"Environmental Concerns and the Business of Banking"

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David Sarokin and Jay Schulkin

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The Journal of Commercial Bank Lending does not usually take up causes. However, when the editors received the following article, they were so impressed by it that they decided to share it with me before publication. After I read it, I felt that as RMA's national president, I wanted to emphasize the article's environmental message even more by writing this introduction.

Lest we get too caught up in the “business” of banking, we must remember that we have a moral obligation to preserve this planet for future generations. This article makes that point and does so with clarity and wisdom.

The authors summarize their message skillfully as follows:

This article is about the relationship of finance and global ecology. The thesis is a simple one: The rising tide of environmentalism, which has already greatly altered smokestack industries, is affecting the financial services sector as well.

As was the case with the manufacturing sector, the impact of environmentalism on the financial community may well be substantial.

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The views expressed in this article are those of the authors and not of the Environmental Protection Agency, with which Mr. Sarokin is affiliated.

Banks that do not take an active stance on environmental issues may instead find themselves reacting defensively to a host of societal, financial, and regulatory pressures.

Therefore, carefully read and heed the message in this article. And as we continue in the banking business, let's do so actively by helping to preserve our environment.

James W. Warren III
President
Robert Morris Associates

Money is essentially a proxy for the goods and services which make up human commerce, and these goods and services are what reshapes our planet. The benefits of having a sophisticated system of financing to help make possible the activities of commerce are clear cut. But these activities can have unintended side effects, often with detrimental environmental results.

There would be far less cause for concern over, say, disappearing rain forests were the activities decimating the forests not heavily financed by commercial banks, multilateral development banks, and individual governments. The business of moving money is inextricably linked to the movements of raw materials, finished goods, labor, and ultimately, to the quality of our environment.

This link between economics and ecology, obvious on the face of it, has nevertheless taken a back seat to more visible environmental concerns that have focused on smokestacks, tailpipes, wastewater discharges, landfills, and other symptoms of environmental degradation noticeably absent from the business of banking.

Chemical plants are subject to environmental scrutiny; banks are not. But this is beginning to change, as more and more people are coming to recognize that the movement of dollars, pounds, and yen may also involve the creation of toxic wastes, ozone-depleting chemicals, global warming gases, and other environmental disruptions.

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As was the case with the manufacturing sector, the impact of environmentalism on the financial community may well be substantial. Banks that do not take an active stance on environmental issues may instead find themselves reacting defensively to a host of societal, financial, and regulatory pressures.
We wish to begin with a very local-level illustration of the link between banking\(^1\) and environmental concerns, with a story we have dubbed the tale of the fish deposit.

**THE TALE OF THE FISH DEPOSIT**

Several years ago, a waste management firm announced its intention to construct a hazardous waste incinerator on the outskirts of a town in Missouri. Many of the town's citizens, outraged both by the incinerator and by the "surprise attack" nature of the announcement, quickly organized a very vocal opposition to the facility, arguing their case to the local press at public hearings and directly to company management. Their objections were to no avail. The company was intent on seeing its project through; the incinerator began to seem inexorable.

**Role of Banks and Fish**

As part of the company's strategy to win converts through economic suasion, management began to negotiate a substantial loan with the local bank to finance construction of the hazardous waste facility. The townspeople, frustrated with the absence of any compromise from the company, began to vent their frustration at the bank, demanding the loan application be rejected.

The bank's reply was straightforward: We appreciate your concerns, but, sorry ... business is business. The bank did not feel it appropriate to take sides in a matter that, while socially controversial, seemed fiscally sound. The anti-incinerator faction seemed close to defeat.

At this point, the exact sequence of events is somewhat obscure. It seems that the loan was close to approval, when customers at the bank began complaining of an odd odor near the safety deposit boxes. The odor grew stronger, more unpleasant, and unmistakably recognizable—someone had "deposited" a fish in one of the boxes, and it was now putrefying. It took several horrid days for bank management to secure the necessary legal papers allowing them to search the boxes ad libitum until the offending fish was found. Whether there is a connection or not, we cannot be sure, but the loan was never approved, the incinerator never built.

