First Bank and a local NGO, ADAF (Appropriate Development for Africa Foundation), help ensure the success of MC² and MUFFA by providing training, refinancing support, supervision, and control through the microbanks to the local communities.

Afriland First Bank is increasingly seen by its clients as a bank that supports sustainable development. As such, bank representatives are often invited to public forums, conferences, workshops, and seminars on sustainable development. First Bank has been invited to participate in the creation of the Cameroon Renewable Energy Fund (CREF), along with SNI (National Investment Company) and E+Co (Energy House). This renewable energy fund will promote investment in smaller hydro-electricity and biomass transformation into electricity, and also encourage the setting up of rural energy enterprises in Cameroon. Within the bank, loan analysts are becoming aware of the importance of environmental risk in loan evaluation and are transferring this awareness to portfolio managers. Afriland First Bank has also gained respect from its partners, such as the Netherlands Development Finance Company (FMO), by abiding by the principles of sustainable development.

>> *Afriland First Bank respects the social and environmental sustainability of all its projects. In line with our goal to be the African Bank of the Third Millennium, we are committed to promoting economic and social development through added value in our investments in Cameroon and Africa according to the mandate for the financial sector set out by the United Nations. Our depositors and shareholders want to see their money invested judiciously and without adverse impacts on either the environment or the social well-being of people.* <<

Dr. Simeon Numbem,

Chief of the Environmental Division,

Afriland First Bank

IMPLEMENTING SOCIALLY AND ENVIRONMENTALLY SUSTAINABLE MANAGEMENT PRACTICES

Only by effectively managing social and environmental opportunities alongside risks can banks create long-term value for their business. Considering risk alone will not be enough to generate new markets and profits. However, pursuing sustainability opportunities does not automatically mean that a bank will reduce its social and environmental risks.

To manage both risks and opportunities strategically and comprehensively, banks need to integrate a systematic approach—a social and environmental management system—into their processes and operations.

A Social and Environmental Management System

Industrial organizations use social and environmental management systems to assess and manage the direct impacts of their operations. Banks do not generate significant social and environmental impacts themselves. However, the way in which their clients manage the impacts of their business activities can pose risks to the bank's assets and reputation, as well as present opportunities for additional financing and growth. Therefore for financial institutions, including banks, **a social and environmental management system (SEMS)** is a systematic process to assess the environmental and social risks and opportunities arising from their clients' business activities, manage the bank's exposure to them, and improve operating efficiency and effectiveness.

The system ensures that sustainability considerations play a part in *all* of the organization's decisionmaking processes, including credit assessments and portfolio analysis. It enables the organization to consider environmental and socioeconomic issues comprehensively, and by so doing, move beyond simply complying with regulations to taking advantage of sustainability opportunities.

Such a management system is sometimes referred to as an **environmental management system**. However, financial institutions are increasingly broadening their systems to include community, social, and more wide-ranging socioeconomic considerations, as well as environmental ones. Accordingly, they are taking a more comprehensive approach to sustainability, and, in the process, generating greater long-term value for themselves, their clients, and society.

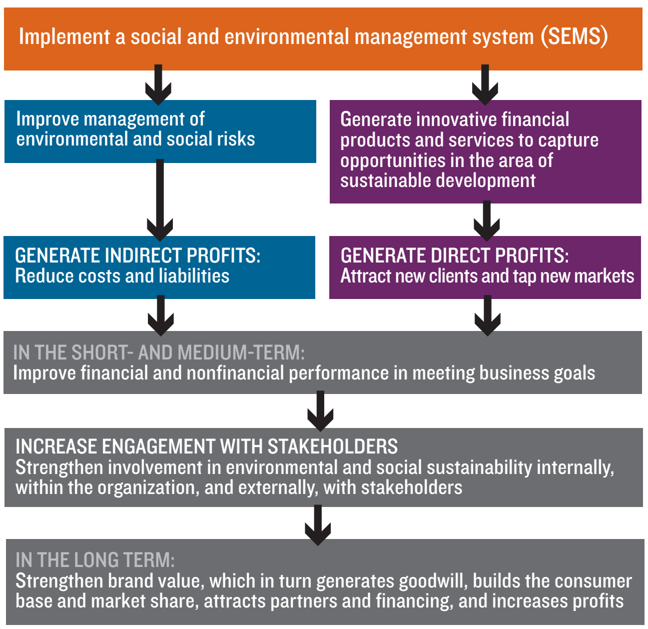
To be truly effective, an SEMS must become a part of a bank's overall management system. It extends to organizational structure, planning activities, responsibilities, practices, procedures, processes, and resources for developing, implementing, achieving, reviewing, and maintaining that system.[1] Such a system offers a more strategic approach, with defined objectives, formal policies, action plans, allocated resources, and trained and expert staff.

At the core of an SEMS is the ability of a financial institution to decide what services it will offer to which clients, what impacts of the client's business/projects are to be taken into account, and what terms of business, advice, and support it will offer.

Building and operating an effective SEMS entails several processes that must occur in parallel (see figure 2.1). A number of initiatives may be required to bring policies into action, such as capacity building in training, setting measurement and evaluation standards, implementing incentive schemes, and carrying out reporting initiatives that target both bank shareholders and a wider group of stakeholders. These processes must be tailored to fit banks' own business goals and organizational culture. The case studies at the end of this chapter and throughout this report illustrate how different banks have gone about putting a sustainability system in place, have directed it toward different goals and different markets/niches, and have carried it forward.

> *To be truly effective, a social and environmental management system must become a part of a bank's overall management system.*

FIGURE 2.1
STRATEGY FOR CREATING LONG-TERM VALUE THROUGH SUSTAINABLE BANKING



© Jouni Martti Eerikainen, IFC | *The Ingenio la Magdalena sugar mill in Ciudad Merliot, El Salvador, financed by Banco Cuscatlán (see story, p. 38). The project design helped the company cut air pollution and waste water.*

The Benefits of a Social and Environmental Management System

An effective social and environmental management system (SEMS) can expand the range of benefits for a financial institution (box 2.1). Social and environmental risk management generates *indirect profits* for a bank (see figure 2.1). That is, by reducing costs and risks, risk management improves the quality of the portfolio and lowers insurance liabilities and compensation claims. Actively pursuing opportunities by introducing and pursuing innovative financial solutions and products generates *direct profits* in new markets, with new clients.

Another major benefit is improved brand value. This is very important for banks, as their business depends on their clients' trust in them and their ability to provide products and services discretely and professionally. Good brand value opens new opportunities and helps attract capital and clients. To create and maintain their brand, banks need to build a reputation of strong and sustainable financial performance, sound corporate governance, and solid corporate responsibility (figure 2.1).

BENEFITS OF CONSIDERING SOCIAL AND ENVIRONMENTAL ISSUES OUTWEIGH COSTS, COMMERCIAL BANKS REPORT

Implementing social and environmental management system is not without costs. A number of banks believe the risks associated with the relatively experimental areas of sustainable

> *Engaging constructively with stakeholders and improving communication of results can generate long-term value for a financial institution.*

banking are high. But the findings of the 2005 IFC survey are revealing: banks that have put in place an SEMS and pursue new opportunities overwhelmingly reported that the benefits outweighed the costs.

86 percent of the commercial banks that responded to the survey reported positive changes as a result of the steps taken to integrate social and environmental issues in their business. 19 percent perceived these changes as significant. Not a single respondent reported a negative change from considering social and environmental issues.

These positive changes include reduced risk (74 percent), improved access to international financing (48 percent), improved brand value and reputation (39 percent), and improved community relations (26 percent). Significantly, 35 percent of banks developed new business as a result of considering social and environmental risk and opportunities. Seventeen percent of respondents reported cost savings as a benefit of considering social and environmental issues at their banks (see figure 2.2).

BOX 2.1
THE BENEFITS OF A SOCIAL AND ENVIRONMENTAL MANAGEMENT SYSTEM

- Systematic and consistent approach to social and environmental issues
- High impact on cost/benefit ratio
- Easy integration into existing organization and management systems, leading to improved risk control
- Better communications, resulting in improved public relations, greater stakeholder dialogue, and credible commitment toward staff and external stakeholders
- Improved access to international capital markets and funding from multilateral institutions and development banks

Source: Competitive Business Advantage Workshop. Developed for IFC by EcoFact (2004)

Improving Stakeholder Engagement

As part of the process of managing social and environmental sustainability, banks need to *increase engagement with stakeholders*, making themselves more open and more accountable to a wider range of interested parties. Banks need to engage stakeholders in their own organization: employees, staff, and the governing board. They also need to reach out beyond their own organization, to shareholders, investors, community groups, the government, NGOs, the media, industry associations, and others, as appropriate.

This process also entails *communicating results clearly, openly, and thoroughly.* This is very important for banks, as their business depends on their credibility, and on the trust that their clients and other stakeholders have in them. Clear, open, and transparent communication can help build trust. It can also build operational efficiency within the organization.

Within the bank, it is important to clearly communicate the goals, directions, policies, and processes entailed in the sustainability management process to *all* employees and make sure they understand them (see lessons learned reported by Banco Itáu-BBA, p. 34).

Outside the bank, it is important to engage the wider community that may be affected by or concerned with the projects and activities the bank backs. Banks must make sure that their initiatives to minimize adverse social and environmental impacts and increase investments in sustainable areas are visible to a wider public. This is a way for a bank to create sound reputational advantage. Communicating a bank's performance in sustainability initiatives and social and environmental management to external stakeholders is a key component in creating long-term value. Among other things, it can enhance the bank's reputation, build its brand, and improve its image in the community (see figure 2.1).

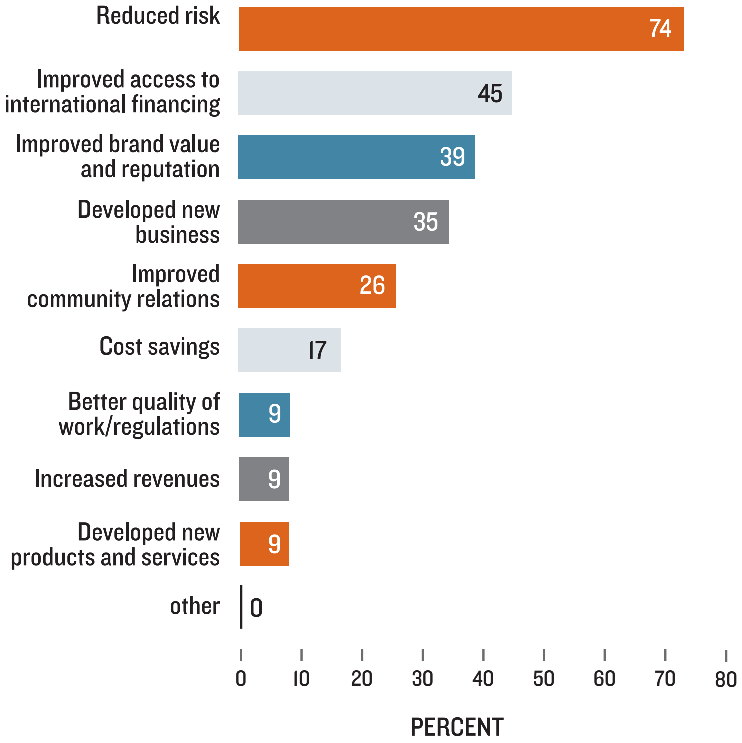
© Martin Dasek, IFC | *Workers building the base of a 2-MW wind turbine in Northern Bohemia, a project financed by Ceská Sporitelna, A.S. (member of the Erste Group)* *(see story, p. 18).*

Demonstrating financial gains from sustainable banking is also a way to enhance shareholder value. Moreover, good public reporting can improve a firm's access to capital and to international markets.

A major part of improving communication is engaging in clearer, more open, and more thorough ("transparent") public reporting on environmental, social, and economic performance. Leadership in reporting can help banks develop their brand and differentiate themselves in the marketplace. It can also generate positive relationships with external stakeholders.[2]

The most commonly used international sustainability reporting guideline across sectors is the Global Reporting Initiative (GRI). The GRI launched its third generation of reporting guidelines (G3) in October 2006, and is currently piloting a Financial Services Sector Supplement containing indicators for social and environmental performance. Today, GRI provides

FIGURE 2.2
BENEFITS OF CONSIDERING SOCIAL AND ENVIRONMENTAL ISSUES
(percent of commercial banks)



***Source:** IFC Sustainability Survey of Financial Institutions (2005).*
Note: The figure shows the percentage of commercial banks that responded to the survey that cited a certain type of benefit as a benefit to their bank.

the most widely used sustainability reporting framework for the banking sector.[3] In addition, several sets of social and environmental performance indicators have been developed as a result of collaboration among different groups of financial institutions (table 2.1).

TABLE 2.1
MAJOR INTERNATIONAL VOLUNTARY SUSTAINABILITY INITIATIVES ADOPTED BY THE BANKING SECTOR

BANKING SECTOR SUSTAINABILITY FRAMEWORKS	CROSS-SECTORAL PRINCIPLES AND FRAMEWORKS
Equator Principles[a]	UN Global Compact[b]
UNEP FI Statement by Financial Institutions[c]	The Business Charter for Sustainable Development, International Chamber of Commerce[d]
The London Principles of Sustainable Finance[e]	The SIGMA Guiding Principles[g]
World Business Council for Sustainable Development Financial Sector Statement[f]	—

a. http://www.equator-principles.com/
b. http://www.unglobalcompact.org/AboutTheGC/index.html
c. http://www.unepfi.org/signatories/statements/fi/
d. http://www.iccwbo.org/policy/environment/id1309/index.html
e. http://www.forumforthefuture.org.uk/aboutus/financingthefuture_page775.aspx
f. http://www.wbcsd.ch/plugins/DocSearch/details.asp?type=DocDet&ObjectId=MTc3
g. http://www.proveandimprove.org/new/tools/sigma.php

Another aspect of increasing engagement with stakeholders is *promoting corporate governance*. Within its own organization, the financial institution may need to undertake a number of steps to build its capacity:

- Improving decision making capacity
- Strengthening the board of directors, to improve their expertise and empowering them in decision making
- Establishing strong internal controls
- Making a high level of transparency and disclosure a standard throughout the organization
- Building up reporting capabilities
- Planning for succession

A discussion of corporate governance within financial institutions is beyond the scope of this report. However, the IFC offers a number of resources to help financial institutions and their clients strengthen corporate governance (www.ifc.org/corporategovernance).

Banks can also help improve the corporate governance of their client companies by providing special financial products (see chapter 4) This is especially important for businesses in emerging markets, where corporate governance improvements can improve a firm's access to capital and access to international markets.

The case study that follows (the Nedbank Group) shows how effective engagement with stakeholders can create value for a bank.

NEDBANK GROUP

Embracing Global Sustainability Standards and Broadening Community Involvement

At A Glance

The Nedbank Group is a leader in corporate responsibility and socially and environmentally sustainable investment in Africa. One of the four largest banking groups in South Africa, the Nedbank Group also operates elsewhere in Sub-Saharan Africa and the United Kingdom. Nedbank is a subsidiary of Old Mutual PLC, which is listed in the UK. It had approximately 3 million retail banking clients, 763 branches and retail outlets, and over 22,000 employees as of March 2006. The Nedbank Group set its vision to become southern Africa's most highly rated and respected bank in ten "Deep Green Aspirations," one of which is to be "highly involved in the Community & Environment." The primary strategic focus also includes a commitment to becoming truly accessible to all South Africans through Black Economic Empowerment (BEE) as well as leveraging investments made in the community and environment and aligning these with primary business imperatives. | **wwww.nedbankgroup.co.za or www.nedbankgreen.co.za**

Nedbank Group's business case for integrating sustainability considerations into its operations includes meeting legislative, regulatory, and supervisory requirements; capturing brand/image and marketing benefits as a "green" bank; capitalizing on the growth of socially responsible investment; improving employee morale; and improving risk identification and management.

Establishing an Environmental Policy and Creating Oversight Structures for Sustainability Management

In 2004, Nedbank developed a comprehensive revised environmental policy on management of social and environmental risks in lending and financing. The policy reaffirms Nedbank's recognition of the precautionary approach to environmental management, which strives to anticipate and prevent potential environmental degradation, while continuing to be sensitive to the environment in the Group's business activities. The Environmental Management Programme is structured so as to provide corporate support and divisional implementation to promote a sustainable environment.

The responsibility for sustainability management and reporting was assigned to the Enterprise Governance Division, headed by former South African public protector Selby Baqwa, who is also a member of the group's Executive Committee. A Group Transformation and Sustainability Board Committee were also constituted, and, at management level, a Group Corporate Citizenship Committee was established (see figure, p. 31).

Pursuing Comprehensive and Credible Sustainability Reporting

Nedbank produced comprehensive sustainability reports for the 2003, 2004, and 2005 financial years. The 2004 report used the Global Reporting Initiative (GRI) standards as the guiding principles, together with sector-specific guidance: the Sustainability Performance Index (SPI) social indicators for the finance sector, and the UNEP/GRI environmental reporting indicators. To achieve high credibility, the report went through a thorough stakeholder feedback process, including stakeholder meetings across South Africa, a full audit by internal auditors, and independent assessments by an

> The support offered by the IFC has been invaluable in growing the skills base and understanding within Nedbank regarding sustainability management. It has also been really useful to interact with other financial institutions on the same path at IFC training sessions and events, and share ideas and case studies.
>
> JUSTIN SMITH, SENIOR MANAGER GOVERNANCE AND SUSTAINABILITY, NEDBANK ENTERPRISE GOVERNANCE AND COMPLIANCE

academic institution (UNISA's Centre for Corporate Citizenship) and a non-profit organization, WWF–SA. Putting the systems in place to undertake sustainability reporting has helped the bank improve the level of management information available, increase transparency in reporting, enhance its reputation among analysts and media, strengthen the brand, and increase organizational involvement.

Building on the Equator Principles

In November 2005, Nedbank became the first bank in Africa to adopt the Equator Principles. Nedbank adopted the Principles for a number of reasons, including the considerable potential to build on Nedbank's reputation. Moreover, a formal policy for social and environmental responsibility in project finance is in line with rapid developments in South African legislation and codes and will bolster the Group's existing risk management processes, as well as the Nedbank Group environmental policy. In addition, Nedbank can share skills and knowledge from collaboration in training and policy development with other Equator banks. Adopting the Principles is in line with the relationships Nedbank has developed with the United Nations Environment Programme, WWF, and the African Development Bank, among others.

Affinity Programs

Nedbank has an active conservation partnership with the WWF called The Green Trust. Initiated in 1990, the trust has been expanded, and has raised at least R65 million ($10.7 million) though green credit cards, check books, and savings accounts to fund more than 140 projects in South Africa, ranging from environmental education to tree planting and food gardening in poorer urban environments. Nedbank is also involved in the Sports, Arts and Culture, and Nelson Mandela Children's Fund Trusts.

