Finance industry: practical leadership in green investment

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Because of their intermediary role in an economy, the role of banks in contributing toward sustainable development is potentially substantial. Banks have a material impact on the economic development of sectors and nations and have the potential to influence the pace and direction of economic growth.

Governments, regulators, the media, NGOs, investors, employees and society have increasing expectations that businesses will be run in an environmentally and socially responsible manner. The integration of sustainability into the banking sector has taken several fundamental directions:

- The pursuit of environmental and social responsibility in a bank's operations through environmental initiatives (such as recycling programs or improvements in energy efficiency) and socially responsible initiatives (such as philanthropy, social impact investing, improved human resource practices),
- Investing in green sectors such as cleantech and renewable energy amongst others. Examples include; supporting clients in climate change carbon reduction initiatives, investing in energy efficiency, renewables, voluntary carbon market carbon offsetting, and also assessing environmental and social risks of mainstream transactions.
- Influencing mainstream sectors to improve their environmental performance.

Sustainability as risk management and corporate responsibility concern

There is growing awareness in the financial sector that environmental issues bring risks (such as a customer's soil degradation or failure to comply with the ever changing environmental regulatory framework which translates into an investment risk*)* and opportunities (such as environmental investment funds) and the sustainability interest at J.P. Morgan includes both of these perspectives. The degree to which sustainability performance has propagated obviously varies greatly across states and sectors and indeed the financial services world as well, discussed further below.

In terms of the risk aspect; J.P. Morgan's Environmental Social Risk Management Team reviews prospective Investment Banking transactions for environmental and social risks, in terms of international standards, as well as reputation risks and for procedural issues (eg disclosures for listing on stock exchanges) or if there are specific liabilities for the firm. The group also assess some transactions that require enhanced due diligence where there are particularly sensitive environmental and social issues, namely; mining, thermal power, hydropower and nuclear power. Key Points to note about our Environmental Risk Policy is that the firm has adopted the Equator Principles (EPs). The EPs are based on the International Finance Corporation (IFC) Performance Standards on social and environmental sustainability, and on the World Bank Group's Environmental, Health and Safety General Guidelines.

Environmental Policy triggers include:

- Location - developing countries - emerging markets, or non-high income countries as defined by OECD.
- Industrial sector - mining, Oil & Gas, power, forestry and agriculture are the most environmentally sensitive sectors in most countries.
- Financial activities - equity and debt underwriting, principle investments (see slide) particularly transactions greater than $10 million, where Use of Proceeds is known.
- Anywhere in the world, where the financing, impacts on primary forested land, affects indigenous populations, impacts on nature reserves, UNESCO World Heritage or unique ecosystems.

In general, a client's risks are the bank's indirect risks. To decrease exposure to environmental liabilities and to improve risk management, banks have started to look more closely at the

environmental performance of their clients, developing mechanisms to assess the environmental risk exposure of their customers, and to protect themselves from potential losses. The first step is actually identifying the risks, tools used include EIAs, EMPs, RAPs, and a huge base of international standards and practices. There is no single standard against which to assess risk, but a rich reserve of guidance, IFC Performance standards, Academic, NGO, commissioned studies and references, internationally certified management systems ISO14000, OHSAS18000, sector standards, guidance and input from organisations such as ICMM, IPIECA, IHA, RSPO, BCI are also considered.

By assessing and understanding the issues faced by our clients, we often can help them improve their environmental and social performance, as well as ensure compliance with our own policies. The Environmental and Social Risk Management team reviewed 180 financial transactions in 2009 compared with 67 in 2007 and 126 in 2008. The increasing number of assessments performed also indicate that the ESRM team has incresed its profile within the firm, and becoming more embedded in the process, as deal teams become better informed about the scope and function of the group, and more aware of what transactions and clients face environmental and social risks.
Both risk and opportunity are now becoming established elements in banking policies towards the environment. Environmental Markets embodies some of the opportunity side of sustainability development. The J.P. Morgan's Environmental Markets business, works with clients to reduce the greenhouse gas emissions for the firms clients from business and individual activities, through the origination, trading and distribution of carbon reduction certificates with environmental attributes.