**Importance of Issues**

The fish deposit story is perhaps more apocryphal than not and certainly at the extreme end of the scale of reactions. But the cast of characters, the depth of feeling, and the issues involved are real and substantial. As environmentalism continues to grow from local, to national, to global in its concerns, these issues may well fundamentally change the international finance community.

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\(^1\) We are using the term "banking" to refer to a broad array of activities that comprise the international finance community.

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**Investment Funds in the U.S. with Strong Environmental Criteria**

<table>
<thead>
<tr>
<th>Investment Fund</th>
<th>Amount Invested (Millions of Dollars)</th>
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<tbody>
<tr>
<td>U.S. College Retirement Equity Fund/ Teacher's Insurance Annuity Association*</td>
<td>$80,000</td>
</tr>
<tr>
<td>Interfaith Center for Corporate Responsibility</td>
<td>25,000</td>
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<tr>
<td>U.S. Trust</td>
<td>800</td>
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<tr>
<td>Calvert Group</td>
<td>600</td>
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<tr>
<td>Franklin Research and Development</td>
<td>200</td>
</tr>
<tr>
<td>Shearson Lehman Hutton</td>
<td>95</td>
</tr>
<tr>
<td>Pax World Fund</td>
<td>92</td>
</tr>
<tr>
<td>SFI Environmental Awareness Fund</td>
<td>15</td>
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* Pending completion of a fund study to develop an environmental screen for its investments.


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**PRIVATE BANKING AND PUBLIC CONCERN**

What banks do with their money is not ordinarily an object of intense public scrutiny. For the most part, there is little interest outside the financial community itself as to who is lending how much to whom or for what purposes. The banker-customer relationship is accorded a certain privileged confidence akin to that between doctor and patient. And to most observers, this is exactly how things should be.

Banks are inherently neutral, and their principal responsibility is to assess fiscal risk. A banker's primary task is protecting the moneys of depositors and shareholders and providing society at large with working capital, while leaving questions of the proper and appropriate activities of society to political forces largely independent of the banks themselves. Politicization of the banking community is not only seen as inappropriate but as a distinct threat to a bank's ability to make the most fiscally sound lending decisions.\(^2\)

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**When the Financial Community Is Exposed to Public Scrutiny**

Occasionally—and we would suggest, with greater and greater frequency—financial transactions do become exposed to the intense glare of public concern and embroiled with community politics. This happens:

1. **When the financial community acts (or appears to act) fiscally irresponsibly with their customers' money.** Examples would be the savings and loan crisis in the U.S. or the Third World debt crisis, each with an ultimate price tag (probably to the taxpayers) of hundreds of billions of dollars. In both cases, govern-

ments have felt compelled to step into the lending business and, with varying degrees of forcefulness, dictate how banking should be conducted.

2. When the financial community is branded as being socially irresponsible. The international investment community has felt the weight of broad social displeasure over continuing investments in South Africa since financial support was viewed as tantamount to support for apartheid. The public pressure was intense and felt at the highest levels of the business community: Chief executives from a broad spectrum of industries, including officials at Barclays Bank, met at sessions chaired by former British Prime Minister Edward Heath to plot their strategies for responding to pressures to divest.

South Africa, while certainly the most notable such issue, is not the only one. The Federation of American Scientists (formed in 1945 by the builders of the atomic bomb) recently petitioned Citicorp, Manufacturers Hanover, and BankAmerica to use the banks' considerable financial leverage to dissuade Brazil and Argentina from building nuclear weapons. The Community Reinvestment Act in the U.S. requires banks to meet the credit needs of low- and medium-income neighborhoods, a legislative reaction to allegations that banks were "redlining" poorer communities.

3. When society becomes greatly displeased with the consequences of a bank's financial transactions. For instance, banks are under increasing pressure to provide details on cash transactions that bear the hallmarks of money laundering from drug trafficking, a "business" that generates at least $85 billion a year needing to be laundered and invested. The Bank for International Settlements has drawn up the Basel Principles to guide member banks regarding money laundering, and the European Commission is considering an EBC-wide rule on the subject. The U.S. has taken the toughest stance of all.

Recent amendments to the Bank Secrecy Act in the U.S. give the government broad powers to require disclosure of banking transactions when money laundering is suspected; BankAmerica was slapped with a fine of almost $5 million for failing to meet its reporting obligations. There is even a monthly newsletter, Money Laundering Alert, to keep bankers apprised of the latest developments.