The Nedbank/WWF SA Conservation Partnership is the first formal conservation partnership in South Africa. WWF provides input into Nedbank's environmental and sustainability policies and strategies and works closely with the Nedbank Foundation to create opportunities for involvement for both staff and clients. Together, the Nedbank Group Foundation, the Green Trust, and the Enterprise Governance and Compliance Division channeled R10.24 million ($1.8 million) into environmental initiatives in 2004 and 2005.

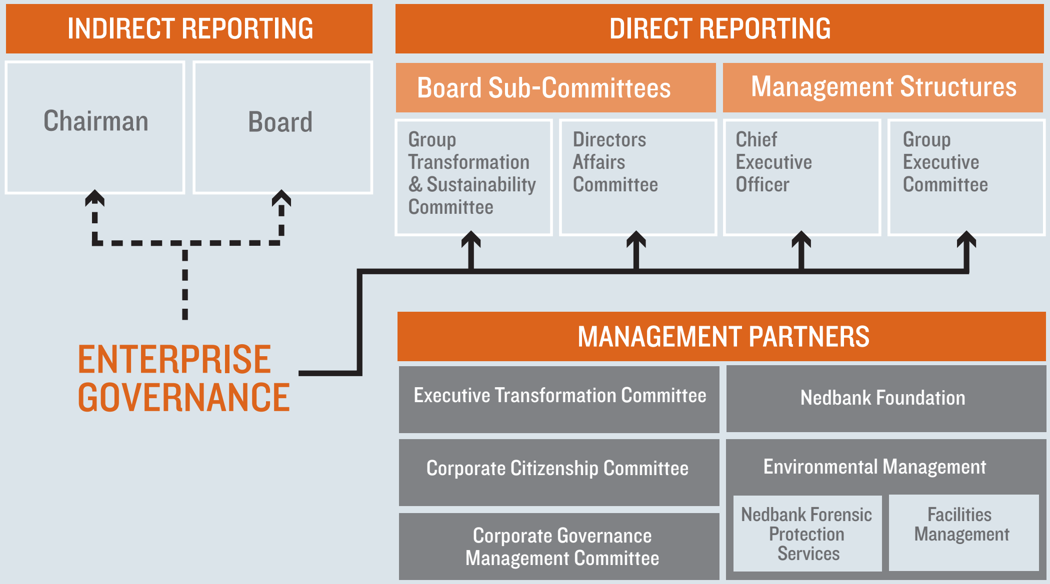
These programs link economic and environmental issues. While they raise funds for environmental conservation, they are also a means of attracting and retaining clients. Support of The Green Trust and Sports, Arts and Culture Trust made nearly half (47 percent) of customers more loyal, according to Nedbank's customer survey.

Enhancing Reputation

Nedbank's efforts have also translated into considerable international recognition.

- Nedbank is one of three South African companies included in the Dow Jones World Sustainability Index and is ranked first in its category in the Johannesburg Securities Exchange SRI index.
- Nedbank was chosen the best emerging market bank for corporate social responsibility at the Banker Awards in London in 2005.
- Nedbank won the Mail & Guardian's Greening the Future award for most improved environmental performance.
- Nedbank was a finalist in the Africa Investor awards in the category of Sustainability Investing in Africa and the Business Reporting award for its Sustainability Report
- Ernst & Young awarded Nedbank second place in the 2005 Excellence in Sustainability Reporting Survey awards in South Africa.

NEDBANK'S SUSTAINABILITYMANAGEMENT STRUCTURE

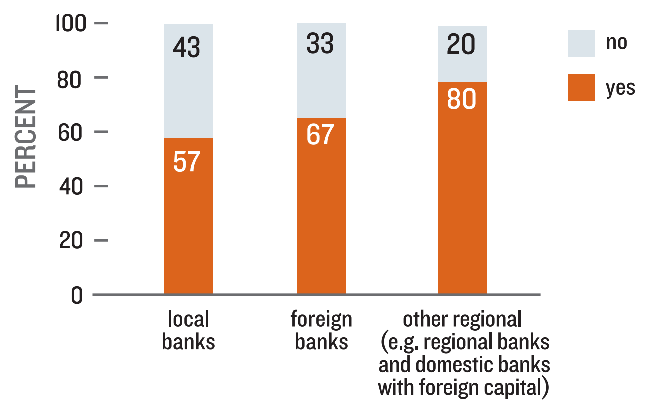


An Expanded Role in Sustainable Development

In 2005, after extensive due diligence, the African Development Bank (ADB) appointed Nedbank as its agent to manage a shared risk loan facility to support development projects in southern Africa. Projects will focus on infrastructure and public/private partnership transactions, natural resources, small and medium enterprises, and transactions that support Black Economic Empowerment (BEE). The ADB will provide up to R1billion ($164 million). Nedbank will match ADB's loan. This important investment signals Nedbank's commitment to playing a pivotal role in such projects. For Nedbank, this deal is a major step forward in terms of securing ongoing business within the BEE and public sector enterprise arenas.

> Banks need to take their social and environmental management systems beyond written policies to achieve tangible results.

IMPLEMENTATION OF A SOCIAL AND ENVIRONMENTAL MANAGEMENT SYSTEM, LOCAL VS. FOREIGN BANKS (PERCENT OF RESPONDENTS)



Commercial Banks' Progress in Adopting Social and Environmental Management Practices

The 2005 IFC survey found that financial institutions — especially commercial banks — had made significant progress in adopting social and environmental management practices. Only 18 percent of all financial institutions surveyed have not adopted or used any social and environmental procedures, compared to 35 percent three years earlier. This figure was even lower for commercial banks (16 percent).

There has been significant progress in developing formal management systems for social and environmental issues. Some 84 percent of commercial banks surveyed reported that they use various social and environmental procedures. 61 percent reported that they have developed a formal social and environmental management system. By contrast, only 22 percent of financial institutions surveyed in the 2002 IFC survey (see *Beyond Risk*, IFC, 2003) had a formal procedure for environmental risk management. Elements of social and environmental management systems (SEMS) developed by commercial banks that participated in the survey are shown in figure 2.3.

The majority of banks now use social and environmental standards. Specifically, 80 percent use local standards and regulations, 60 percent use the IFC Exclusion List,[4] and 43 percent use IFC's project categorization.[5] These results are particularly noteworthy because a significant portion of banks that participated in the survey (41 percent) were not IFC clients. Moreover, some banks have multiple lines of credit from various international financial organizations — such as the European Bank for Reconstruction and Development (EBRD), the Netherlands Development Finance Company (FMO), and the Brazilian Development Bank (BNDES) — and use the environmental standards of those organizations, which are similar to those of IFC.

Site visits and environmental impact assessments are the most frequently used tools for social and environmental assessment (used by 91 percent and 66 percent of commercial banks that participated in the survey, respectively). Environmental audit and environmental liability insurance were used by a significantly smaller number of banks: 23 percent and 20 percent, respectively.

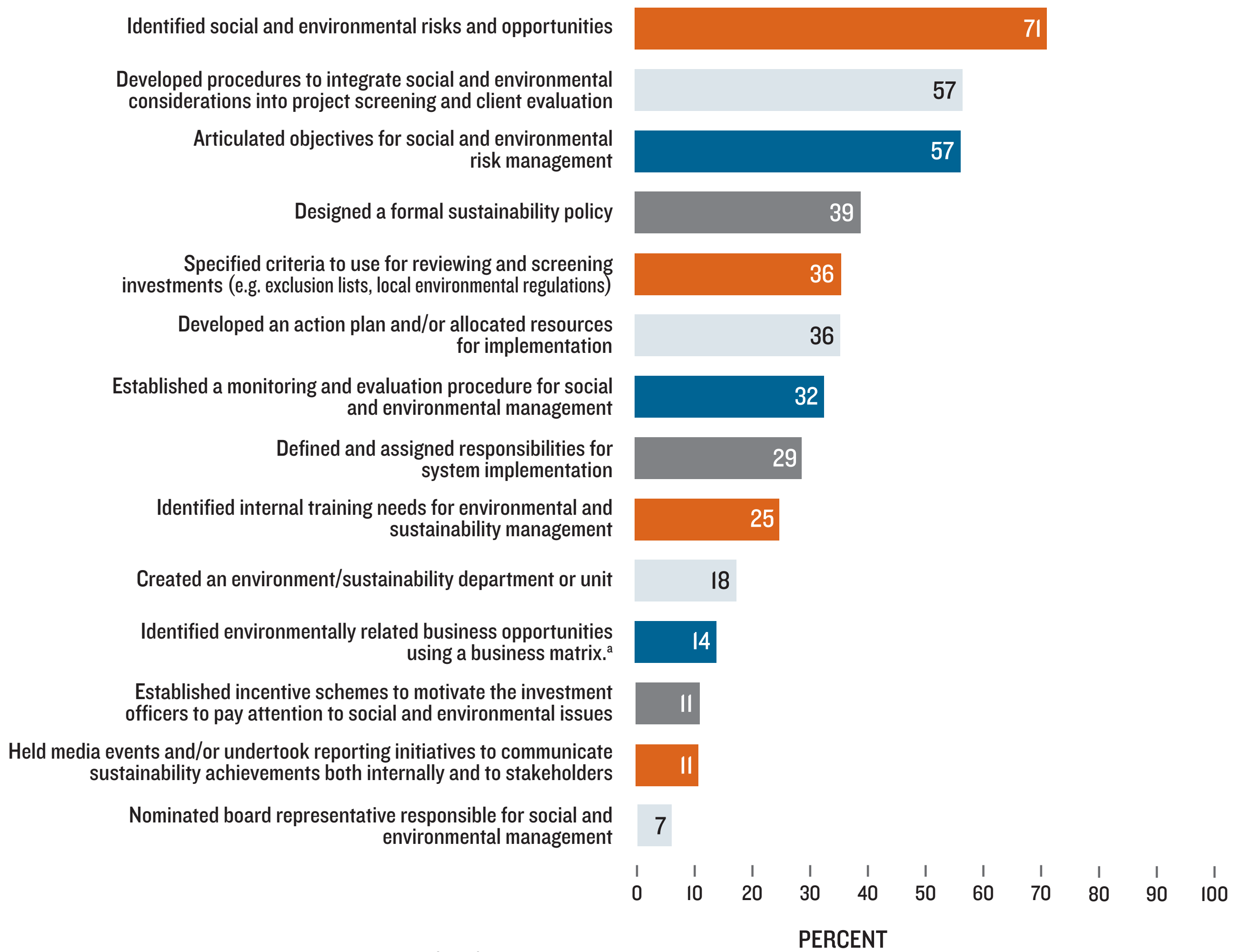
The case study that follows highlights one bank, Banco Itaú-BBA in Brazil, which gained very valuable experience over more than five years in creating and improving its SEMS. The case offers some especially valuable lessons learned.

ELEMENTS OF SOCIAL AND ENVIRONMENTAL MANAGEMENT SYSTEMS PUT IN PLACE BY COMMERCIAL BANKS

What kinds of elements have banks actually put in place in the process of developing their SEMS? The 2005 survey revealed that many commercial banks have undertaken steps to identify social and environmental risk and/or opportunities (71 percent), have developed procedures to integrate social and environmental considerations into project screening and client assessment (57 percent), have articulated objectives for environmental risk management (57 percent), and have designed a formal sustainability policy (39 percent).

However, a closer look reveals that the systems developed do not always go beyond written policies and formulated objectives to allocate sufficient resources for implementation. Only 36 percent of respondents from commercial banks have developed an action plan and allocated resources for implementation, and have specified criteria for reviewing and screening investments. Even fewer banks have established a monitoring and evaluation procedure for their management

ELEMENTS OF SOCIAL AND ENVIRONMENTAL MANAGEMENT SYSTEM DEVELOPED BY COMMERCIAL BANKS
(PERCENT OF RESPONDENTS)



Source: IFC Sustainability Survey of Financial Institutions (2005).

a. The business case matrix was developed by SustainAbility, an independent think tank and strategy consultancy company. See IFC (2003. Available online at http://www.ifc.org/ifcext/sustainability.nsf/Content/DevelopingValue)

systems (32 percent), defined and assigned responsibilities for social and environmental management (29 percent), or identified internal training needs (25 percent).

Only 18 percent have created a management department or unit dedicated to social and environmental management. Only 11 percent of banks have undertaken initiatives to raise awareness of sustainability management efforts both internally and with stakeholders. And 11 percent have established incentive schemes to motivate their investment staff to pay attention to social and environmental issues (figure 2.3).

The 2005 IFC survey confirms that implementation of SEMS' is being led by foreign and international banks in emerging markets (figure 2.4).

BANCO ITAÚ-BBA:

Setting Sustainability Benchmarks for the Banking Industry

At A Glance

Banco Itaú-BBA was formed in 2002 after the acquisition of Banco BBA Creditanstalt, the tenth largest private financial institution in Brazil at that time, by Banco Itaú, Brazil's second largest private bank in terms of total assets. Banco Itaú-BBA is now 95.75 percent owned by Banco Itaú Holding Financeira. Itaú-BBA had $18.4 billion in assets and $1.8 billion in equity as of December 31, 2005. Banco Itaú-BBA is operationally independent from Banco Itaú and focuses on wholesale corporate banking and investment banking, operating in such sectors as banking, insurance, real estate, chemicals, and electronics. | **www.itaubba.com.br**

In 2000, Banco Itaú-BBA (at that time, Banco BBA Creditanstalt) became the first bank in Brazil to establish a set of formal procedures to manage social and environmental risks, and to require explicit consideration of environmental issues in its lending activities (see figure, p. 36). Itaú-BBA's focus on corporate banking makes it essential to minimize exposure to companies with poor social and environmental practices and to attract new business. Itaú-BBA believes that its social and environmental management system brings the following benefits:

- Reduces the risk of project failure
- Helps avoid environmental liabilities
- Improves the bank's image
- Provides competitive advantage at no extra cost
- Opens up new business opportunities
- Allows the bank to do business in accordance with local policies, procedures, corporate principles, and environmental legislation

The development of a social and environmental management system started in 2000, well before the acquisition, and continued afterward, extending social and environmental management procedures and policies into both Banco Itaú and the new Itaú-BBA banks. The development of the system was based on consultations and guidance from IFC. A number of Itaú-BBA representatives have attended IFC's Competitive Business Advantage workshops several times and have successfully transferred their learning into practice. The bank has extended the use of the system to all its projects, regardless of whether they are financed through IFC funds or other international multilateral agencies. Having a state-of-the-art social and environmental management system in place has allowed the bank to transfer more than $200 million from IFC and other multilateral financial institutions to its clients through lending activities between 2000 and 2005.[a] Between 2000 and 2006, Banco Itaú-BBA also on-lent more than $1.8 billion in funds extended by the Brazilian development bank (BNDES) to finance projects in infrastructure, agricultural, industry, and oil and gas.

Itaú-BBA has hired an international environmental consultancy company to establish a comprehensive due diligence process to be applied in credit analysis. To enhance staff awareness, the bank started environmental workshops in October 2004 and plans to continue holding them on an annual basis.

In line with its values of social responsibility and corporate governance, both Banco Itaú and Banco Itaú-BBA subscribed to the Equator Principles in August 2004. In 2004, 50 employees from various departments in Banco Itaú and Banco Itaú-BBA attended a two-day Equator Principles workshop sponsored by IFC.

a. IFC provided about $100 million in funding to Banco BBA, including long-term project finance and a trade finance facility, which was transferred to Itaú-BBA after its acquisition by Banco Itaú.

The support Itaú-BBA enjoyed from IFC's sustainability training was crucial to the implementation of our social and environmental management system. Through this support, we were able to shed light on relevant topics that were treated in an appropriate manner. The guidelines we received on how to implement an internal environmental policy and how to deal with clients' resistance were key to our success.

Roberto Dumas Damas, M.Sc., CFA, Banco Itaú-BBA, Area de Financiamento de Projetos

Generating More Sustainable Business

Improved management of social and environmental issues helped the bank generate a stronger portfolio with projects that achieved

- Cost savings through such means as process efficiency and waste minimization
- Reduction of polluting emissions
- Benefits from switching to raw materials or processes with lower environmental impacts
- Reduction in insurance premiums, permit fees, or other costs because of improved environmental performance
- Improved lost time accident record and/or number of injuries
- Positive attention from the media and NGOs
- Citations and awards

EXAMPLES OF BANCO ITAÚ-BBA'S LENDING TO PROJECTS WITH SUSTAINABILITY COMPONENTS

INDUSTRY	SUSTAINABILITY COMPONENTS	LENDING PORTFOLIO ($MILLIONS)	AVERAGE PROJECT LENGTH (YEARS)	ACTIVITIES FINANCED (EXAMPLES)
Cosmetics	Biodiversity conservation	32.63	10	Higher process efficiency and utilization of waste
Oil and gas	Safer gas supply	33.70	10	Cogeneration program and iron cast renewal program[a]
Electric energy	Alternative sources of energy	104.00	10	Construction of small hydro plants and cogeneration plants using sugar cane biomass
Agriculture	Worker safety and sustainable land use	23.61	7	Establishment of new sugar cane plants with cleaner sugar cane processing
Sewage	Sewage and water treatment	70.00	10	Implementation of structures that improve wastewater and sewage treatment
Total		263.99		

Note: Data are as of February 2006.
a. Cast-iron renewal reduces the possibility of gas leaks by replacing old cast iron gas mains with new plastic gas pipes and in some cases steel gas mains.

BANCO ITAÚ-BBA'S SOCIAL AND ENVIRONMENTAL MANAGEMENT SYSTEM

IDENTIFICATION →	PROJECT APPRAISAL →	APPROVAL →	MONITORING
1. IDENTIFICATION: Describe the project and gather detailed information about the company 2. CATEGORIZATION: Classify the project according to related social and environmental aspects	3. ASSESS ENVIRONMENTAL IMPACT BY UNDERTAKING: • Major hazard assessment • Compliance evaluation • Site assessment. 4. EVALUATE THE NEED TO HIRE INDEPENDENT CONSULTANTS TO: • Establish an Environmental Action Plan • Ascertain what steps to request that clients take to mitigate and/or offset social and environmental risks or problems. 5. ESTABLISH AN ENVIRONMENTAL ACTION PLAN: • Ask the client to take actions to mitigate and/or offset environmental risks or problems.	6. DEFINE LOAN TERMS AND CONDITIONS: Make the contract contingent on obtaining licenses and other environmental authorizations from the State and/or municipal authorities, depending on the results of the appraisal stage and the Environmental Action Plan.[a] 7. INCLUDE SPECIAL OBLIGATIONS OF AN ENVIRONMENTAL NATURE, in addition to those required by law, as applicable (covenants, loan agreements). 8. PRESENT TO THE CREDIT COMMITTEE.	9. CONDUCT PERIODIC VISITS TO MONITOR AND EVALUATE: • Compliance with the Environmental Action Plan • Social and environmental performance • Making sure that a client fulfills financial obligations and meets expected project milestones.

