Finance and the Environment:
Transparency, Disclosure and Environmental Reporting

Highlights of Meeting and Follow-Up Steps

Commission for Environmental Cooperation of North America

On 25 March 2002, the Commission for Environmental Cooperation (CEC) of North America hosted a small, informal and off-the-record meeting on financing and the environment. Representatives of leading financial institutions, smaller investors, academics, industry consultants, federal governmental representatives from Canada, the United States and Mexico, a representative of the World Bank and others participated. The informal meeting was co-chaired by Gabriel Quadri de la Torre, President of CESPEDES, John Ganzi, President of Environment and Finance Enterprise, and Scott Vaughan of the CEC.

The objective of the meeting was to explore to what extent the disclosure of environmental information through mandatory or voluntary channels affects the business decisions of different actors in the financial sector.

Background: Transparency and Financial Markets

The importance of transparency in supporting well-functioning markets is well recognized. Events around the Asian financial crisis in the late 1990s redoubled work by numerous national and international bodies to clarify transparency and disclosure provisions affecting different segments of financial markets. For instance, work by the Bank for International Settlement (BIS), the Financial Stability Forum, the International Organization of Securities Commissions and its Multidisciplinary Working Group on Enhanced Disclosure continue to focus on strengthening existing transparency provisions, and introducing new ones where necessary.

The collapse of Enron has made the transparency debate all the more urgent, and served to underline the importance of reliable information around corporate disclosure that accurately conveys different aspects of financial risk.

As financial markets become more integrated through globalization, the interdependence of securities regulators increases. Clearly, as NAFTA has accelerated market integration at the North American level, the comparability of securities regulations is an important issue, and one examined in various organizations.

Within this general rubric of the comparability of disclosure provisions and transparency initiatives in North America, the Commission for Environmental Cooperation of North America (CEC) has recently begun examining the disclosure to financial markets of different types of environmental information. The purpose of this effort is to find ways of promoting investment by the private sector in the NAFTA countries in general, and to promote investments in commercial operations that effectively manage and report on different kinds of environmental risks.

Two broad questions formed the basis of informal discussions regarding the disclosure of environmental information.

I. What are the similarities and differences among the NAFTA partners of the mandatory disclosure to financial markets of environment-related risks? Given the differences in the level of detail of disclosure obligations and enforcement among the three countries, can a case be made for the harmonization of different obligations? In examining this question, Dr. Robert Repetto led a research effort for the CEC that examined different mandatory financial risk disclosure provisions in place in the three countries. (The final version of the background paper is attached.)

II. To what extent are efforts related to the voluntary disclosure of environmental information useful to the financial services industry? And, what is the relations, if any, between the mandatory disclosure of environment-related risks, and information that is disclosed via different corporate environmental reporting activities? In recent years, initiatives led by the private sector to provide shareholders, customers, communities and regulators with environmental information has increased significantly. Examples of methods by which companies provide information about their environmental and other commitments to corporate responsibility include the adoption of ISO 14,000 series, the expanding role of the Global Reporting Initiative, individual company reports providing information to the public, consumers, shareholders and others such as 'socially responsible' investors who might ask for information on various environmental operations and corporate commitments.

The following highlights some of the key themes covered during the March 2002 meeting. In addition, the report identifies follow-up work that the CEC will pursue in the near term.

Meeting Highlights:

A. Mandatory Disclosure Provisions: Experience suggests that while obligations regarding the disclosure provisions covering environment-related risks are on the books, their evidence of enforcement is uneven.

While various examples were noted regarding the enforcement of disclosure regulations relating to environmental risks – notably the ongoing cooperation between the Securities Exchange Commission (SEC) and the Environmental Protection Agency (EPA) – several participants noted that a consistent and predictable approach to disclosure appeared lacking. Examples of disclosure of different kinds of information were noted. For instance, the United Kingdom now requires that pension funds disclose information about the environment and other 'socially-responsible' issues.

A key purpose of the meeting was therefore to explore the degree to which the disclosure of environmental liability or risk was of interest to the different financial actors in environment-related disclosure.

B. Information Needs and Gaps Among Mainstream Financiers: Numerous examples exist of small-scale financial agents taking leadership positions in promoting environmental and sustainability goals. Examples range from the launching of the Dow Jones Sustainability Group Index in October 1999 and the SAM Sustainability Index to funds like the Storebarnd Scudder Environmental Value Fund and Calvert Managed Growth. A wide range of criteria – ranging from environmental performance to work with communities to provide a part of revenues to charities – guide niche investments into companies that embrace different aspects of sustainability.

At the same time as green and social investments remain niche segments of the market, there does not seem to be a bridge between mainstream banking and investment decisions and environmental issues. The mainstream banking sector is not regularly demanding specific kinds of environmental information, nor making use of the avalanche of environmental data that already exists.

It was noted that information required by securities regulators on environmental compliance does not address more general information/data needs of financiers. For example, it was noted that SEC filings were not a useful source of information about environment-related issues. It was also noted that other regulatory bodies, such as the FDIC and OCC, have enormous weight when issuing non-binding memos regarding accepted norms of good business practices. However, to date, few regulations of substance are on the books that require the disclosure of different kinds of environmental risk.