"Neutrality" of Financial Institutions

In each case, the "neutrality" of financial institutions is readily breached when society which may be a small group of local citizens, a vocal collection of shareholders, a federal legislative body, or an international network of activists) identifies both a problem and a connection between that problem and the business of moving money.

This should not come as a surprise. For better or for worse, we live in an age when virtually all our institutions are subject to a large dose of social influence: science (animal rights, military research), medicine (AIDS, contraception), academia (classical versus progressive curricula), and so on. It is no small wonder that banking, the activities of which touch almost every life and every type of activity, is subject to similar social forces.

An Insulated World

Perhaps the very idea that banks are in some sense "neutral" needs to be reexamined, much as philosophers of science or law—activities once thought to be preeminently detached from the vagaries of social mores—now recognize both to have at their core value systems which are anything but neutral.

One's stance on the world is always from a particular perspective. Banking may well occupy similar value-laden territory, marked as much by what it overlooks as by what it encompasses.

Consider the words of one critic, discussing the influence of banks:

The managers of the quiet institutions whose decisions shape millions of destinies are not trained to entertain the notion that their activities might have anything to do with such embarrassing categories as life and death. They are competent, well-paid technicians and go about their work at a comfortable remove from those whose lives they will ultimately touch. Their world is an insulated one, somewhat like that of the encapsulated bomber pilot.

This hardly strikes us as a fair characterization of the bankers we know. But it may not make very much difference whether many (or any) bankers accept such a statement as a legitimate characterization of their business. If enough of the community at large comes to accept it as true, it will demand of its banks that they act as if it were true and will insist on actions that are collectively thought of as "responsible."

As the fish deposit story shows, the environment can be one of the things that can unexpectedly plunge the business of banking into the midst of social controversy. It can be driven by the conviction of a community that its well-being, its way of life, or even the lives of its citizens are in danger and that the community's bank is not only not acting to stop such danger, but is positively encouraging it.

THE GREENING OF THE WORLD BANK

This sentiment, growing in numbers and sophistication as the environ-

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mental movement matures, has the power to change the business of banking. Nowhere is this more apparent than in the operations of the multilateral development banks.

The largest of such banks, the World Bank, lends more than $20 billion ($20,000 million) a year to developing countries, with approximately $1.38 billion in total loan commitments. Another $9 billion is leveraged through cofinancing arrangements.

The objectives of the Bank are straightforward: "to help raise standards of living in developing countries by channeling financial resources from developed countries to the developing world." Although clearly operating on a different premise from the private financial community, the World Bank shares one important feature with more conventional banks: It is in business to make money. The Bank realizes an average return on its loans of about 8%, or an annual net income of more than $1 billion.

**Gear Shifting**

The focus of the World Bank has shifted gears several times since its inception. The Bank has traditionally focused on infrastructure loans—building ports, roads, communications, utilities, and the like. In the past two decades, agriculture has grown to become a major segment of the Bank's activities. In recent years, the Bank has added a focus of debt-service reductions, combined with structural reforms in the economic policies of the countries receiving aid.

In 1987, the focus seemed to shift yet again. The World Bank, quite suddenly, went green. In speech after speech and publication after publication, the rhetoric of environmentalism rang out. The Bank went so far as to admit a sort of culpability for the absence of an environmental framework in its past activities.

"If the World Bank has been part of the [environmental] problem in the past, it can and will be a strong force in finding solutions in the future," announced Bank President Barber Conable. And in a Bank publication: "The Bank has had to change. Although the Bank did not ignore environmental issues altogether in the past, it did not give them sufficient attention."

Words were followed with deeds. The Bank brought in a highly professional and sizable environmental staff and created project review and approval mechanisms that incorporated environmental considerations.

**Reason for World Bank's Embrace of Environmentalism**

We will review some of the World Bank's environmental mechanisms later on. For the moment, the question of interest is what prompted the Bank to so dramatically embrace environmentalism. The answer is a simple one—social pressure, in this case pressure brought to bear by the community of international environmental activists. Using techniques far more sophisticated (and far less odious) than the fish deposit, environmentalists launched a concerted campaign that was singularly successful in getting the normally insular institution to revamp its operational philosophies completely.