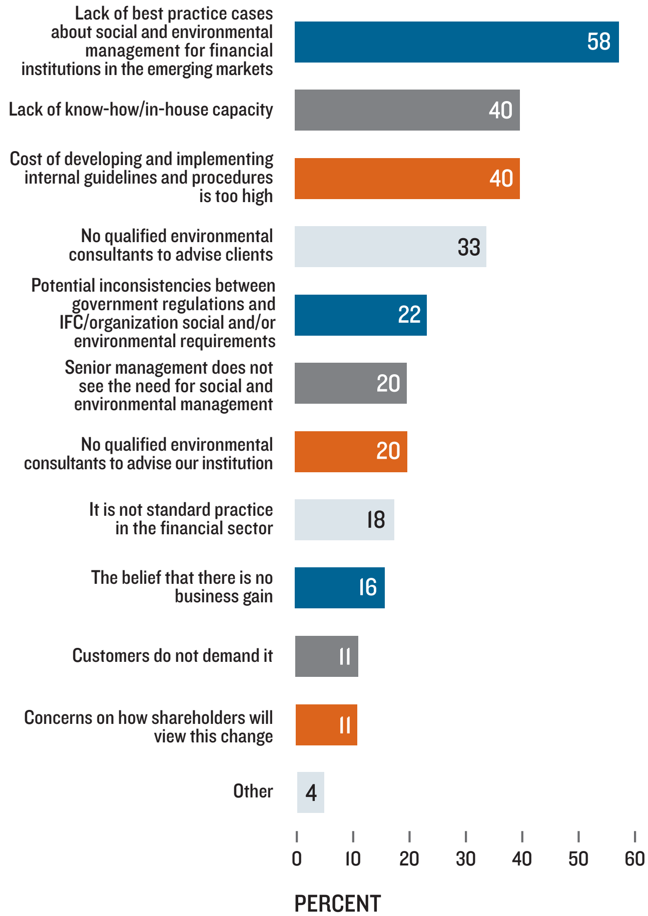
a. In Brazil, projects must obtain an approval from IBAMA, the Brazilian Institute for the Environment and Natural Renewable Resources, an official certification and standard setting agency affiliated with the Ministry for the Environment which is responsible for environmental compliance of the private sector, including financial institutions.

Lessons Learned: a Message for the Banking Sector

Banco Itaú-BBA has a very valuable experience over a five-year period of creating and improving its social and environmental management system. The bank recommends paying more attention to the following key issues when implementing such a system:

- Involve all key bank staff and stakeholders in the process to a greater extent.
- Clearly explain how social and environmental issues can lead to credit risks and what opportunities exist, in both internal documents and other information channels. It is crucial to stress that environmental risk is one of several kinds of risk that financial institutions must take into account when assessing new loans or investment opportunities.
- Define roles and responsibilities within the process and assign staff to them. All staff who deal with clients should be aware of the company's social and environmental management system
- The Equator Principles are becoming a condition of financing and an industry standard. Banco Itau-BBA's goal is not simply to specify standards, but to work with the best in class clients as partners, jointly devising business-focused solutions that will boost growth for both parties.

FIGURE 2.5
BARRIERS TO IMPLEMENTING A SOCIAL AND ENVIRONMENTAL MANAGEMENT SYSTEM
(percent of commercial banks)



Source: IFC Sustainability Survey of Financial Institutions (2005).
Note: The results present responses from all commercial banks, regardless of whether or not they had implemented an SEMS.

Lowering Barriers to Implementation by Building In-house Capacity

Even though banks in emerging markets have greatly increased their awareness of social and environmental issues and the need for their effective management, many still see significant barriers to implementing a social and environmental management system, the 2005 IFC survey results reveal (figure 2.5). The most significant barriers reported were lack of best practice examples and case studies (58 percent), lack of in-house capacity (40 percent), and high costs of developing a system (40 percent).

The perception of barriers has changed dramatically since the 2002 IFC survey. The number of respondents saying that social and environmental management is not a standard banking practice decreased sharply, from 50 to 18 percent. The perception that customers do not want their bank to implement such procedures decreased from 19 to 11 percent, and the belief that there is no business gain (or a lack of reward) decreased from 31 to 16 percent.

At the same time, some of these barriers may be more apparent than real. Only 37 percent of banks that had implemented a system considered implementation costs to be high, as compared to more than 44 percent of banks that had not implemented a system. The concern that customers will view these changes negatively and will not demand them dropped from almost 17 percent to only 7 percent.

Moreover, banks that implemented a formal system scored a bit higher on their demand for best practice examples. This may indicate that banks realize they need more help and practical guidance than they initially expected as they go through the process. Best industry practices provide useful benchmarks for banks in gauging their own progress in implementation and provide valuable models and lessons learned. The best practice examples throughout this report are offered to help meet this need.

Banks need assistance in developing new products in areas that are new for banks, the 2005 survey indicates. Only 35 percent of commercial banks that were introduced to sustainable finance concepts during IFC Competitive Business Advantage workshops and subsequently participated in the IFC 2005 survey have developed sustainability-related financial products (see appendix D for more information about the IFC workshops).

The overwhelming majority of commercial banks responding to the 2005 survey (86 percent) stated they would like to receive further assistance on sustainability issues. They specified the following areas: providing means to enhance sustainability learning (73 percent), providing information (70 percent), and providing technical assistance and advisory services (68 percent). They rated two other areas—assistance in providing sustainability-related products and services, and providing financial resources—significantly lower (51 percent and 49 percent, respectively).

Responding to the need for more good practice examples, the case that follows illustrates how a regional bank (Banco Cuscatlán, Central America) established its environmental management system, tailored lending to environmental projects, and offered innovative financial products.

BANCO CUSCATLÁN:

Reducing Risk and Offering Innovative Financial Products

At A Glance

The Cuscatlán Group, a union of Cuscatlán banks in Central America, is one of the leading commercial and retail banking institutions in Central America. Headquartered in El Salvador, the Cuscatlán Group is a well-diversified financial group with operations that span Central America through subsidiaries and a network of branches, mini-branches, and ATMs in Costa Rica, El Salvador, Guatemala, Honduras, and Panama. The Group is owned by a holding company, UBC International Corporation (UBCI). | **www.bancocuscatlan.com**

Expanding to New Markets

The Cuscatlán Group is becoming a truly regional bank in Central America. Its subsidiaries in all five countries are achieving leading market positions. This reflects the public recognition and acceptance of the Cuscatlán trademark. In 2005 Banco Cuscatlán bought all the assets of Lloyds TSB in Guatemala, Honduras, and Panama, which brings a strong corporate client base to the group.

In the process of its regional expansion, the support the Group received from multinational financial institutions, including IFC, has played an important role in its institution building. In addition to investments totaling $65 million aimed at strengthening the Cuscatlán Group's capital base and supporting the expansion and consolidation of its operations in Central America, IFC has assisted Cuscatlán in strengthening its analysis of subprojects and developing social and environmental risk management capabilities. A representative of the bank attended IFC's Environmental Business Advantage workshop in Miami in June 2001, as well as IFC and FMO's Social and Environmental Management Workshop in Costa Rica in February 2005.

Establishing an Environmental Management System

The Cuscatlán Group has introduced a comprehensive and well-coordinated environmental management system (EMS), which includes unified annual reporting from all country subsidiaries. The bank makes a continuous effort to mainstream social and environmental components into overall lending operations. The EMS includes detailed procedures and checklists for environmental appraisal, screening, and monitoring, including requirements of the IFC Exclusion List. The social and environmental impacts are carefully analyzed according to the checklist. An Environmental Action Plan is tailored for each project and for working capital loans.

The screening system is based on identified social and environmental concerns, weighed according to their importance. The projects are assigned a numerical value that indicates the environmental, health, and social risk category. Projects are categorized according to a unified system that includes grades of red (high risk), yellow (medium risk), and green (low risk). Each appraisal and monitoring report includes a chapter stating the conclusions and recommendations of the responsible credit officer.

Since November 2001 all projects in Cuscatlán's portfolio have been subject to environmental review and supervision. Before starting the analysis of each project, a site visit is conducted to learn about current social and environmental conditions. To gather more information, formal meetings are also held with the client. The process of detailed environmental analysis and classification of projects using IFC's procedures has significantly improved the quality of assets for all banks of the Group:

- The EMS has enabled all subsidiaries to exclude projects with high social and environmental risks from their portfolios.
- These measures allow subsidiaries to gradually improve performance of medium-risk projects and increase the number of projects in the low-risk category.
- Projects are supervised for their social and environmental impacts during implementation. All subsidiaries are

>> *In Banco Cuscatlán, we understand the relationship that exists between environmental performance and competitiveness. We are continuing to extend our environmental policy to all our subsidiaries in the Central America region. At the same time, we are promoting initiatives in investments that improve the competitiveness of client companies and their social and environmental performance.* <<

José Francisco Rodríguez García, Environmental Officer, Banco Cuscatlán, El Salvador

directed to increase the number and frequency of project environmental evaluations, including site visits.

- The bank's efforts have generated goodwill and improved cooperation with sources of external environmental funding organizations and environmental, health, and safety authorities, such as the Ministry of Environment.

To ensure that its environmental policy reaches everyone in the institution, Banco Cuscatlán has extensively trained its employees and engaged qualified specialists in environmental management. Training includes such aspects as identifying environmental risks and impacts in different industries, integrated waste management, and treatment of residual waters. Training sessions have a very practical focus and include site visits to the bank's clients. The bank uses questionnaires to get employee feedback on the performance of the EMS.

Lending to Environmental Projects and Offering Innovative Financial Products

Banco Cuscatlán also offers innovative products in cleaner production, energy efficiency, and financing projects for environmental improvements.

The guarantee program for cleaner production projects is directed at small and medium enterprises in Central America. Supported by USAID as a guarantor through its cleaner production program, Banco Cuscatlán finances and provides guarantees for cleaner production projects for its clients and manages the guarantee program (see box, this page). The program receives technical support from CNPML (Centro Nacional de Producción Más Limpia de El Salvador, the Salvadorian National Centre for Cleaner Production and Environmental Technologies) and universities that perform cleaner production studies sponsored by CCAD (Comisión Centroamericana de Ambiente y Desarrollo). Banco Cuscatlán in El Salvador has provided four clean production loans totaling $514,000 for the acquisition of machinery and equipment.

Environmental sureties help the bank's clients meet requirements created by El Salvador's environmental law. The surety is a guarantee to ensure that the enterprise complies with the environmental management program. Between 2001 and 2005, Banco Cuscatlán El Salvador provided 201 sureties, totaling $6,742,680. Banco Cuscatlán's accomplishments have been recognized in various ways. In 2001 Banco Cuscatlán El Salvador was selected to administer El Salvador's Fund for Environmental Investments, based on the bank's environmental record. Cuscatlán's EMS helped it gain access to $10 million in FMO funds in 2001.

TYPICAL CLEANER PRODUCTION GUARANTEES

- Qualifying projects: Investments designed to encourage the adoption or expansion of cleaner production practices or environmental management plans
- Guarantee amount: $1 million
- Expiration date: September 30, 2010
- Guarantee percentage: 50 percent of the credit amount
- Complementary guarantee: Optional

© Jouni Martti Eerikainen, IFC | At J. Hill y Cía, a coffee plant in Santa Ana, El Salvador, workers handpick the best organic beans to ensure a high-quality coffee product. The company is a client of Banco Cuscatlán

MANAGING RISKS, PURSUING OPPORTUNITIES, AND OVERCOMING BARRIERS

What are the major social and environmental risks that banks face in emerging markets? How can these risks be transformed into opportunities? How can banks in emerging markets find new markets and clients in sustainable areas? The 2005 IFC survey sheds light on these important questions. The first half of this chapter discusses types of social and environmental risks, and how they are perceived and ranked by banks in emerging markets. The second half delves into ways financial intermediaries, particularly commercial banks, can pursue social and environmental opportunities and overcome barriers to sustainable banking. Case studies illustrate how banks have tackled various challenges.

Managing Social and Environmental Risks

How well banks handle social and environmental risks is increasingly important because, in today's global economy with unrestricted information flows, such risks can affect a bank's reputation and long-term business success.

Yet risk management is more difficult than ever. The type and range of risks that financial institutions in general and banks in particular confront has widened (figure 3.1). Moreover, in emerging markets, financial institutions/banks must contend with a special set of risks, growing out of the nature and activities of their clients, as well as underlying social, environmental, economic and cultural conditions; the role, practices, and policies of government; and the business climate and markets.

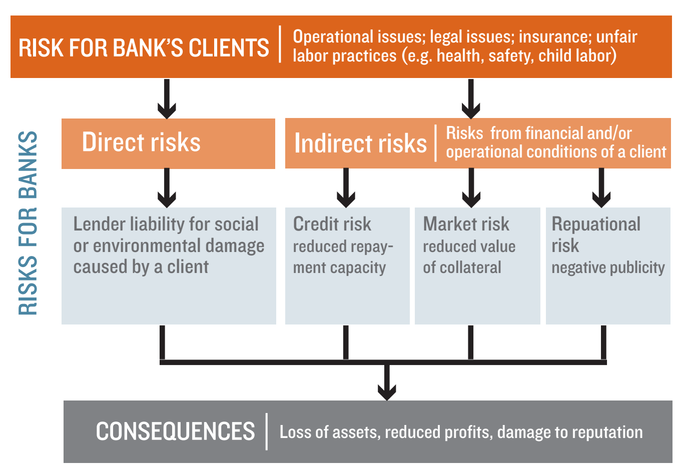
The following discussion looks at how banks in emerging markets perceive and understand social and environmental risks for themselves and their clients. It aims to help financial institutions, particularly banks, in emerging markets identify, classify, and quantify risks.

A Widening Array of Risks

In the 1990s, the main risks that financial institutions faced in social and environmental arenas were limited to **direct legal risks** posed by governments and third parties, such as liability for the clean-up of contaminated collateral pledged to the bank; negligence in assessing actual and potential environmental risks of clients' projects; liability for misrepresentation of environmental risks posed by their clients; or direct liability, if a financial institution was a principal owner of an enterprise that caused environmental or social problems. Today, financial institutions increasingly realize that **indirect risks** are far greater.

Financial risks confront the bank because of the weakened (unsustainable) financial and/or operational conditions of a client, stemming from social and environmental problems. Such problems can affect a client's ability to repay loans and/

FIGURE 3.1
POSSIBLE SOCIAL AND ENVIRONMENTAL RISKS FOR BANKS IN THEIR LENDING OPERATIONS



How well banks handle social and environmental risks is more important than ever because in today's global economy with unrestricted information flows, such risks can affect a bank's reputation and long-term business success.

or can drive down the value of a client's collateral. A client's failure or lapse in handling environment and social considerations and risks can hurt the business, which in turn can hurt the bank that has supported it. Indirect risks may lead to a decline in the bank's customer base, costly litigation, or loss of revenue (see next section, Risks for Bank Clients, p. 43).

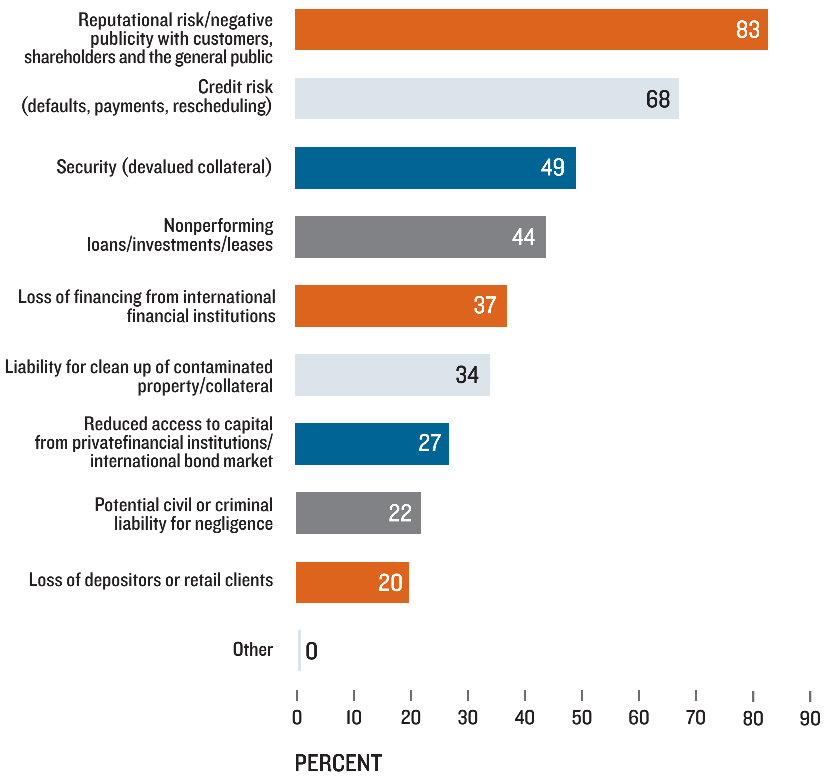
Another major type of indirect risk for banks is **reputational risk**: the potential for negative publicity and thus damage to brand value arising from an institution's poor social and environmental practices — including its association with socially and environmentally problematic investments, projects, or clients.

Key Social and Environmental Risks Identified by Commercial Banks

The major risk identified by emerging market commercial banks in the 2005 IFC survey was reputational risk. The overwhelming majority of emerging market commercial banks (83 percent) ranked the risks of negative publicity and loss of reputation as a more important long-term risk than credit risk (figure 3.2).

These results suggest that emerging market banks have significantly changed their perception of social and environmental

FIGURE 3.2
KEY SOCIAL AND ENVIRONMENTAL RISKS IDENTIFIED BY COMMERCIAL BANKS (percent of commercial banks)



Source: IFC Sustainability Survey of Financial Institutions (2005).

Most banks ranked the risks of negative publicity and loss of reputation from their association with socially and environmentally problematic activities as a more important long-term risk than credit risk.

> *Banks' social and environmental risks are those of their clients. To avoid these risks, banks need to ensure that their clients' financial and operational sustainability is not undermined by adverse impacts on environment or society.*

risks they may face. In 2002, financial institutions identified nonperforming loans as the major source of sustainability risks.[1] Risks to their reputation ranked third, cited by 46 percent of survey respondents.

Commercial banks cited credit risk as their second major concern. **Credit risk** occurs when clients are unwilling and/or unable to fulfill their contractual obligations. 68 percent of commercial banks cited this risk, compared to 59 percent of all financial institutions surveyed.

Banks cited ***market risk****—the risk of reductions in the value of collateral—as their third concern.* This is not surprising, since highly collateralized debt financing is typical for emerging markets. Environmental and/or social problems can reduce the value of collateral; for example, if a production site becomes contaminated, the market value of the underlying collateral will fall. 49 percent of commercial banks respondents cited the risk of receiving devalued collateral as payment for a loan, compared to 39 percent of all financial institutions surveyed. Banks also face liquidity risks from social and environmental problems. For example, if they receive contaminated collateral, they might have to expend their internal resources to meet government clean-up requirements or to clean the site up before they could sell it. 34 percent of respondents from commercial banks consider this risk important.

The risk of nonperforming loans related to clients' social and environmental problems ranked fourth, cited by 44 percent of commercial banks.