This is not to say that environmental liability is never used in evaluating investment risk. There was discussion of specific instances in which bankers and investors followed environmental data issues around the possible on-site contamination of hazardous wastes involving real estate transactions, and the existence of asbestos in older buildings. Other kinds of data, however, such as toxic release emissions inventories, were not of immediate interest to financiers, since reported TRI data by companies fall within lawful limits.

Even though information about environmental liability has sometimes proven useful, bankers and investors remain reluctant to initiate comprehensive environmental audits seeking information about the track-record of potential borrowers above minimum regulatory compliance. It has long been recognized that the financial services sector should not police their clients, nor to assume roles of public regulatory agencies. In the US, there are thousands of very large and small banks.

Even if banks did think it were important, there remains the problem of the access to appropriate information. The problem is not a lack of environmental information. In fact, the opposite is true: the sources of different kinds of environmental and sustainability indexes and benchmark data exist, and are growing.

The problem is that this kind of environmental information -- transmitted through a multitude of reporting initiatives – are not measured in a unit of analysis that is useful to financial community. For example, the extent to which a company adopts an ISO 14,000 series certification may be a general indicator of the extent of that company's commitment to the environment. However, in the end whether a company does or does not adopt ISO or other voluntary standards means very little operationally to mainstream financiers.

As an immediate step, it was noted that some kinds of environment-related information – in particular records from regulatory agencies on environmental compliance, infractions and fines and other records - exist but are difficult to access at the parent holding level (the level at which SEC information is filed).

To make matters more complicated, the timeframe of most investments affects the need to consider this risk. If financing is structured over the long-term, say 0-15 years, then the lead bank or investor can persuade the lender to adopt some recognized standards of good practice. Moreover, if the banker or investor is not the lead financier, then they generally take a back-seat to the lead financier to undertake some kind of environmental audit.[1] However, if the duration of investments is 12 months, long-term liabilities are not considered, and it is too short a time-frame

[1] It was noted that these generally comprise on-site audits, compliance audits, some regulatory prospectus including current and future regulatory circumstances.

for financiers to spend on comprehensive investigations of the environmental risk of an investment.

As such, it seems that before the financial community begins to routinely and systematically consider environmental liability when making business decisions, a number of hurdles need to be overcome.

Barriers to the Usefulness of Environmental Information

The Lack of Clear Business Case:
Environmental information fails to make a business case to the financial community as to how environmental issues are affecting, or may affect, bottom-line operations. That is, there appears to be little analysis as to how environmental information will affect cash flows, asset values, direct and indirect liability, corporate reputation, investor relations, and other issues. A specific way in which this gap could be closed is to quantify in financially meaningful and understandable terms different kinds of environmental risk, for different segments of financial operations, in a way that meets the needs of lenders and investor, perhaps starting with only a few sectors.

Accounting and Auditing:
An important source for the financially meaningful reporting of environmental information can be found in accounting and auditing practices. During the past year, senior officials and members of the business community in Mexico have identified auditing and accounting as important areas. To date, a multiplicity of standards for accounting and auditing exist. It was noted that efforts by UNCTAD had concentrated on the harmonization of environmental auditing and accounting procedures. Moreover, the International Organization of Securities Commissions underlines the importance of convergence for recognized accounting and auditing standards, as a contribution to well-functioning markets.

The Leadership Question:
Governments around the world continue to face fundamental changes in how they approach both environmental regulations, and capital market oversight. It remains unclear where the pendulum swing will stop between deregulation and tight market regulation. However, a key determinant of how public policies are going to partner with market-based approaches is by engaging corporate leaders.

Next Steps for the CEC:

- **Analytic - The Information Overload**: Conduct research on what environmental data, indicators and reporting exists now which is of use to financiers? How much is being used now, or could be used, by mainstream financial analysts. How can environmental audits, environmental accounting, reporting and data sources (for instance, TRI-PRTR) help mainstream banking operations?
- **Analytic**: **The Business Case?** Prepare analysis, in cooperation with lenders and investors, identifying business cases for taking account of environmental issues. This will include analysis translating environmental risk into business risk, through the quantification of environmental risks.
- **Meeting**: Organize a larger, working-level meeting to examine disclosure-related issues. Participants to include:
    - Accounting standards bodies, such as the Financial Accounting Standards Board and others;

- Auditing and accounting firms engaged in environmental risk analysis;
    - Large institutional investors and commercial banks;
    - Buy-side analysts tracking environmentally-sensitive sectors like mining, pulp and paper, chemicals, smelting, energy and some segments of agriculture;
    - Financial rating agencies;
    - Securities regulators;
- **Meeting:** Following the analysis and working-level meeting, organize a meeting with some CEOs or banks and investors from North America, the President of the World Bank, the environment ministers of the NAFTA countries, and various government officials. The purpose of the meeting would be elaborated during the working-level meeting and follow-up, and include options for specific comments and announcements.