An example case study

J.P.Morgan Environmental Markets group were involved in a project to reduce gas flaring. Gas flaring is the burning off of natural gas, a by-product of oil production. This adds to greenhouse gas emissions and wastes a potentially valuable energy resource. It is estimated that if carbon dioxide emissions from flaring were stopped, this would amount to about 13 percent of the emission reductions that industrialized countries have committed to under the Kyoto Protocol for the period 2008-2012. In 2009, J.P. Morgan worked with JSC Sibur Holding, Russia's largest petrochemical company, on the provision of carbon finance services in the to dramatically reduce the emissions profile of the Yuzhno Balyksky Gas Processing Plant ("YB-GPP"), located in Russia. YB-GPP receives and treats up to 1.5 billion cubic metres of associated petroleum gas ("APG") and then delivers the treated dry gas into the Gazprom network. It also produces Butane and Propane for commercial sale. As the APG would otherwise have been flared, which releases carbon into the atmosphere, the project will generate emission reductions - up to 9.64 million tonnes of over the period Jan 09 to Dec 12. J.P. Morgan's role in the project has been to support Sibur, as its carbon finance partner, with the development of all documentation needed for Kyoto Protocol approval. It then extends to the commercialization of the full volume of Emission Reduction Units "ERUs", to be produced by the project, with a structure that provided Sibur with a financial hedge against downside market risk and increases its certainty on the financial performance of its investment.

Whilst there is no disputing that fossil fuel related industries have a significant environmental impact, to the extent they can be reduced, this is an improvement. Anti-carbon markets proponents believe however, that carbon reduction projects linked to fossil fuel related industries actually facilitate longer life span of these assets. It is reasonable to view such interventions as being tactical in nature – as part of a strategic direction to fully decarbonise.

Another example of were sustainability has been integrated into a bank's core businesses is in renewable energy investments. Banks can create opportunities for sustainable business through their financing policy. By year-end 2009, JPM had provided financing of $2.6 billion in renewable energy projects in the US. This was predominantly through tax equity financing. In the same time frame, the firm had raised another $3.3 billion from other institutions for investment. The portfolio includes 60 wind farms as well as a large, concentrated thermal solar project. The total installed capacity of more than 5,800 megawatts can power close to 1.6 million U.S. homes annually.

On the mainstream side, the ESRM group, uses financing as a leverage point to get clients to improve their environmental and social performance. As an example, a mine in Africa may not be subject to

the same legal requirements as one in Australia and the group works with clients to build their understanding on why international standards for areas such as biodiversity, health and safety systems and water management are needed. Apart from pure-environmental reasons, the rationale the ESRM group cite for this include maintaining a social license to operate in the eye of civil society and the media, attracting international investment requires international standards and that these standards de-risk a project and protect against business continuity risks.

The growing concern in the banking sector about clients' environmental performance is evident and is now starting to manifested itself in lending and investment decisions. This has begun to act as an additional driver of sustainability in the private sector.
In comparing the mainstream market size against the sustainable, there is no question mainstream is certainly dominant. Indeed at J.P. Morgan Asset Management, there is not yet a single sustainable fund in it's portfolio and although the Fund market itself is increasing the mix substantially year on year. This remains a question of identity – does a bank see itself as responding to the market – or shaping it? Should they choose, banks can play a pivotal role in influencing client's behaviour and companies now have another reason to pursue ever improving environmental and social performance.

As discussed earlier, the role of banks in contributing toward sustainable development is potentially enormous. There is growing awareness in the financial sector that environment brings risks and opportunities. The upward trend in numbers of transactions assessed by the ESRM team at J.P.Morgan mirrors the growing concern in the bank about clients' environmental performance and this has begun to act as an additional driver of sustainability in the private sector. Companies now have one more reason to pursue environmentally and socially sound solutions. Through areas such as Environmental Markets and financing of renewable power, banks work with clients to reduce the environmental impact of business and individual activities, through the origination, trading and distribution of certificates with environmental attributes. Banks can create opportunities for sustainable business through their approach to financing. Banks can, if they choose, play a crucial role in determining whether society - from governments to individual consumers - succeeds in following an environmentally sustainable path.