FIGURE 3.3
BANK'S PERCEPTIONS OF KEY SOCIAL AND ENVIRONMENTAL RISKS FACING THEIR CLIENTS
(percent of commercial banks)

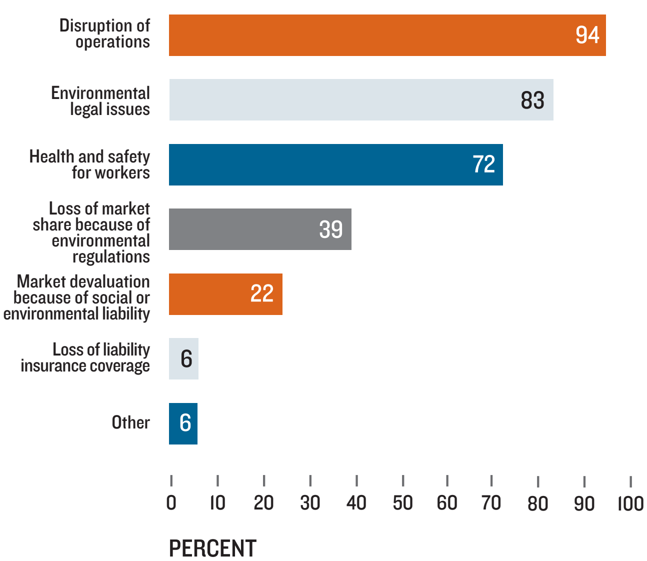
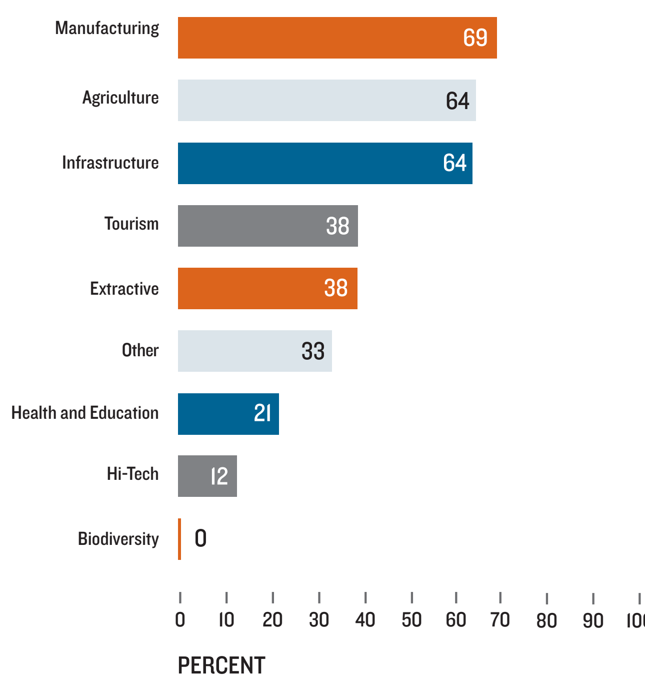


FIGURE 3.4
MAIN SECTORS FINANCED BY COMMERCIAL BANKS SURVEYED (percent of commercial banks)



Source: IFC Sustainability Survey of Financial Institutions (2005).

Risks for Bank Clients

In essence, banks' social and environmental risks are those of their clients. To avoid these risks, banks need to ensure that their clients' financial and operational sustainability is not undermined by adverse impacts on environment or society. The 2005 IFC survey asked banks about their perception of social and environmental risks of their clients (figure 3.3).

Virtually all commercial banks (94 percent) cited *operational risks to their clients caused by changing external environmental conditions*, such as farms going bankrupt because of deterioration of water resources, *or social conditions*, such as higher labor costs related to HIV/AIDS because of insurance expenses, health care, and higher staff turnover. The percentage of all financial institutions surveyed that cited such operational risks was considerably lower: 70 percent. Operational risks can trigger the most significant decreases in a client's profits and thus its prospects for staying in business—and affect its ability to repay a loan. For example, if a client is losing market share because its products do not meet the growing demand for more environmentally friendly products, that client might not be able to sustain its profits. 39 percent of commercial banks cited loss of market share because of environmental issues. 22 percent cited market devaluation of clients' assets, leading to devaluation of collateral for banks.

83 percent of commercial banks cited *clients' legal issues related to environmental issues,* compared to 76 percent of all financial institutions. *Health and safety for workers* was cited by 72 percent of commercial bank respondents. Such health and safety issues can contribute to both operational disruptions and legal problems.

Social and environmental risks for banks depend to a great extent on what industry sectors their borrowers operate in and the nature of the client base that a bank works with (whether large project finance or smaller borrowers, for example). The following sections look in more detail at sector-specific and industry-specific risks, and social and environmental risks and SMEs.

Sector-specific and Industry-specific Risks

Banks need to have a clear picture of the possible social and environmental risks surrounding the projects and companies they finance. One way to begin pinpointing such risks is to collect sector-specific and industry-specific information.

This is particularly important for sectors where products and production processes, as well as emissions and byproducts of these processes, may be potentially harmful for the environment, communities, and/or society. Agriculture, fisheries, extractive industries, and manufacturing are considered the most socially and environmentally sensitive in most countries.[2] Within a particular business, different functional divisions or lines of business may also generate more or fewer environmental or social risks, depending on the nature of their transactions.[3] For example, a company may produce a variety of construction materials, ranging from environmentally friendly drywall to potentially dangerous paint that involves toxic chemicals.

The commercial banks surveyed by IFC do business with clients in a variety of industries (figure 3.4). The banks were asked to rank the risks these clients face, by industry. Their responses appear in table 3.1. For example, 100 percent means that 100 percent of respondents whose banks finance a certain industry believe that these risks exist for clients in that industry.

The most significant risk for banks' clients appears to be disruption of operations; responses ranged from 89 to 100 percent by industry. *Legal issues arising from noncompliance with environmental regulations ranked second*, ranging from 78 to 100 percent. *Loss of market share stemming from new social and environmental regulations and buyer requirements was cited by the highest number of respondents whose banks finance tourism and agriculture* (57 percent and 44 percent, respectively). *Banks that finance infrastructure most frequently mentioned concern that a client may face market devaluation as a result of social and environmental liability* (22 percent).

To manage social and environmental risks, especially in large projects they finance, increasing numbers of banks in emerging markets are turning to various international standards, considered as best practice. One such set of standards is the Equator Principles, supported by a number of developed and emerging market banks (see box 3.1).

Social and Environmental Risks and SMEs

A special consideration in emerging markets is the preponderance of small and medium enterprises (SMEs). In different regions, SMEs can range from sizable manufacturing, trade, or service companies with tens or even hundreds of employees to individual entrepreneurs that are in need of microfinance (see chapter 4).[4] In many emerging markets, SMEs are the main form of business, generate most of the jobs, and play a critical role in economic growth. Unlike large businesses, many SMEs do not have resources to train employees about social and environmental issues, invest in assessment and technological solutions to minimize environmental impact and protect worker safety, or implement relevant social and environmental management procedures.

At the same time, SMEs are an increasing market for emerging market banks. SME access to capital in emerging markets is generally limited, as is their ability to attract equity capital. Thus debt financing is their most important option. Recognizing their potential, increasing numbers of emerging market banks are making it a strategic priority to build high-quality, profitable, and sustainable SME portfolios.

The 2005 IFC survey sheds light on how commercial banks perceive the major social and environmental risks of their SME clients. *88 percent of responding banks cited operational risks. 75 percent cited legal risks and labor risks, such as health and safety, as major risks for their SME clients.* They rated other sustainability-related risks as considerably less significant (figure 3.5.).

Banks also face the general challenge of assessing social and environmental risks of their SME portfolio because of the large number of smaller firms and their diversification. Such assessment requires banks to pursue a commitment to sustainability, training and education for bank employees, and adequate social and environmental management that includes unified appraisal and monitoring procedures and cooperation with local authorities.

The case study of Bank "Center-invest" shows how a bank in Russia reached out to tap the SME market and also to meet the demand for financing for energy efficient projects (see p. 46).

TABLE 3.1
MAIN SOCIAL AND ENVIRONMENTAL RISKS FOR CLIENTS: A BREAKDOWN BY INDUSTRY
(percentage of respondents who mentioned these particular risks, in relation to the industries that their banks finance)

	MANUFACTURING	INFRASTRUCTURE	AGRICULTURE	TOURISM	EXTRACTIVE	ALL OTHER INDUSTRIES
Disruption of operations	91	89	**100**	**100**	**100**	**100**
Environmental legal issues	82	78	89	**100**	83	**100**
Health and safety for workers	64	56	**89**	71	50	71
Loss of market share because of environmental regulations	36	33	44	**57**	33	**57**
Market devaluation because of environmental or social liability	18	22	11	14	17	**29**
Loss of liability insurance coverage	9	11	11	**14**	0	0

Source: IFC Sustainability Survey of Financial Institutions (2005).

Note: Highest response appears in bold. Another category of "other" concerns added up to less than 1 percent of responses in all industries.

BOX 3.1
THE EQUATOR PRINCIPLES

The Equator Principles are a voluntary set of social and environmental guidelines for project finance lending. They are used by about 80 percent of the project finance market worldwide. The principles help screen social and environmental risks of investment projects that exceed $10 million. They provide a framework for banks to manage social and environmental issues related to projects they finance anywhere in the world and to all industry sectors, including mining, oil and gas, and forestry. The Principles are based on IFC's standards and procedures (see new IFC performance standards on social and environmental sustainability, online at **www.ifc.org/EnvSocStandards**)

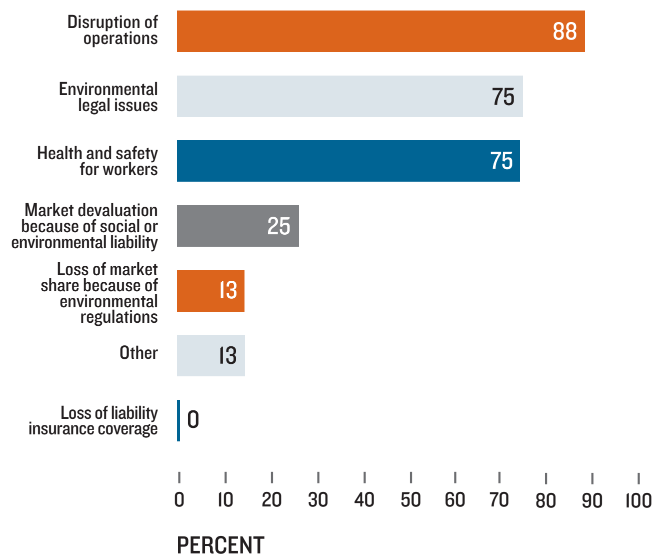
The Equator banks commit to put in place internal policies and processes consistent with the principles. At a project level, this means the following:

- The bank screens the level of social and environmental risks and assigns a risk category.
- The borrower completes an Environmental Assessment.
- The borrower prepares an Action Plan that describes and prioritizes the actions needed to implement mitigation measures or corrective actions, and monitoring measures.
- The borrower discloses impacts and consults with affected groups.
- The borrower covenants to comply with the Action Plan and report on compliance.

The Equator banks continue to grow in number, from ten leading banks from seven countries, when the principles were launched in 2003, to 41 banks by June 2006. An increasing number of banks in emerging markets are now signatories, in addition to major international commercial banks. IFC helps train Equator banks professionals in implementing the principles. (For more on the Equator Principles, see **www.equator-principles.com/**)

a. IFC Sustainability Report (2005a, p. 22)

FIGURE 3.5
KEY SOCIAL AND ENVIRONMENTAL RISKS FOR SME CLIENTS
(percent of commercial banks providing SME finance)



Source: IFC Sustainability Survey of Financial Institutions (2005).

BANK "CENTER-INVEST"

Sustaining Market Share through Lending to SMEs and Energy Efficiency Projects

At A Glance

Established in 1992 in the city of Rostov-on-Don, Bank "Center-invest" ranks among the largest 150 Russian banks and is the largest privately owned bank in the Rostov Region. It has 9 branches and 33 sub-branches, mainly in the Rostov region, which service both large corporations and SMEs. Since 2004, the bank has been expanding to neighboring regions and has established representative offices in Moscow and in London. Since 2002, it has received investments and trade finance from IFC, EBRD, DEG, KFW, and USAID, along with technical assistance in the areas of credit underwriting, risk management, international accounting standards, business organization, and social and environmental management. | **www.centrinvest.ru**

Market Challenges

"Center-invest" is aggressively developing its retail business. It has an excellent reputation in its home market, which has enabled the bank to attract the most important enterprises in the region as clients, as well as the second largest retail deposit base. "Center-invest" intends to remain focused on a product strategy that relies on using international best practices and technology to keep ahead of its competition. The bank's association with international financial institutions—particularly the equity investment from EBRD in 2004 and DEG in 2005, and two loans from IFC—enhanced the bank's reputation and have enabled it to provide longer-term funding. However, competition is intensifying. Sberbank, the biggest Russian bank, is the main player in the market and Moscow-based banks are expanding their operations in the region. The management of "Center-invest" is responding by directing the bank to provide superior service to its clients, expand in new areas, and leverage its local connections and knowledge of the local market.

Social and Environmental Management

"Center-invest" has taken a number of steps to implement social and environmental considerations in overall lending activities. For example, two representatives of the bank attended IFC's Competitive Business Advantage workshops in Moscow in November 2004. Guided by IFC's Exclusion List and Project Categorization, as well by local social and environmental requirements, "Center-invest" uses environmental impact assessment and site visits to evaluate social and environmental criteria of funded projects, and also takes on environmental liability insurance.

"Center-invest" routinely carries out active consultations with clients on social and environmental impacts and, with participation of local social and environmental authorities, assists in developing an activity plan to monitor them. The following are examples of ways in which "Center-invest" is supporting clients through sustainability and growing its business in the process:

- The bank encourages its clients take measures to reduce their emissions of pollutants to meet strict State requirements.

- It had developed a successful program, "Support to SMEs of the Don River Region," which serves over 9,000 small businesses and 4,000 individual entrepreneurs. IFC provided a $5 million ruble-linked loan to the program in 2005, which the bank will use to extend long-term loans to SMEs in rubles. In 2005, "Center-invest" provided over $343 million in credit to

SMEs, or 38.8 percent of the total volume of SME lending in the region.

- In 2005, "Center-invest" ranked among the 25 leading Russian banks to provide affordable housing finance.

Lending to Energy Efficiency Projects

With its diversified loan portfolio in a broad range of sectors, "Center-invest" is in a good position to provide energy efficiency loans to energy equipment producers, maintenance services, industrial energy consumers, and local regional and municipal governments. This area has been a strategic priority for the bank and is strongly supported by senior management.

In August 2005 IFC started a program to assist "Center-invest" in developing a pipeline of energy efficiency projects. Training events for both bank staff and bank clients were held in Rostov and Krasnodar, and IFC staff worked with "Center-invest" staff to build up a network of suppliers of energy efficient equipment. In 2006 IFC provided a $4 million loan to "Center-invest" for lending specifically to these energy efficiency projects. IFC's financial products and technical assistance are enabling "Center-invest" to expand and improve its lending to energy efficiency in the region. The bank has been marketing the energy efficiency program very aggressively. Since the beginning of 2006, the bank has made decisions to finance eight projects totaling $4.4 million. Out of these projects, three were financed by "Center-invest" from its own resources and will be re-financed from the loan funds.

In addition to the above projects, the bank has a strong pipeline of energy efficiency projects: over 22 current projects totaling at least $8.4 million, as of May 2006. Among the industries and projects financed are the food processing industry (a sunflower oil extraction factory, confectionery, bakeries, meat processing, milk processing); a brick factory; machinery production; leather processing; local municipal and private apartments maintenance; construction (new apartment buildings); packaging; and printing.

>> *At 'Center-invest' we realize that market differentiation and expansion of our services into market segments with high potential are key factors to increase our competitiveness and sustain revenue growth. That is why areas such as lending to SMEs and energy efficiency projects are among our highest strategic priorities. However, this work also requires greater attention to social and environmental factors. IFC's assistance in this regard has been very useful.* <<

Grigory Chorayan,

Head of Treasury, Bank "Center-invest"

© Martin Dasek, IFC | *Rotor of a 2-MW wind turbine in Northern Bohemia, a project financed by Česká Spořitelna, a.s. (member of the Erste Group) (see story, p.18)*

Pursuing Opportunities in Sustainable Banking Products and Services

Increasingly, emerging market financial institutions recognize that sustainability-related products and services can expand their portfolio, differentiate them from competitors, and improve their reputation among customers and stakeholders. Teams of specialist bankers have emerged whose mandate is to find innovative ways of financing projects or creating products with significant social and environmental benefits, while also meeting their banks' profit targets.[5]

Banks can transform sustainability risks into opportunities by

- Identifying new potential markets in sustainable areas and channeling investment to them, thereby generating additional revenue streams
- Developing business in new areas with existing clients by cross-selling sustainability-related banking products and additional services, and also generating additional revenues
- Undertaking detailed sustainability risk assessments of large projects in various sectors
- Financing only those projects that adequately take social and environmental considerations into account, thereby reducing credit risk
- Achieving market differentiation by developing knowledge and in-house capacity in evaluating the potential of sustainability-related products, thereby attracting customers seeking professional advisory services in sustainability areas in addition to financing
- Enhancing the banks' reputation and brand value by supporting sustainable development, thereby meeting a high priority for governments and international organizations, and perhaps attracting international financing
- Taking advantage of international market-based regulatory mechanisms, such as the Kyoto Protocol and the Convention on Biological Diversity[6]

Some of the opportunities can be successfully captured with regular banking products, such as loans, project finance, or insurance. Banks, as deposit-taking institutions, can design specific financial products on the liability side to meet the growing demand from customers and others. Sustainability-related banking products on the investment side are sometimes referred to as "green investment" or "social (ethical) investment."[7]

Capturing other opportunities may require innovative ways to approach investments in social and environmental areas (see table 3.2). The sustainable banking products most frequently mentioned by the commercial banks that responded to the 2005 IFC survey were environmental loans for SMEs, green investment funds, environmental credit cards, and renewable energy finance.

Banking services targeted at two innovative sustainable areas—carbon finance and financing for energy- and resource-efficient housing—are discussed in the next section. A case study showing how one bank, Bank of Georgia, attained first mover advantage by offering affordable housing finance, is also presented.

Chapter 4 discusses how banks can benefit from investing in various sustainability-driven areas (energy efficiency, renewable energy, biodiversity conservation, and offering banking services to low-income, underserved groups). The chapter includes some examples of emerging market banks that were successful in some of these areas.

TABLE 3.2

BANKING PRODUCTS AND FINANCING MECHANISMS THAT PROMOTE SOCIAL AND ENVIRONMENTAL SUSTAINABILITY: A SAMPLE

OPPORTUNITIES	ENERGY EFFICIENCY	RENEWABLE ENERGY	CLEANER PRODUCTION	BIODIVERSITY CONSERVATION	SUPPORTING UNDERSERVED SOCIAL GROUPS	EXAMPLES
PRODUCTS AND SERVICES ON THE DEPOSITORS' SIDE						
				✓	✓	"Environmental" affinity credit cards and savings accounts; social and environmental investment funds. These products are usually targeted to specific environmentally/ socially sustainable aspects or areas.
PRODUCTS AND SERVICES ON THE BORROWERS' SIDE						
LOANS with a sustainability focus	✓	✓	✓	✓	✓	Loans to promote sustainable energy, energy efficiency, or biodiversity conservation, or to finance sustainable supply chain management.
LEASING with a sustainability focus	✓	✓	✓			Leasing for sustainable projects, such as for equipment that is energy-efficient or is used to generate renewable energy (solar panels, micro hydro turbines).
CARBON FINANCE	✓	✓	✓			Projects in various areas, such as promoting renewable energy to displace fossil fuels; switching from fuels with high to low GHG intensity, which reduce green house gas emissions (see p. xx).
MICROCREDIT					✓	Micro loans or micro leasing to underprivileged groups (such as women, indigenous people, people in rural areas); banks can cooperate with NGOs and microfinance organizations to channel resources to these areas more effectively.
HOUSING FINANCE	✓				✓	Affordable housing programs; "green" mortgages that provide financing to build or renovate homes in a way that increases efficiency of energy use; mortgages to small businesses or individual entrepreneurs.
SUSTAINABLE SUPPLY CHAIN FINANCE			✓	✓		Financing buyers of or suppliers of various products (coffee, timber, non-timber forest products) at different stages in the supply chain (including SMEs) to facilitate more sustainable practices in agriculture, forestry, and other sectors, and to protect biodiversity
SECURITIZATION IN SUSTAINABLE AREAS		✓		✓		Securitization of projects that are low-profit allows banks to cover previously uninsurable risks using the capital market (alternative risk financing) or to bring forward future cash flows (asset-backed securitization).
ENVIRONMENTAL/ SOCIAL LIABILITY INSURANCE	✓	✓	✓	✓		Insurance coverage for certain types of social and environmental liabilities/damage.
ADVISORY SERVICES	✓	✓	✓	✓	✓	Strengthening organizational capacity of bank's clients and governments to meet their needs for information and knowledge related to social and environmental sustainability. This is particularly important for SMEs.
COMMUNITY PROGRAMS				✓	✓	Charitable donations; cultural and social finds to support children, education, sports, environmental protection, and the like.

Source: Adapted from Jeucken (2001).

Note: Check marks indicate the most commonly pursued opportunities in each of the sectors. Opportunities also exist between sectors, such as a project that uses cleaner production and also is more energy-efficient, or a micro loan to underserved groups that includes a biodiversity conservation component (for example, organic agriculture).

The innovations discussed here are only some of the possibilities. The market is developing. This discussion is intended to provide general overview of the possibilities and areas that may spur future innovation. Unique products and transactions may be tailored to specific needs of clients and financial institutions and depend on the country context.

>> *Emerging market banks that get involved in the carbon market at an early stage will gain a competitive advantage by establishing themselves as key players within the international framework and developing internal capacity in carbon trading.* <<

BOX 3.2

FOCUS ON INNOVATIVE FINANCING

Carbon Finance

Carbon finance is a term applied to the purchase of greenhouse gas (GHG) emission reductions ("carbon credits") in trading schemes as well as the financing of climate mitigating greenhouse gas reduction projects. It is estimated that the markets for carbon credits will be worth $10 billion in less than 10 years.[a]

The carbon market developed as a result of an agreement signed at Kyoto, Japan, in 1997 by industrialized countries to limit climate altering greenhouse gas emissions, which include carbon dioxide and methane, among others. Entry into force of both the Kyoto Protocol and the EU Emissions Trading System (ETS) in 2005 has stimulated demand for emission reductions.[b] Kyoto's Clean Development Mechanism (CDM) and Joint Implementation (JI) allow Kyoto-ratifying industrialized countries to reduce greenhouse gas emissions in exchange for their investments in climate friendly technologies and infrastructure in emerging markets.

This represents an opportunity for the emerging market banking sector to get a sizable share of the growing carbon market by participating in carbon trading in two ways:

- Banks can serve as providers of credit for new projects that reduce GHG emissions. These opportunities can be found in projects relating to such fields as bioenergy, rural electrification, renewable energy and energy efficiency, urban infrastructure, forestry, and water resource management.
- Banks can act as agents of change and provide finance for their existing clients to introduce technological innovations that result in emission reductions, and thus generate carbon credits.

Asia now represents half of the supply of project-based emission reductions and Latin America represents more than a quarter (27 percent).[c] There are substantial opportunities in other regions as well. The banks that get involved in this market at an early stage will gain a definite competitive advantage by establishing themselves as key players within the international framework and developing internal capacity in carbon trading (see story on Unibanco, p. 52).

One of the major benefits of a bank's participation in carbon finance transactions is lower country (or sovereign and political) risks for lending to projects that are eligible for carbon credits. In such a case, emission reduction payments to the projects are channeled directly from the buyer to the bank that provided up-front financing for a project eligible for carbon credits. This eliminates major risks associated with emerging markets volatility.[d] This will, in turn, reduce pricing of the loans and enable banks to provide larger and longer-term loans on favorable terms, making the banks' credit more attractive for the borrowers.

Additional benefits for the banking sector may include:

- Developing a relationship with international financial institutions
- Business development from financing new type of projects

Emerging market banks that tap into the huge market for low-income and energy and resource efficient housing can capture both the bottom of the pyramid market and benefit from investing in environmental opportunities.

- Selling additional financing products, such as financing for conducting emission reduction evaluations
- Earning fees by working as in-country intermediaries for carbon deals
- Benefits to the bank because of the improved (reliable) cash stream to the project
- Improved risk profile, allowing the primary lender to benefit from the project's ability to access additional resources, such as mezzanine debt.

Participation of emerging market banks in the carbon market involves close collaboration with carbon finance funds. Carbon finance funds use money contributed by governments and companies in countries that have obligations to reduce greenhouse gases, to purchase project-based greenhouse gas emission reductions in emerging markets. The emission reductions can be purchased through carbon funds managed on behalf of the contributor, and within the framework of the Kyoto Protocol's Clean Development Mechanism or Joint Implementation.

Although some private funds are being raised, a large portion of the government-backed carbon finance funds are managed by international multilateral organizations such as the World Bank and IFC.

Source: Adapted and modified from Kossoy (2005).

a. IFC, Choices Matter (2005b, p. 57).

b. The most recent figures about trades can be found at www.UNFCCC.com

c. Pollan (2005).

d. Emission Reduction Purchase Agreements (ERPAs) are contracts denominated in hard currency, working as a natural hedge for foreign exchange risk. They are free of price fluctuations and lower lenders' concerns about borrowers, creditworthiness.

BOX 3.2
FOCUS ON UNDERSERVED MARKETS

Housing Finance for Low-income Borrowers and Energy Efficient and Resource Efficient Housing

About half the world's population—some 3 billion people—live in urban areas. Over the next 25 years, more than 2 billion people will be added to the urban population, UN-HABITAT predicts. This will greatly add to to the demand for housing, water supply, sanitation, and other urban infrastructure services. Some 96,150 housing units will need to be completed each day to meet the demand for housing.[a]

In emerging markets, a large part of the population lives in poverty or has low income. They represent a vast market for banks to provide housing and renovation finance.

Meanwhile, as much as half of energy use is estimated to be in the residential sector. Providing loans for housing projects that conserve energy and resources is an area of great market potential that can create value. Opportunities for financial institutions include:

- Mortgage finance (energy efficient retrofitting, construction loan products, credit lines to developers)
- Construction and land finance (sustainable building materials, resource maximization and alternatives, such as water and solar energy; supply chain linkages, sustainable construction techniques and community development).

First mover advantages can be significant in these huge untapped markets. The case study that follows shows how Bank of Georgia generated a market for mortgage lending in Georgia and benefited from first-mover advantage (p. 54).

a. UN Habitat(2005).

UNIBANCO

Attaining a Stronger Market Position through Sustainability

At A Glance

Unibanco is Brazil's third largest private bank, with more than 80 years in the market and consolidated assets of R$92 billion (US$39 billion) as of December 31, 2005. In 2004 Unibanco introduced major changes in its strategy and organization. It is now focused on increasing profitability, encouraging a cooperative atmosphere, maintaining excellence in human resources, and strengthening attention to the retail and wholesale business segments. The new strategy has produced results: ROAE climbed from 13.8 percent to 24.2 percent from 1Q 2003 to 4Q 2005. | **www.ir.unibanco.com/ing/hom/index.asp**

Strengthening Sustainability Management

In 2002, Unibanco became one of the first Brazilian banks to launch a social and environmental risk management system and to disclose nonfinancial information, including information on sustainability, through external reporting. Unibanco has successfully implemented its Environmental Management System (EMS), as agreed with IFC. The system has helped Unibanco increase its awareness of social and environmental matters and strengthen its overall risk management. The bank has a team of professionals dedicated to environmental management in the areas of domestic and international lending and project finance. Environmental managers have attended many sustainability training events, including IFC's Competitive Business Advantage workshops in 2002 and 2004. Since 2004, Unibanco has carried out a training program for its employees on social and environmental issues.

Adopting the Equator Principles

In June 2004 Unibanco became the first emerging market bank to adopt the Equator Principles. It signed the Principles to strengthen its project finance expertise and improve its position in the market. Unibanco applies social and environmental standards to all projects eligible for the Principles, and has more consistently implemented social and environmental control of the bank's investment projects through unified standards and tools. The bank's approach is based on the following beliefs:

- By actively targeting its business activities toward clients that have sustainable business practices, its own risk profile—and ultimately its cost of capital—will decline, thus contributing to its strategic goals of maximizing profits and efficiency.
- An improved capacity to provide assistance in social and environmental risk management attracts new clients and allows the bank to better serve existing clients in socially and environmentally sensitive areas. For example, as of December 2005 Unibanco has 20 project finance mandates totaling R$1 billion in such sectors as transmission and distribution of electric power, logistics, oil and gas exploration, health, food and drink, and agribusiness.
- Better social and environmental management improves access to funding from international financial organizations. As of February 2006, Unibanco had approximately $60 million in credit lines from international banks, including IFC, NIB, and DEG.

Pursuing Sustainability Initiatives

ENVIRONMENTAL CREDIT CARDS. Unicard backs some credit cards that channel part of the annual fee and a small percentage of charged purchases to NGOs and well-known groups such as Greenpeace, Fundação Ruben Berta, Aqualung, Abrinq, and Pelé. The 18,000 cards generated about R$154,000

We believe that the adoption of Equator Principles guidelines has been very positive for Unibanco. Environmental management has improved the effectiveness of the exchange of information between Unibanco and its clients, thus reducing social and environmental risks. Since Unibanco adopted the Equator Principles, we have counted upon IFC's support in developing our Environmental Management System.

Roberto Nakamura, Compliance Responsabilidade Ambiental, Unibanco

($72,195) in donations to the sponsored groups in 2004.
MICROCREDIT. Unibanco operates in this segment through Microinvest, a partnership of Fininvest (82 percent) and IFC (18 percent). Since 2005, Microinvest has issued over 5,000 loans totaling more than R$13 million ($5.6 million).

SOCIAL INVESTMENT FUND. Part of the Fund's revenue is donated to projects and organizations dedicated to vocational education. An initiative of Unibanco's Private Bank, the Fund had donated some R$900,000 ($420,000) as of 2005.

COMMUNITY INVOLVEMENT. Unibanco promotes its social activities through two institutes. The Unibanco Institute concentrates on education. The Moreira Salles Institute promotes Brazilian culture through photography, literature, cinema, art, and popular music.

Exploring the Carbon Finance Market

In April 2006, the Aterro Bandeirantes Project concluded its first sale of carbon credits. Located in a landfill named Bandeirantes—which receives half the waste collected in São Paulo (approximately 7,000 tons per day)—the Usina Bandeirantes thermoelectric plant is the largest plant of its kind in the world. The plant, financed by Unibanco, uses landfill methane gas to power 24 Caterpillar generator sets that produce 20 MW of electric energy: enough to supply a city of 300,000 inhabitants. Between 2004 and 2005, the project, jointly owned by Unibanco, Biogás, and the City of São Paulo, delivered 1 million tons of carbon credits generated from burning methane.

Currently, all of Unibanco's administrative buildings in São Paulo are supplied with this form of clean energy, which represents 25 percent of all energy consumed by the Unibanco group. The excess output from Usina Bandeirantes is sold to third parties by Biogeração, an independent energy producer managed by Unibanco.

© Unibanco | Usina Bandeirantes thermoelectric plant in São Paulo, Brazil (production facilities) produces clean energy from landfill gas and delivers a substantial amount of carbon credits. The plant is the largest of its kind in the world and was financed by Unibanco.

BANK OF GEORGIA

Attaining First Mover Advantage by Offering Affordable Housing Finance

At A Glance

Bank of Georgia is one of the leading banks in Georgia, with total assets of $300.2 million in the beginning of 2006. As part of the State privatization program, it was converted into an open joint stock corporate bank from the former State Commercial Housing Municipal and Social Development Bank (Binsotsbank) in October 1994. The government's shares were mostly sold to bank staff. By late 1995, the government had no direct ownership in the bank. | **www.bog.ge**

An Opportunity to Reach a Growing Market

With a branch network throughout Georgia and the largest retail customer base in the country, Bank of Georgia found itself in a good position to launch mortgage loans. However, in the early part of this decade, mortgage lending did not exist in Georgia and the banking sector was still at an early stage of development. Most bank lending in Georgia was very short-term, highly collateralized, and made to related parties. At the same time, the Government of Georgia, supported by USAID, KfW, and the World Bank, had completed important work to develop land and building registries. Moreover, properties had been privatized and most Georgians owned their own homes. All these conditions suggested that a project to finance home acquisition, home improvement, and construction could be successful.

An Innovative Financial Product

Georgian banks were struggling to attract private deposits following several high-profile bank failures. For the Bank of Georgia, long-term financing from IFC (a credit line of $3 million in 2000 and $5 million in 2003), coupled with an extensive technical assistance program, played a critical role in its successful implementation of innovative housing finance solutions. The bank's housing finance product was the first source of finance targeted at developing real estate finance in Georgia, focusing in particular on residential mortgages

*© **Bank of Georgia** | A Georgian entrepreneur stands in front of her storefront, remodeled with a small housing loan from the Bank of Georgia.*

and home improvement loans. The bank soon determined that the product with the greatest market demand and which could earn the bank the highest risk-adjusted return were residential mortgages designed for acquisitions of properties, renovations, and home improvement—often for less than $10,000. Commercial mortgages for SME activities, such as restaurants, cafes, hotels, grocery stores, retail shops, tailors, dentists and beauty salons, also proved to be commercially profitable.

Business Advantage

IFC investment and technical assistance enabled the bank to create a profitable loan portfolio and offer a new product to the bank's existing retail and commercial depositor base. Loan officers were trained in best practices in underwriting mortgage loans, assessing risk, and performing loan monitoring. Between July 2000 and December 2004, the bank approved over 644 loans worth $6.7 million. Moreover, the project brought the bank significant publicity in Georgia and some recognition internationally.

After the introduction of the IFC mortgage lending project and IFC's subsequent coordinated efforts to finance the mortgage lending sector, competition quickly followed, making housing finance increasingly attractive for borrowers. Following IFC's example, DEG provided a 3 million euro credit line to the Bank of Georgia for mortgage lending in April 2002, which allowed the bank to expand its business in this area. Other banks started making similar loans and, in five short years, competition has significantly improved the terms for borrowers.

Nonetheless, the Bank of Georgia continues to enjoy the benefits of a first mover and is using its growing expertise to develop this line of business further. By the end of 2005, the bank's portfolio of mortgage loans had grown to $21.2 million. By helping a largely underserved Georgian population gain access to finance, Bank of Georgia contributed to sustainable development while creating a profitable business.

>> *Housing finance has become one of our main business lines and a real competitive edge for Bank of Georgia. Yet mortgage lending did not exist when we started to pursue this untapped market. IFC's support was critical and helped us realize the great potential of the market for small residential mortgages.* <<

Thea Jokhadze,

Head of Funding, Bank of Georgia

Getting access to financial resources and technical assistance from the international development community and investors can help banks overcome barriers to financing new products or new areas.

© Bumaga-Yug | Bumaga-Yug, a printing/packaging company in Timashevsk, Russian Federation, acquired new equipment that reduces labor, has higher output capacity, and uses significantly less electricity. The upgrade was financed by Bank "Center-invest" under the IFC Energy Efficiency Program (see story, p. 46).

Overcoming Barriers to Investing in Social and Environmental Areas

Despite the large potential that exists in such areas as energy efficiency, renewable energy, biodiversity conservation, and socially oriented finance, providing financial products and services for projects in these areas can sometimes be difficult. Financial and nonfinancial barriers for banks to engage in these areas include the following:

- **INSUFFICIENT KNOWLEDGE.** Information about the opportunities and benefits of investing in sustainability-related areas of business is not easily available in emerging markets. Moreover, because many emerging market banks have not undertaken sustainability reporting initiatives, other players cannot learn about their achievements in these areas.
- **LACK OF INSTITUTIONAL CAPACITY.** Loan officers have little practical experience and insufficient market information to evaluate potential investment opportunities that involve innovative technological applications or other sustainability components. Because they sometimes do not understand the full economic advantage of such projects, they sometimes reject these investments as too risky.[8]
- **FINANCIAL FEASIBILITY.** Innovative projects often require financing with lower interest rates and/or longer payback periods. Longer tenors are needed so clients can achieve higher levels of production to compete with (and, in some cases, outperform) traditional technologies and areas of investment. For banks, it can mean higher returns on investments
- **LOWER GROSS RETURNS.** Because of their innovative nature, these projects are relatively small in size and have not yet reached economies of scale. While such an important gauge of a company's profitability, Return of Assets (ROA), may be within market limits, gross returns on smaller projects are less attractive. Small size also contributes to higher transaction costs.

These issues can be resolved by gaining access to financial resources and technical assistance from the international development community and investors. Financial resources such as long-term credit lines and partial guarantees can help banks overcome the barriers to financing promising projects. Banks can reap benefits by developing innovative financial solutions, coupled with best international expertise.

International development organizations such as the World Bank and IFC have become important partners in helping financial institutions in emerging markets overcome barriers to investing in and building their capacity in social and environmentally sustainable banking and sustainable finance. IFC, for example, has greatly increased financing of the emerging markets banking sector, in recognition of the importance of the financial sector as an intermediary in emerging market development. IFC's investment in the emerging market financial sector reached almost $2.3 billion in FY2005.[9] These investments are coupled with technical assistance and advisory services to financial institutions to improve their credit risk management, operational efficiency, and corporate governance.

The case study that follows illustrates how one bank, Bank Aval in Ukraine, was able to add value and attract investors, as well as spread social and environmental practices to companies in which it invests, by strengthening its capacity in social and environmental management. The bank drew on technical advice and financial support from IFC.

BANK AVAL | MEMBER OF RAIFFEISEN INTERNATIONAL BANK-HOLDING AG
Increasing the Bank's Value for International Investors

At A Glance

A part of Raiffeisen International Bank-Holding AG, Aval is one of the largest banks in Ukraine[a] and the largest provider of credit to the private sector, particularly local enterprises. It has 3.2 million individual clients, 210,000 corporate clients, and 1,400 branches and sub-branches. Aval has earned a reputation for safety, transparency, and conservatism. Financial statements have been prepared in accordance with International Financial Reporting Standards and audited by Ernst and Young of Ukraine. Aval was recognized by EBRD in 2004 for its success within the trade development program and received a commitment for $10 million to implement a housing finance program. IFC provided loans of $35 million in 2004 and $50 million in 2005, which helped increase Aval's capacity to offer longer-term funding to Ukrainian SMEs. | **www.aval.ua**

In October 2005, the Raiffeisen International Group acquired Aval in order to enter the fast-growing Ukrainian banking sector by teaming up with a financial institution that meets high international standards on performance, governance, risk management, and sustainability. Aval is targeting a 40 to 50 percent increase in its corporate client portfolio in 2006, with an average market growth of 30 percent a year in this segment. The bank will pay special attention to the quality of the portfolio. Thus sustainable investment management is an increasing priority.

Strengthening the Bank's Social and Environmental Management System

The bank has added social and environmental components to a risk minimization system previously developed with the help of Andersen Business Consulting. The earlier system streamlined decisionmaking, better defined various management processes, reduced the overlap of functions, and developed better interaction between processes. This helped the bank control costs while maintaining its market share. After a representative from Aval attended IFC's Competitive Business Advantage training in 2004, the bank decided to extend its risk management to better assess sustainability risks and opportunities. The president, the chairman, and the Board initiated the process of developing and implementing an integrated social and environmental management system (SEMS), which has been widely adopted by the bank's employees. Aval's personnel department has coordinated extensive training programs, overseas training, and incentive schemes.

Social and environmental risk assessment has been embedded in all relevant credit documents and processes such as credit risk assessment, loan approval guidelines, and client agreements. A variety of methods are used to assess sustainability opportunities: analysis of the operational and investment cycle of clients and potential clients, sales channels and supply chain, and stakeholder mapping. Consolidated financial statements of corporations and groups of enterprises are analyzed to obtain a full picture of their performance. Based on this performance and projected market changes, the bank creates a model of an enterprise's further development, which helps determine the viability of an existing investment project and prospects of developing new business.

a. Measured in terms of interest earnings, total loans, and total assets.

Meeting Market-driven Demand for Funding Sustainable Industrial Development

Such steps come at a time when Ukrainian manufacturers must comply with high standards of quality and have growing needs to upgrade their production facilities, as the scope of trade relations with the European Union and neighboring Russia widens. Clients must also grapple with Ukraine's serious energy problems. Aval's financing has helped a number of Ukrainian businesses produce competitive exports. Most of the projects the bank finances to modernize production or obtain new equipment have an environmental component, such as energy efficiency, cleaner production, or reduction in human hazards. Social and environmental management has helped the bank identify and successfully pursue environmentally savvy opportunities in the residential sector (energy efficient heating systems and energy conservation technologies), as well as in virtually all industry sectors of the country (see table, this page). Aval is evaluating the economic potential of an emerging opportunity in the form of wind power plants in southern Ukraine.

The bank finances different stages of operations and different types of enterprises, including SMEs and large firms, as well as holdings that span all stages of the supply chain in many industries. The bank offers a customized combination of products (trade finance, factoring, short- and long-term loans) that will help achieve clients' goals. This includes social and environmental components, which are integrated into each client agreement. The bank's extensive branch network enhances its capability to reach out to many SMEs that are in need of medium- and long-term financing.

The bank's due diligence risk assessment has enhanced its credibility and reputation, helping it obtain guarantees from such well-established international banks as Dresdner Bank AG, Commerzbank AG, GMBH, (Germany); Bank Austria Creditanstalt AG (Austria); ING Bank N.V. (the Netherlands); American Express Bank; and JP Morgan Chase Bank (UK). Aval has attracted $55 million in additional financing from EBRD for targeted investment in sustainability-related projects.

IFC provided substantial and, more importantly, timely support in the process of integrating sustainability considerations into our credit approval process. The bank has made a giant step forward in its development.

VIKTOR GORBACHEV,
DIRECTOR OF CREDIT DEPARTMENT, BANK AVAL

INTEGRATION OF SOCIAL AND ENVIRONMENTAL SUSTAINABILITY INTO BANK AVAL'S CREDIT ANALYSIS AND APPROVAL PROCESS

EXAMPLES OF BANK-FINANCED PROJECTS WITH ENVIRONMENTAL AND SOCIAL COMPONENTS

PROJECT	AMOUNT	IMPACT
Textile manufacturer: Full reconstruction and upgrading of production process	Đ10.967 million[a]	Significantly reduced gas consumption (~20 times); automated production to avoid worker hazards; helped attain international certification of production process and end products, facilitated exports, particularly to the EU
New mill complex: Construction and equipment	US$1.204 million	Achieved EU standards of product quality, cleaner production, and environmental protection
Micro oil processing and petrochemicals production: Construction of a plant	US$3.641 million	Guaranteed high quality of products though state-of-the-art technology for processing raw materials; avoided use of heavy metals in production technology, leading to ecologically cleaner petrochemical products
Large agricultural holding: Expansion of operation	US$2.140 million	Modernized production processes throughout the entire supply chain (better quality of produce and internationally certified end-products)
Business center: Reconstruction of one of Ukraine's biggest centers	US$3.022 million	Increased energy efficiency and thus helped increase return on investment
Dairy plant: Modernization and new equipment	US$3.600 million	Through cleaner production process, helped ensure high quality and proper international certification

Source: Aval's project list as of September 2005.

DEVELOPING BUSINESS WITH A FOCUS ON SOCIETY AND THE ENVIRONMENT

This chapter focuses on business opportunities in four fast-growing areas:

- **Sustainable energy**
- **Cleaner production**
- **Biodiversity conservation**
- **Banking services to low-income, underserved groups**

It describes how investments and strategies in each of these areas can contribute to business goals. It presents some country examples, and provides cases of banks that have innovated in these areas: how they went about developing their business, and how it worked for them. It also looks at an opportunity for banks to benefit through the financing of improvements in the corporate governance of client companies.

In pursuing business opportunities with a focus on society and the environment, banks should identify priority areas and focus on them. Sustainability is an evolving terrain and new opportunities are constantly emerging. The discussion that follows is only illustrative. Banks may also need to tailor products and services to meet the needs of clients and anticipate or respond to changes in the market and overall business context.

Sustainable Energy

TAKING ADVANTAGE OF MARKET-BASED INCENTIVES AND REGULATORY FRAMEWORKS

A number of drivers are converging to encourage investments in sustainable energy. **Energy efficiency** directly impacts the bottom line of many businesses in emerging markets, as energy costs are increasing faster than other overhead expenditures. Examples of investment possibilities for energy efficiency include building construction and renovation with energy-saving features, cogeneration or combined heat and power (CHP), efficient lighting (such as municipal street lighting), fuel switching (changing to lesser polluting and more efficient fuel sources), heating and cooling.

The same drivers are also stimulating development of **renewable energy** sources, such as wind power, solar energy (solar photovoltaic cells, and solar thermal energy), micro hydropower plants, biogas, and biofuels. Recognizing the potential of these sources, many emerging market governments have implemented programs that stimulate development of renewable energy, with support from international organizations.

Banks have a huge role to play in financing energy efficiency and renewable energy projects. For example, carbon finance has become a real market-driven mechanism that is increasing lending to a number of industries and projects that normally would be difficult to finance (see chapter 3). The sale of carbon emission reduction credits is an extra stream of revenue for a project.

HOW DOES FINANCING ENERGY EFFICIENCY AND RENEWABLE ENERGY CONTRIBUTE TO BUSINESS GOALS?

- *Access to large market with high growth potential:* The global potential for lending to energy efficiency projects is $80 billion a year, according to IFC estimates. Financing renewable energy projects offers competitive advantages for financial institutions. Banks that build expertise in feasibility assessment and profitability analysis of lending to such projects will capitalize on the first mover advantage in these untapped markets (see stories on energy efficiency, Bank "Center-invest," p. 46, and renewable energy, ACBA Leasing, p. 62).
- *Expanding commercial offering to existing clients:* Opportunities in funding energy efficiency projects exist in a wide variety of industrial and retail segments. Banks can offer loans to their existing customers to upgrade their technologies to achieve energy savings in areas as diverse as infrastructure, manufacturing, housing, building maintenance, and rural and urban municipalities. Such financing may compliment almost any bank product.
- *Market differentiation:* Banks can differentiate themselves through financial innovations, such as carbon trading and various schemes of financing energy projects.
- *Lower credit risk and improved portfolio strength:* Bank clients that have achieved cost savings through energy

© Kuban Confectionary Manufacturing Factory | *A chocolate-forming machine at the Kuban Confectionary Manufacturing Factory, Krasnodar, Russian Federation. The new machinery improves product quality, increases output, reduces labor, and saves energy. The upgrade was financed by Bank "Center-invest" under the IFC Energy Efficiency program (see story, p. 46).*

© Unibanco | *Usina Bandeirantes thermoelectric plant in São Paulo, Brazil (A view from above), the largest of its kind in the world, delivers substantial amount of carbon credits (see story, p. 52).*

efficiency will be less vulnerable to operational risks and have more stable revenue streams that are less dependent on energy costs. Moreover, they will meet government requirements for energy consumption and production process certification. These achievements will reduce the indirect risks of nonperforming loans for banks that have lent to those clients.

- *Revenue growth:* Providing energy efficiency and renewable energy finance attracts new clients and increases business volumes from existing clients through cross-selling of financial products.
- *Increased brand value:* By participating in regional and national government programs that finance sustainable energy, banks can enjoy greater visibility and the advantages of working with large customers, such as municipal governments.
- *Improved access to international financing:* International financial organizations increasingly provide financial resources to financial institutions for targeted lending to energy efficiency and renewable energy projects.

Country Examples and Opportunities

BRAZIL: GROWING MARKET FOR BIOFUELS

Over the past few decades, Brazil has been successful in producing ethanol from sugarcane, and biofuel production costs have become competitive with petroleum prices. Between 1975 and 2004, 230 billion litres of gasoline were displaced by ethanol in Brazil. Today, 5.4 million hectares and 320 conversion plants are used for producing and processing sugarcane, and 12.5 billion litres of ethanol are produced per year.[1] Ethanol production is focused in the productive center-south of the country. After a period of stagnation, the ethanol market has been revitalized by the advent of flex-fuel vehicles (which can run on any combination blend of gasoline and ethanol) and now accounts for 40 percent of motor fuel in the country. Opportunities for exports are also great. The regulatory-induced demand in OECD countries is now driving interest in international export of biofuels from developing countries that can produce biofuel cheaply, presenting a great opportunity for financial institutions.

INDIA: A BIG AND DEVELOPING MARKET FOR SOLAR ENERGY

India is one of the few tropical countries with long days and plenty of sunshine, and is suitable for harnessing solar energy for a number of applications. The government plans to more than double the installed capacity of energy from renewable sources from 3,700 MW to 10,000 MW by 2012.[2] India has one of the world's largest programs for deployment of renewable energy products and systems: a countrywide solar photovoltaic program. The solar photovoltaic industry in particular offers huge growth potential, as the Government of India is planning to electrify 18,000 remote villages by 2012 using solar photovoltaic systems.[3] The Indian photovoltaic industry has successfully gone through the education, policy support, standards, and demonstration and industry involvement phases, and is on the verge of maturing into a demand-driven market. Opportunities for financial institutions can be found in financing the manufacturing and installation of solar equipment and the necessary infrastructure, as well as after-sales service.

UKRAINE: REDUCING ENERGY CONSUMPTION, INCREASING INVESTMENT IN RENEWABLE SOURCES

Ukraine's dependence on **foreign** energy supplies in some parts of the country is as high as 80 percent for oil and 75 percent for natural gas. Energy safety issues have affected the country's economic competitiveness as well as economic and political interests in the international arena. Ukraine has a good potential for wind power plants on the coast of the Black Sea in southern Ukraine, where winds are strong. The development of wind power in Ukraine is part of a worldwide trend, in which global wind energy capacity is expected to more than double over the next five years and triple by 2010.[4]

ACBA LEASING

Attracting New Business by Strengthening Capacity in Renewable Energy Projects

At A Glance

ACBA Leasing is the first leasing company ever registered in Armenia. ACBA Leasing actively supports farms and other SMEs in upgrading their equipment and means of production, improving their risk management, and bringing their activities closer to international standards. Part of one of Armenia's largest banks, ACBA Bank, it was founded by ACBA Bank, Credit Agricol Leasing, IFC, and LLC (Lebanese Leasing Company). As of March 1, 2006, ACBA Leasing had a lease portfolio totaling $3.2 million. | **www.acba.am (ACBA Bank)**

© ACBA Leasing | A micro hydropower plant provides energy for rural Armenia. The project was financed by ACBA Leasing.

In Armenia, in the absence of a proper legal environment, the integration of social and environmental sustainability is being driven by increased competition from foreign banks and new financial products. In this environment, the application of international standards of risk management is critical for business success. Leasing is an important instrument for financing economic development, especially for SMEs.

After a representative of ACBA Leasing attended IFC's Competitive Business Advantage workshop in Moscow in November 2004, sustainability practices became an integral part of ACBA Leasing's work with its clients. ACBA Leasing has

- Evaluated the advantages of integrating sustainability practices
- Developed a sustainability policy
- Analyzed sustainable development issues
- Planned management procedures
- Organized internal audit and monitoring procedures
- Organized external reporting to local authorities and investors

As a result of these activities, ACBA Leasing started two small projects in the area of renewable energy in 2004. They provided $130,000 in equipment for two micro-hydro stations. Before starting the project, ACBA Leasing carried out a detailed study of the potential of micro-hydro in the Armenian market and consulted with the equipment manufacturer to evaluate the project's technical and economic advantages and after-sales service.

> Financing micro-hydro stations is a good alternative for Armenia, where atomic energy has been a major supply of power. Micro-hydro started as a small project but turned out to be a catalyst for establishing an entire line of business in renewable energy finance. A small investment grew into a new financial product that differentiates us in the Armenian market. We attract new clients, get repeat business, and are thinking about financing other renewable energy areas.
>
> Arsen Bazikyan,
>
> Deputy Director, ACBA Leasing

The projects had the following impact on ACBA Leasing's business:

- They led to development of a new financial product that supports alternative energy sources and benefits local communities—Micro-hydro uses water as an energy source without polluting the environment, while reducing local demand for other sources of energy. The projects also created 17 jobs with better working conditions.
- The client's profitability increased, and the client decided to apply for an additional loan from ACBA Leasing to expand its business and build another micro-hydro station.
- ACBA Leasing gained confidence in financing renewable energy projects. As a result, ACBA Leasing was invited to share its experience at a local workshop.
- Good reputation and publicity helped ACBA Leasing attract other clients interested in renewable energy.
- Client demand has led to the prospect of developing business in other areas of renewable energy. For example, ACBA Leasing is collaborating with a new client to develop a new financial product called Solaren Leasing, which involves the leasing of equipment for solar power stations.
- Today, manufacturing equipment and equipment for hydro stations comprises 15.7 percent of ACBA Leasing's total leasing portfolio.

ACBA Leasing's experience in social and environmental management is bringing substantial business benefits and is being transferred to ACBA Bank through regular training programs. With over 100,000 accounts in all regions of Armenia, the incorporation of sustainability principles in the bank will have a great impact.

Cleaner Production

REDUCED CREDIT RISK AND BETTER RETURNS

Cleaner production is an integrated strategy to maximize profits by making more efficient use of natural resources (materials, energy, or water) in manufacturing and service industries, while minimizing waste and emissions at the source. A business-oriented, problem-solving approach focused on improving production efficiency, cleaner production is best business practice. The drivers are usually legislative compliance and the continuous quest for lower manufacturing cost. Additional benefits are increased eco-efficiency, reduced incident and reputational risk, and better social outcomes.

Opportunities for the banking sector come in two forms. The first is providing loans to help firms upgrade existing equipment and production facilities, improve and attain certification of production processes, and use new materials. The second is investment in new production facilities that use new technologies and environmental equipment. The returns on investment in the second type of opportunity typically will be higher, according to some studies of cleaner production benefits.[5]

HOW DOES FINANCING CLEANER PRODUCTION CONTRIBUTE TO BUSINESS GOALS?

- *Access to market with high growth potential:* As regulatory frameworks in emerging markets improve and foreign buyers increasingly require goods produced using certified clean production processes, the demand for equipment and financing of production process improvements will grow. A considerable part of the installed industrial base and of the energy production capacity in Africa, Asia, Latin America, and Eastern Europe is obsolete and needs to be replaced in the coming years. Cleaner production provides a cost-effective and profitable opportunity to do so.
- *Stronger, more diversified portfolio:* A manufacturer using cleaner production is likely to benefit from a cost-based competitive advantage as well as enhanced brand image, and thus is likely to be more profitable. Moreover, opportunities exist in virtually every sector, from agriculture to energy generation
- *Lower credit risk:* Investing in cleaner production reduces the social and environmental risks of lending, by lowering manufacturing costs, minimizing hazards to workers, and reducing waste production and emissions. Client companies can better comply with regulations and avoid legal liabilities, while also reducing operational risks, such as costly clean-ups and production disruptions because of public protests.
- *Revenue growth:* Providing loans or leasing equipment for cleaner production will generate additional revenue streams from both new and existing clients (through cross-selling of financial services).
- *Market differentiation*: Gaining in-house knowledge and capacity for financing cleaner production projects will attract clients with a need for such services and will generate additional revenues from advisory services.
- *Increased brand value*: The reputational gains include better community relations from supporting a cleaner local environment, and improved ability to attract financing from international financial institutions for on-lending to finance cleaner production projects or provide guarantees.

Country Examples and Opportunities

HONG KONG: FINANCING CLEANER PRODUCTION TO MEET EUROPEAN STANDARDS IN ELECTRONICS MANUFACTURING

Hong Kong's electronics industry accounted for almost half (45 percent) of Hong Kong's total exports in 2004.[6] Starting in 2005, Hong Kong producers of electronic equipment must meet two new EU directives to design electrical and electronic equipment in a more environmentally friendly and efficient way, which takes waste management fully into account. These are the Waste Electrical and Electronic Equipment (WEEE) Directive[7] and the RoHS Directive restricting the use of certain hazardous substances. Companies must act now to make sure that their products do not contain the banned substances,[8] as this involves changes not only in product design, but also in stock control, production, and other processes. Manufacturers need capital to finance such changes to keep their market share.

MEXICO: HIGH POTENTIAL FOR ENVIRONMENTAL TECHNOLOGIES

Mexico invests more in the environmental sector than any other country in Latin America, except Brazil. Water and wastewater investments represent approximately 60 percent of Mexico's environmental market, followed by air pollution control equip-

© Banco Itaú-BBA | The Santa Adélia in Jaboticabal in São Paulo, Brazil, a sugar cane cogeneration project financed by Banco Itaú-BBA (see story, p. 34). Residues of sugar cane production are used to generate clean energy for local energy distributors and the client's own use.

ment at 21 percent, and municipal and hazardous waste at 12 percent and 5 percent, respectively.[9] Industrial wastewater equipment and services industry total market was $369.2 million in 2005 and is expected to grow by approximately 6.4 percent from 2006 to 2007. The total market for hazardous waste equipment and services was $508.9 million in 2004 and is expected to grow by 8.8 percent from 2005 to 2006. The National Water Commission (Comision Nacional del Agua, CNA) is planning to invite private companies to bid on the construction of at least 36 new wastewater treatment plants.[10]

TURKEY: TEXTILES AND CLOTHING INDUSTRY NEEDS CAPITAL TO UPGRADE PRODUCTION

Turkey's textile and clothing industry is regarded as a key industry propelling the country's progress. It accounts for 10 percent of GDP, 21 percent of industrial production and industrial employment, and 37 percent of total manufacturing export earnings.[11] The European Union has become Turkey's main trading partner, importing 10,571 million euros of textile products from Turkey in 2004.[12] However, Turkish producers are finding it challenging to comply with European legislation on social and environmental requirements for exporters, including market requirements such as hallmarks, management systems, and codes of conduct. Meeting these requirements is especially important in light of Turkey's desire to join the Union. Joining the Union will also eliminate trade barriers and probably spur demand to expand production facilities. Turkish textile and clothing producers will have increased need for capital to upgrade their equipment and modernize production processes.

Biodiversity Conservation

HELPING CLIENT-COMPANIES BOOST PRODUCTION AND EXPORTS OF PRODUCTS THAT CONSERVE BIODIVERSITY AND PRESERVE NATURAL HABITATS

A major driver for businesses to take biodiversity and natural resources into account is green consumerism. **Green consumerism** aims to create a balance between the expectations of consumers and the profit motives of businesses, within the context of environmental protection. It calls upon consumers to look at the entire life cycle of their purchases because a consumer does not just buy a product, but also everything that went into its production, and everything that will happen as a result of that product. Green consumerism also calls upon businesses to respond quickly to demands of consumers for products and services that are environmentally friendly.[13]

The following areas offer especially strong business models for financing biodiversity protection and natural resources conservation:

- Financing more **sustainable production** in such industries as organic agriculture, sustainable fishing, forestry, and non-timber forest products. Sustainable production in these areas often needs to be confirmed by certification.
- Financing **sustainable supply chains**. Banks can fund different stages of the supply chain to help ensure that sustainable practices are used.
- Financing **sustainable tourism**. Banks can lend to hotel and resort developers, tour operators, tourism infrastructure, hotels, and privately owned conservation attractions to promote tourism that protects the environment and/or conserves biodiversity.[14]

Country Examples and Opportunities

CHINA: CAPITALIZING ON THE GROWING ECONOMIC VALUE OF NON-TIMBER FOREST PRODUCTS

The total world trade in Non-Timber Forest Products (NTFPs) such as mushrooms, berries, honey, and medicinal plants has reached $11 billon and growth has averaged nearly 20 percent a year for the last decade. China has been a major player in this market and is the largest producer of NTFP. By 2004, the share

URALTRANSBANK:

Offering Financing for Cleaner Production and Energy Efficient Technologies

At A Glance

UTB is one of the five leading banks in the Sverdlovsk Oblast and the eleventh largest in the Ural Federal District. With a main office in Yekaterinburg (Ural region), the bank has 43 branches and offices throughout the region, and a wide client base comprised of large industrial enterprises as well as SMEs. The European Bank for Reconstruction and Development (EBRD) holds a 25 percent + 1 share in the bank. IFC provided a $10 million loan to UTB in 2003 to increase the bank's capacity to provide credit to local SMEs. | **http://www.utb.ru/**

Market Demand

The Ural region has one of Russia's greatest concentrations of industrial enterprises. The region's industrial base is developing rapidly, especially in the light industrial non-ferrous machine sectors. The equipment and production technologies of these enterprises are often outdated, and companies need considerable investments to sustain their market position and meet new quality standards and environmental requirements. With its extensive network of branches throughout the region and a strong pipeline of projects in various industrial sectors, UTB is well positioned to help clients achieve the benefits of increased energy efficiency, cleaner production, more effective waste utilization, and biotechnology.

Investing in Sustainability

UTB invests in sustainability in a variety of ways. For example,

- UTB actively supports small businesses that use advanced technologies to process waste generated by the wood processing industry. These technologies lower industrial demand for new timber, thus reducing logging. The bank has channeled $700,000 through regional timber and forestry companies to these small enterprises.
- UTB actively pursues opportunities in the automotive and auto services market to help enterprises meet emission requirements, such as Euro 4—one of the latest EU standards for emission regulations for passenger cars and light commercial vehicles—which affects major automotive companies present in the Russian market, including BMW, Peugeot, Renault, and Toyota. The bank had made $1.3 million in investments in this area as of January 1, 2006.
- UTB is taking advantage of the growing market for energy efficiency by including it as a priority in the bank's Business Development Strategy for 2006, which focuses on long-term financing for energy efficiency projects.
- UTB had invested $450,000 as of January 2006 for new equipment to produce a unique biomedicine for cells cultured for replacement therapy.

Increased Competitiveness

With a high number of financial institutions in the Ural region, competition is intense. Financing new projects in innovative, sustainability-driven areas allows the bank to implement more comprehensive business processes while lowering risks and unforeseen costs associated with local and nationwide environmental requirements. UTB has received strong support from international financial institutions, including EBRD and IFC. In 2004 UTB received technical assistance from IFC to improve its credit risk management, operational efficiency, and corporate governance. Representatives from the bank also attended a Competitive Business Advantage workshop in Moscow in 2004.

> *With a high concentration of industry in the region, UTB understands that cleaner production and energy efficiency technologies are key factors determining competitive advantage. We have responded by developing financial product lines to help industry take advantage of these technologies. Collaboration with international financial institutions is our major competitive advantage and proof of the bank's strong performance.*

SERGEI NETEPENKO, SENIOR AUDITOR AND MANAGER INVESTOR RELATIONS, UTB

of NTFP in China's forestry sector was comparable to timber and wood products. Major products include bamboo ($400 million), nuts ($80 million), and dried mushrooms ($20 million), with increasingly large portions for export. The industry is growing and includes 680,000 hectares of plantations, in addition to natural forests. More than 1,000 plants process NTFPs.[15]

KENYA: INVESTMENTS IN SUSTAINABLE TOURISM YIELD HIGH PROFITS

Kenya is one of the foremost tourist destinations in Africa. The tourism industry accounts for more than 800,000 visitors annually, 80 percent of whom come for natural attractions, including wildlife and beaches. Over the past few decades, approximately 10 percent of the country has been set aside for conservation of wildlife and biodiversity.[16] Kenya's National Tourism Master Plan underscores the need to diversify the tourism product range and open up new avenues such as adventure tourism, lake cruises, canoeing conferences, sports and cultural pursuits. While implementing the plan, care has been taken to ensure that developments are not carried out at the expense of environmental considerations. Tourism revenues grew 15.9 percent in 2005, much of it in hotel subsector, earning about $680 million.[17]

LATIN AMERICA: INVESTING IN THE INTERNATIONAL COMPETITIVENESS OF ORGANIC FARMING

The world's market for organic products is growing quickly and is valued at $23 billion.[18] Argentina, Brazil, and Mexico have some of the world's largest tracts of land set aside for organic farming.[19] In Mexico, for example, organic land area and production is expanding at 45 percent a year; virtually all (98 percent) of the country's certified organic production is for export.[20] Many studies show that a switch to organic production in Latin America improves profitability.[21] Although about 40 percent of Latin American agricultural products are organically cultivated, a large portion of them are not certified because of the high cost of this process.[22] Importers are implementing new regulatory frameworks for organic agriculture that require organic products to be produced and certified according to national standards in foreign markets. For example, exporters will face new European Union regulations by 2006.[23] This presents an opportunity for the financial sector to target new business arising from financing organic technologies and certification.

Banking Services to Low-income and Underserved Groups

NOT JUST CORPORATE RESPONSIBILITY, BUT CAPTURING A HUGE, UNTAPPED MARKET

Providing access to finance for underserved segments in emerging markets is increasingly seen as part of the corporate responsibility of banks by some major stakeholders.[24] However, for banks operating in emerging markets, it can mean far more than that. Large portions of the population belong to groups traditionally excluded from mainstream banking services. Poor people have immense entrepreneurial capabilities. Some of the world's most exciting, fastest-growing markets can be found at the bottom of the pyramid.[25] Some of the banking opportunities to low-income, underserved groups include

- SME products
- Microfinance funds and intermediaries
- Housing finance (access to housing and community redevelopment)
- Access to finance for women entrepreneurs
- Indigenous Peoples enterprise finance
- Other forms of economic empowerment, such as trusts, pension funds, resource revenue management models, and global banking alliances for women
- Islamic finance
- Channeling of remittances into savings, credit, and investment products and services

How does this contribute to business goals?

- *Access to large markets:* More than 4 billion people around the world have incomes of less than $1,500 per year. Combined, low-income markets present a huge opportunity for financial services.
- *Revenue generation:* The poorest of the poor often operate in the informal economy, which by some estimates accounts for 40 to 60 percent of all economic activity in developing countries—and thus represents a vast market for credit.
- *Lower competitive pressure:* Maturing consumer and financial markets in developed countries are pushing capital flows into the developing world, where the concentration of low-income populations is the greatest.

© Nedbank | *The Rustenberg wine estate in South Africa. The biodiversity and wine project of Nedbank's Green Trust (see story, p. 29) encourages wine estates to undertake efforts to conserve the unique biodiversity of the Cape Fynbos region as part of their wine production.*

- *Lower credit risk:* A number of studies have demonstrated that low-income customers in microfinance and SME investments—particularly women-run businesses—have *lower* credit risk than better-off borrowers. For example, recent figures from Bank of Indonesia's show that only 0.01 percent of loans to SMEs are nonperforming.[26]
- *Market differentiation:* Low-income customers can be reached with a variety of banking products and services through innovative financial solutions and delivery mechanisms, such as partnering with microfinance organizations and/or international financial organizations. For instance, the World Bank estimates that there are now more than 7,000 microfinance institutions, serving some 16 million poor people in developing countries, the World Bank estimates.
- *Brand value and reputation:* Lifting people out of poverty can boost the reputational advantage of a financial institution, winning community support. It may also result in greater government support and financing from international development banks and aid agencies, as their main goals are poverty alleviation and providing access to credit to underserved populations.

Examples of Opportunities

MICROFINANCE AND BANKING: A PROFITABLE ALLIANCE

Microcredit is a financial innovation that originated in developing countries, where it has successfully enabled extremely impoverished people (mostly women) to engage in self-employment projects that allow them to generate an income and, in many cases, begin to build wealth and exit poverty. Because the success of microcredit has been demonstrated in many markets, many institutions in the traditional banking industry have begun to realize that microcredit borrowers should more correctly be categorized as pre-bankable: they have a potential to use microcredit as an entry to other banking services. Thus microcredit is increasingly gaining credibility in the mainstream finance industry. Many traditional large banks are contemplating microcredit projects as a source of future growth. Banks have increasingly entered in partnerships and initiatives with microfinance NGOs to develop delivery mechanisms that channel financial resources to the markets that have been beyond the reach of banks. Successful examples of such schemes in emerging markets include ICICI bank in India, Grameen bank in Bangladesh, and Barclays Bank, which operates in a number of developing countries. The case study of ACLEDA bank in Cambodia illustrates some of the possibilities of commercializing microfinance successfully (p. 70).

EMPOWERMENT OF DISADVANTAGED GROUPS

The private sector's responsibility for human rights is now at the top of the human rights agenda and the sustainable development agenda. Women, indigenous people, and visible minorities can be good prospective markets. For example, in Sub-Saharan Africa, women run about 40 percent of businesses, yet have very limited access to obtaining finance because of gender inequality. The case study of First Rand shows how a bank in South Africa is expanding its activities to achieve Black Economic Empowerment (see p. 72).

BOX 4.1

FOCUS ON INNOVATIVE FINANCING

SUPPORTING SUSTAINABLE SUPPLY CHAINS

Many purchasers are adopting a more strategic relationship with their suppliers by incorporating environmental, labor, and governance criteria into contractual relationships. A number of EU and international eco-labeling schemes make sure that products of particular industries, including the fishery, forestry, and agriculture industries, meet the strict export standards of the European Union, North America, and other major markets. Suppliers able to meet their eligibility requirements are likely to enjoy increased business. However, many firms (often small enterprises) lack the essential financial and technical support to improve operational performance.

Financial institutions have opportunities to finance projects and companies that conserve biodiversity and/or use resources sustainably to improve their production processes and attain necessary certification to export their products. The demand for such financing is already high. In the absence of other lending, purchasers or international brokers frequently meet suppliers' demand for short-term and pre-export finance. Financial institutions can stake a claim in this promising market by providing financing themselves. The involvement of purchasers that undertake an obligation to buy products of biodiversity-friendly companies for their supply chain reduces collateral risk, further enhancing the attractiveness of deals, with typical paybacks in the seven-year range.

How does financing sustainable supply chain contribute to a bank's business goals?

- LARGE MARKET WITH GOOD GROWTH POTENTIAL: The market for sustainable and organic goods is growing. Moreover, opportunities to finance suppliers exist in multiple sectors, including timber, cotton, sugar, coffee, cocoa, fruit, vegetables, and flowers.
- LOWER CREDIT RISK: Helping suppliers implement best environmental, social, and governance practices is likely to be reflected in sound risk management, operational efficiencies, and increased profitability, thereby reducing exposure to credit risk.
- IMPROVED CLIENT SERVICE: Finance is essential to help suppliers produce a better quality product in order to meet the eligibility requirements of large companies that are sourcing these products and facilitating integration of sustainability in their supply chains (often involving certification). Banks can benefit by building competitive and profitable businesses, which add to their portfolio volumes and returns.
- MARKET DIFFERENTIATION: Sustainability standards have become a competitiveness issue for suppliers. Banks well-acquainted with the specificities of the sustainable supplier market and offering value-adding services to improve sustainability performance can extend their market reach.
- INCREASED BRAND VALUE: Financial institutions can enjoy the reputational benefits of supporting businesses that have good environmental, social, and governance standards, which in turn generate increased brand value among policymakers, shareholders, and customers.

ACLEDA BANK PLC.

Promoting Sustainable Microfinance

At A Glance

The Association of Cambodian Local Economic Development Agencies (ACLEDA) started in 1993 as a nongovernmental organization (NGO) under a UNDP/ILO business development project to provide microfinance loans to the poor. With support from IFC, it was relicensed as a commercial bank in 2003. Today, ACLEDA Bank is Cambodia's second largest lender and has Cambodia's largest banking network, with 141 branches and district offices. Its loan portfolio exceeds $100 million (up from $10 million in 1998). Almost two-thirds of ACLEDA's 141,672 borrowers were women as of January 31, 2006. ACLEDA's ROA in 2005 was 3.67 percent. ACLEDA is a profitable microfinance organization and (unusual for a start-up bank) has paid dividends consistently every year since 2000. In addition, ACLEDA is the only Cambodian bank to have obtained an international credit rating. It is now 51 percent-owned by Cambodia interests, including its staff, with the remainder taken up in equal parts by IFC, DEG, FMO, and Stichting Triodos Doen, together with Triodos Custody B.V., as custodian of Triodos Fair Share Fund. | **www.acledabank.com.kh**

A Leading Provider of Microfinance Services

When ACLEDA started its operations in 1993, no commercial bank operated outside Phnom Penh and more than half a million refugees and internally displaced people were returning and resettling in Cambodia. For one of these refugees, In Channy, ACLEDA's founder, launching ACLEDA presented the opportunity to realize his dream of improving poor people's lives. Mr. Channy and his colleagues built ACLEDA one client at a time. In the beginning, ACLEDA's credit officers would walk to villages in search of clients. By 1998, they were serving about 55,000 small borrowers.

A Commercial Bank

As ACLEDA continued to grow, the leadership felt the constraints of being organized as an NGO with board oversight from donor organizations and sought the greater flexibility, commercial self-reliance, and access to capital of a private organization. In 1998, ACLEDA received its first support from IFC, in the form of technical assistance through IFC's Mekong Private Sector Development Facility. ACLEDA, by then the largest microfinance institution in Cambodia serving small businesses across the country, began looking for commercial investors.

At the same time that IFC was financing technical assistance, ACLEDA's internal leadership was also actively driving the transformation of the organization by getting their members and shareholders on board and talking to their clients and the government.

Through investments in 2000 and 2003, IFC acquired an equity stake in the company, mobilized other investments, and provided financing to expand the bank's lending to microenterprises. Considering ACLEDA's success and the vital role microfinance institutions can play in bringing financial services to rural areas, the National Bank of Cambodia soon licensed ACLEDA as a "specialized bank" and relicensed it as a commercial bank in 2003.

>> *It is my firm belief that sustainable microfinance is an important tool for economic growth at the grassroots level and a powerful tool in the fight against poverty. IFC has been a valuable partner in helping us become a full-fledged commercial bank that brings critical financial services to ordinary entrepreneurs and families in urban as well as rural areas.* <<

In Channy, Founder and General Manager, ACLEDA Bank

A Promoter of Social and Environmental Sustainability

ACLEDA Bank is focused on achieving strong, sustainable financial returns, while respecting the environment and community within which it operates. It has adopted a number of policies that prohibit the provision of credit to activities that might harm the environment, be morally repugnant, or jeopardize human rights. ACLEDA is developing indicators for measuring and reporting on its performance and impacts on society and the environment, and is working to implement a reporting structure based on the guidelines of the Global Reporting Initiative. For this purpose, ACLEDA became an active participant and supporter of the Transparency and Sustainability in Finance initiative led by Triodos Bank, a Dutch bank that provided a loan to ACLEDA through its Triodos-Doen Foundation and which is one of ACLEDA's founding shareholders.

In 2003 the bank appointed a full-time Environmental Officer. It has introduced a number of initiatives to improve its environmental performance. In addition, the bank is taking steps to reduce the environmental impact from its own operations, such as recycling paper and conserving water.

Functioning as a commercial bank has allowed ACLEDA to launch several innovative new products and services targeted to consumer and retail customers. ACLEDA is thus achieving its business goals, while retaining a commitment to sustainable development.

Source: Schulich School of Business, York University (2005) and the ACLEDA Bank Web site.

© ACLEDA Bank, Plc. | *Opening ceremony of ACLEDA Bank, Plc, Cambodia, a microfinance institution that successfully transformed into a commercial bank with IFC's assistance.*

FIRSTRAND LIMITED:

Promoting Black Economic Empowerment through the Financial Sector

At A Glance

FirstRand Limited (FirstRand) is a financial services group covering the full spectrum of banking and insurance activities. Its wholly owned banking subsidiary, FirstRand Bank, represents approximately 80 percent of the group's total profits and is one of four banks that collectively account for 85 percent of the country's banking market, along with Standard Bank, ABSA,[a] and Nedbank. FirstRand Bank has about a 19 percent market share of the South African banking sector and has $58 billion in assets, $39 billion in loans, and $4.6 billion in equity. Standard Bank and ABSA were the first banks in South Africa to undertake transactions to meet the requirements of the country's Financial Sector Charter. FirstRand approached Black Economic Empowerment (BEE) transactions as a way to differentiate the bank in a competitive market. The FirstRand transaction has set a benchmark for future BEE transactions in South Africa across sectors. Although the four major banks have now completed BEE deals, more activities are expected among other financial institutions and firms. | **www.firstrand.co.za**

The Business Case for Black Economic Empowerment in South African Financial Institutions

Post-apartheid South Africa is responding to the long-standing economic marginalization of black South Africans by transforming its economy through a concept known as Black Economic Empowerment (BEE). Recognizing that South Africa's economic and social inequalities prevent the country from achieving its full economic potential, the South African government developed a BEE Charter in the mining sector. Other industry-led initiatives have followed, including the financial, petroleum, construction, agriculture, information and communications technology, maritime, and tourism sectors. The Financial Services Sector Charter was the first industry-led BEE charter. Signed in October 2003, the Charter establishes the principles upon which BEE will be implemented in the financial sector, establishes targets to implement the principles, and outlines mechanisms to monitor and report on progress.

The FirstRand Black Economic Empowerment Transaction

Seeking a broad-based deal, FirstRand finalized the terms of its BEE transaction in early 2005, with IFC's participation. The deal included the financing and transfer of 10 percent of FirstRand's share capital to four trusts, which obtained the full economic and voting rights associated with their ownership (see figure, p. 73). The trusts were selected based on their broad base of black stakeholders, business history, institutional track record, strong social development programs, and ability to add value to FirstRand's business.

The BEE transaction created incentives for the BEE partners to contribute actively to FirstRand's value creation and business initiatives. The directors of the partner beneficiaries sit on FirstRand's board of directors. In addition to black ownership and control through board representation, FirstRand's BEE program includes skill development and training for black professionals

a. Barclays purchased a 54 percent share in ABSA in May 2005 for $5.1 billion

FirstRand

6.5% ownership	3.5% ownership
FIRSTRAND EMPOWERMENT TRUST	STAFF TRUSTS
MARKET VALUE OF FIRSTRAND SHARES: R5.2B	MARKET VALUE OF FIRSTRAND SHARES: R2.8 BILLION
R2.9 billion Third party financing	R2.1 billion contribution
BENEFICIARIES: Kagiso Trust (2% ownership worth R1.6 bn)	BENEFICIARIES: Black employees and black non-executive directors:
Mineworkers Investment Trust (0.83% ownership worth R650 million)	Black Employees Share Trust (2.9% ownership worth R2.3 bn)
Women Development in Banking Trust (0.83% ownership worth R650 million)	FirstRand Staff Assistance Trust (0.3% ownership worth R281 m)
FirstRand Empowerment Foundation* (2.1% ownership worth R1.6 billion)	Black Non-Executive Trust (0.3% ownership worth R211 m)
R600 million or 0.74% of shares allocated to beneficiaries based on their performance	

* At the commencement of the transaction, 100% of the shares aquired by the First Rand Empowerment Trust will benefit broad-based BEE groups.
5.5 Rand = $1 US Source: FirstRand Bank

>> *Our approach to social transformation through BEE has resulted in new business opportunities which present themselves because of a paradigm shift in our business, our industry, and our society. We are developing new products and services for a market that was previously not on our radar screen, to the benefit of all.* <<

Marlene Hesketh, Head,

Transformation of First Rand Limited

and managers, increased access to financial services by underserved black South Africans, and additional procurement from black-owned businesses.

A unique feature of FirstRand's BEE transaction is that it includes performance incentives for the beneficiary trusts. FirstRand will allocate approximately $100 million over seven years to the trusts according to their contribution toward FirstRand's business. This incentive scheme is designed to ensure proactive involvement and participation by the BEE partners and encourage the generation of business development ideas, particularly, but not exclusively, for disadvantaged populations, such as microfinance, providing low-income housing loans, and banking the unbanked.

Source: Adapted from McKague (2005).

BOX 4.2
FOCUS ON BUILDING A STRONGER PORTFOLIO

FINANCING IMPROVEMENTS IN CORPORATE GOVERNANCE IN CLIENT COMPANIES

Sustainable businesses are well-governed businesses. Well-governed companies benefit from higher prices for their shares, have access to cheaper debt, and simply perform better than their poorly governed peers. Firms with transparent and professional boards of directors are also more likely to understand the importance of taking social and environmental considerations seriously and mainstreaming them in their operations.[a]

Good corporate governance—well-defined shareholder rights, strong internal controls, high levels of transparency and disclosure, and an empowered board of directors—can improve a company's performance and profitability, and make it more attractive to investors and lenders. For this reason, corporate governance is an increasingly important consideration for businesses, especially those in emerging markets, where corporate governance improvements can improve a firm's access to capital and access to international markets. This opens opportunities for banks to offer client companies special financing to undertake improvements in their corporate governance and business performance, while reducing their own bottom-line portfolio risks.

How does financing improvements in clients' corporate governance contribute to banks' business goals?

- ACCESS TO LARGE MARKET WITH HIGH GROWTH POTENTIAL: Financial institutions can extend corporate governance finance to any client—from family-owned businesses, listed companies, and newly privatized companies to small and medium enterprises (SMEs)—making this a large potential market.
- LOWER CREDIT RISK: Good corporate governance improves the management and credit-worthiness of client companies, leading to stronger operational performance and reducing the risk of nonperforming loans. For instance, an ABN/AMRO study showed that Brazilian firms with above-average corporate governance had returns on equity (ROE) that were 45 percent higher and net margins that were 76 percent higher than those with below-average governance practices.[b]
- MARKET DIFFERENTIATION: Financial institutions well-acquainted with best practice in corporate governance have value-added appeal to companies seeking to improve business performance in highly competitive domestic and regional markets. This may lead to added business volumes from existing clients, as well as new ones.
- IMPROVED PORTFOLIO STRENGTH: If good corporate governance leads to stronger performing client companies, financial institutions benefit in turn by strengthening their bottom-line portfolio performance.
- LOWER COST OF CAPITAL: Rating agencies see businesses with good governance in a better light, which may also lower the cost of capital for financial institutions.
- INCREASED BRAND VALUE: Financial institutions can enjoy the reputational benefits associated with good corporate governance and promoting the same standards with client companies, thereby adding value for all stakeholders.

One of the most prominent examples of best banking practices in supporting improvements in clients' corporate governance is ABN AMRO Real S. A. (Banco Real) in Brazil. In cooperation with IFC, the bank has established a formal procedure for the utilization of corporate governance criteria in its credit decisionmaking processes for certain types of on-lending transactions.

a. IFC, Choices Matter (2005, p. 45).
b. Erbiste (2005).

A LOOK AHEAD

>> *Financial institutions must expand their view of what generates long-term value: for themselves, for their clients, and for society.* <<

Better understanding of the business case for sustainability is prompting the banking sector to be more proactive in implementing changes in policies and management systems. These changes are taking place through continual improvements of social and environmental management tools, better corporate governance, and greater participation in society. Moreover, in emerging markets, the banking sector is joining international industry-led initiatives that will spread best practice in social and environmental risk management in lending practices. The Equator Principles hold the potential to become a model for a number of other industry-led standards that take into account regional perspectives and specifics.

To continuously improve, financial institutions need to not only incorporate better standards in social and environmental risk management, but also expand their view of what generates long-term value for themselves, for their clients, and for society. This requires tapping into new opportunities and markets to yield greater environmental, social, financial, and economic benefits. As this report has demonstrated, banks will need to build their capacity to experiment with new financial products and services.

Such a move to achieve greater long-term value is expected to be driven from both inside and outside financial institutions. From the inside, successful implementation of management systems that include organization-wide awareness, employee involvement, and effective stakeholder engagement will help attract and strengthen human resources.

From the outside, innovation will be increasingly driven by higher industry standards; greater competition; market incentives, such as market globalization and trade standards; government regulations; and the growing importance of stakeholder groups and their ability to communicate their views using worldwide means of communication and connectivity. While industry-led initiatives are expected to be the main driver for the banking sector in embracing a new sustainability agenda, governments are expected to support this process by requiring greater disclosure as well as providing incentives for financing in sectors such as carbon finance, sustainable energy, and cleaner production, which are increasing in importance under a variety of international and regional priorities for sustainable development.

© Banca Comerciala Romana | *The headquarters of Banca Comerciala Romana in Bucharest, the largest bank in Romania, which successfully privatized in 2005, with IFC's assistance (see story, p. 76).*

Banks and other financial intermediaries that use these strategies will gain a competitive edge. They will also strengthen their positions by contributing to the macroeconomic development of their countries or regions, facilitating their integration into the international financial community, and serving as models of best sustainability practice that others can follow (see story, Banca Comerciala Romana, p. 76).

BANCA COMERCIALA ROMANA (BCR)

Increasing the Bank's Marketability in the Privatization Process and Facilitating Romania's Banking Reform through Strong Social and Environmental Management

At A Glance

BCR is Romania's largest bank, with over 9 billion euros in assets—representing approximately 27 percent of the country's total banking assets—406 domestic branches, and nearly 11,000 employees. BCR was incorporated and licensed to conduct commercial banking activities in 1990.

THE PRIVATIZATION PROCESS

As of 2002, the Government of Romania still maintained a significant stake in BCR (69.88 percent). The remaining 30.12 percent was held by five financial investment companies that were formed for the express purpose of aiding privatization of state-run operations. At the time, efforts to privatize the bank were being undermined by high operating costs, declining domestic interest rates, and increased competition from foreign-owned domestic banks. In January 2003, the Government of Romania invited the European Bank for Reconstruction and Development (EBRD) and IFC to participate in a pre-privatization strategy for BCR.

At the core of the strategy was an Institution Building Plan that focused on enhancing the bank's operational efficiency by improving processes and reducing procedural overlap, as well as strengthening its corporate governance and internal control framework. Building capacity in social and environmental management was a key component. Other initiatives included developing procedures aimed at preventing money laundering and combating the financing of terrorism, improving the bank's purchasing strategy, and streamlining insurance administration. In 2005, after a competitive bidding process, the government awarded a 61.88 percent stake in BCR to Erste Bank of Austria. Six other major international banks submitted bids: Deutsche Bank AG (Germany), Dexia SA (Belgium), Banco Comercial Portugues SA (Portugal), the National Bank of Greece SA, Banca Intesa SpA (Italy), and BNP Paribas SA (France). The high level of investor interest demonstrates strong international confidence in Romania's progress and is yet more proof of developed-country banks' growing interest in emerging markets. | **www.bcr.ro**

In 2004, we became the first Romanian bank to introduce an environmental procedure to assist corporate lending activity. This was based on EBRD procedures and IFC operational policies regarding social and environmental concerns and worker safety. We support our customers in developing environmentally friendly businesses and in learning how to comply with environmental, health, and worker safety regulations.

Nicolae Danila, CEO, Banca Comerciala Romana

Enhancing Social and Environmental Management Practices

As Banca Comerciala Romana (BCR) undertook steps after 2002 to prepare for privatization, capacity building in social and environmental risk management emerged as a prevalent theme and ultimately contributed to successful privatization by improving BCR's value to outside investors. Notably, in February 2004, BCR established an Environmental, Health, and Safety (EHS) Unit. IFC and the European Bank for Reconstruction and Development (EBRD) have encouraged internal capacity building within this unit through practical training. A "training of trainers" program enabled the unit to improve its proficiency at risk assessment of loan transactions and strengthen its interaction with local regulatory authorities. The EHS unit has been offering its own training workshops in social and environmental risk management to BCR's loan officers since 2005, and trained 597 corporate loan officers throughout the entire BCR network in 2005. The training centers on BCR's risk management policies, practical tools, and case studies for risk management throughout the project cycle.

Recent BCR efforts in social and environmental management have progressed beyond risk management to actively identifying opportunities. These have included financing environmentally friendly businesses in need of financing relationships, developing new business with existing clients, financing new and cleaner technologies, and backing environmental improvements. To track performance under its Environmental Policy, BCR is considering incorporating environmental metrics into its internal audit framework. BCR's efforts in social and environmental management support the environmental, health, and safety measures required by Romanian environment authorities to meet European Union (EU) standards. These must be reached by the end of 2006 to fulfill Romania's obligations for EU accession.

A Catalyst in Private Sector Social and Environmental Responsibility

BCR's pre-privatization strategy has resulted in several important political, economic, environmental, and social benefits, such as contributing to international recognition of Romania's progress in reform, facilitating Romania's macroeconomic development, supporting Romania's private sector environmental projects, and strengthening the business case for social and environmental management. These achievements are especially important in the wake of EU accession. BCR has also positively influenced the environmental performance of its customers. This will help them survive in a very competitive market after EU accession and has facilitated their relationships with environmental authorities.

These efforts earned the bank a ratings increase during the first half of 2004 by both Fitch and Standard & Poor's. In January 2005, the latter raised BCR's long-term counterparty credit rating from B+ to BB-, with a stable outlook.[a] The upgrade reflected "the strengthening of corporate governance and the bank's organizational and operational framework ahead of privatization." The rating of BCR by Standard & Poor's was further upgraded to BBB- in the end of 2005, after "the successful completion of BCR privatization tender."[b]

BCR was consequently well positioned to expand its loan portfolio. Capacity-building efforts have been transformed into a competitive business advantage that is benefiting not only the institution and its employees, but also its customers and the environment in general.

Source: Adapted from McKague (2005).

a. *Standard & Poor's, "Banca Comerciala Romana Rating Raised to 'BB-': Outlook Stable," January 25, 2005, © Standard & Poor's.*
b. *Standard & Poor's, "Banca Comerciala Romana LT Rating Raised To 'BBB-' After Erste Bank Wins Privatization Tender," December 22, 2005, © Standard & Poor's*

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2. IFC Sustainability Resources

IFC's sustainability portal provides information on IFC's approach to sustainability and examples of how the Corporation and donor partners are helping businesses innovate through social and environmental sustainability. (http://www.ifc.org/sustainability)

The following studies and reports can be downloaded free of charge at www.ifc.org/enviropublications:

The Promise of Private Equity (November 2006)

Animal Welfare in Livestock Operations—Good Practice Note (November 2006)

Creating Business Opportunity through Improved Animal Welfare (April 2006)

Taking Stock—Adding Sustainability Variables to Asian Sectoral Analysis (February 2006)

Non-Discrimination and Equal Opportunity—Good Practice Note (January 2006)

Who Cares Wins: One Year On (November 2005)

Managing Retrenchment—Good Practice Note (September 2005)

The ELI Story: Transforming Markets for Efficient Lighting (May 2005)

Ecolodges: Exploring Opportunities for Sustainable Business (February 2005)

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SRI in Asian Emerging Markets (October 2003)

Beyond Risk (2003)

HIV/AIDS in the Workplace—Good Practice Note (December 2002)

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Developing Value: The Business Case for Sustainability in Emerging Markets (2002)

3. Sustainable Banking Resources and Research Institutions

African Institute of Corporate Citizenship. http://www.aiccafrica.com

The Arab Academy for Banking and Financial Sciences (AABFS). http://www.aabfs.org

Association for Sustainable & Responsible Investment in Asia. http://www.asria.org

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5 Categorization occurs during IFC's internal process of project screening, to decide on the nature and extent of the environmental assessment (EA) needed for the project. The initial decision about project categorization occurs at a very early stage in IFC's project cycle. The rationale for categorization, including social and environmental issues and any policy concerns, are documented to assist management in decisionmaking.

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ACKNOWLEDGEMENTS

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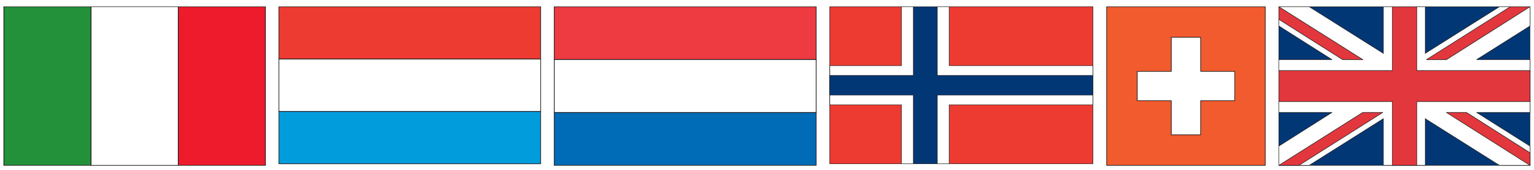
Many thanks to the financial institutions that kindly allowed us to feature their success stories and the people who helped us develop them
ACBA Leasing: Arsen Bazykian
ACLEDA Bank, Plc.: In Channy
Afriland First Bank: Dr. Simeon T. Numbem
Banca Comerciala Romana: Alina Gabriela Radu
Banco Cuscatlán: José Francisco Rodríguez García
Banco Itaú-BBA: Maria Estela Campos, Roberto Dumas Damas, Eliana Maria Salmazo
Bank Aval, member of Raiffeisen International Bank-Holding AG: Julia Galchun, Viktor Gorbachev, Victoria Masna, Maksim Zhukovskyi
Bank “Center- invest”: Grigory Chorayan
Bank of Georgia: Thea Jokhadze
Česká Spořitelna, member of the Erste Group: Ladislav Dvořák, Richard Dolezal, Kristyna Havligerova
FirstRand Bank: Marlene Hesketh
Nedbank: Justin J. Smith
Unibanco: Roberto Nakamura, Deives Rezende Filho, Richard Allen Bird, Nira Bessler
UralTransBank: Sergei Netepenko

Photography
ACBA Leasing, ACLEDA Bank, Banca Commerciala Romana, Bank of Georgia, Bankca Itaú-BBA, Bumaga-Yug, Martin Dasek, Jouni Martti Eerikainen, Olga Kordova, Kuban Confectionary Manufacturing Factory, Nedbank, Texterno, Unibanco, World Bank

Design
Patricia Hord.Graphik Design



Since 1997, IFC has been delivering strategic capacity building and technical assistance on the environmental and social aspects of finance and investment in emerging markets. Undertaken through IFC's Sustainable Financial Markets Facility, this assistance has included training workshops to managers from many financial institutions around the world and the production of leading good practice material to support the business case for sustainable finance.

These activities have been made possible by the support of the governments of Italy, Luxembourg, the Netherlands, Norway, Switzerland, and the United Kingdom.

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