Environmentalists around the world—led by well-established groups in the U.S. such as the Environmental Defense Fund and the Sierra Club, and including organizations in Europe as well as in developing countries receiving World Bank assistance—organized a campaign to target the World Bank.

The campaign was centered on the principle of accountability. The Bank would not be allowed to operate as an "encapsulated bomber pilot" but would instead be boxed with testimonials about the negative environmental impacts of Bank-sponsored activities. It would be made the object of public, government, and media scrutiny.

Through letter-writing campaigns, press releases, government hearings, and open demonstrations, the environmental community made its displeasure known with the Bank's operations known in a very public fashion. Publications with alarming titles like Financing Ecological Destruction: The World Bank and the International Fund began appearing regularly, often for distribution at the Bank's annual meetings.

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The pressure was more than mere embarrassment. In the countries that support the operations of the World Bank, especially in the U.S. and West Germany, the financial backing of the Bank was on the line as legislators questioned the continued wisdom of supporting environmentally destructive activities. In countries receiving support from the Bank, the ability to carry out controversial projects was threatened by grass-roots actions, often supported by an international network of activists. The protests of 100,000 tribemen in the Philippines, for instance, forced the Bank to withdraw from the huge Chico Dam construction project.

**Effect of Commercial Banking**

The details of the pressure applied to the World Bank and the reasons for environmentalists' concerns with Bank activities have been well reviewed elsewhere.\(^*\) Does the greening of the World Bank foreshadow forces that may change commercial banking as well?

We believe the answer to this question to be a definitive "yes." The details of what the changes will be have yet to be defined, but the various forces at work steering banking toward environmentalism—public pressure among them—are coming into clearer focus.

In addition to the "outside-in" forces that can thrust a financial institution into direct involvement with

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environmental affairs, there are also factors at work within the financial community which are elevating the importance of making environmental concerns a routine part of doing business. Bit by bit, environmental concerns are being incorporated into the day-to-day business of banking.

ENVIRONMENTAL PROBLEMS

At times, banks become involved in a very direct manner with serious, and potentially costly, environmental problems. The most notorious example of this is the extension of environmental liability for, say, a hazardous waste site, to institutions whose only connection with the site are purely financial.

Under the provisions of the Superfund law in the U.S. for remediating contaminated dump sites, banks that foreclose on contaminated properties (or become closely involved in property management) can be held legally responsible for the costs of cleaning up that site. The banks become, in the vernacular of the regulators, the most convenient "deep pocket."

Maryland Bank & Trust, reluctant owner of a farm later found to be grossly contaminated with toxic chemicals, reached a court-ordered settlement with the U.S. Environmental Protection Agency for $500,000 for site clean-up, a precedent which sent a shock through the lending community in the U.S. The Maryland district court case is the landmark decision—United States v. Maryland Bank & Trust Co., 632 F. Supp. 573 (D. Md. 1986).

Some of the Issues

Foreclosures of residential properties can also bring trouble. A house contaminated with flaking asbestos insulation, or with lead paint on the walls, may have no market value until remedial work is undertaken and may have a liability associated with it if sold without being decontaminated. As is the case with commercial properties, the losses involved as a result of environmental liability can far exceed the value of the property itself.

Banks have had to confront toxic property issues head-on, and in very conventional terms—environmental problems pose a substantial risk, one that banks are learning to minimize. To accomplish this, banks have turned to professional environmental assessments for many of their real estate transactions. According to a survey of the Mortgage Bankers Association of America, more than 70% of all commercial real estate transactions now undergo such assessments (compared to 15% a few years ago), and the figure is expected to rise to 85% in the next few years.

Toxic liabilities are not unique to the U.S., although the Superfund law carries such liabilities further than in most countries. But in many places around the world the increasing involvement of the financial community in industrial ventures ties the operations of the former to the environmental issues of the latter.

In an era of unprecedented financial flexibility, the boundaries between the "money-as-goods" and the "goods-as-money" industries have grown less distinct. This is especially true in the 500 or so debt-for-equity swaps that have arisen as a means of reducing Third World debt, a practice that often breaches the traditional barriers that distinguish banking from heavy industry.

Examples of Banks' Involvement

For instance, as a result of debt-for-equity swaps with Mexico, a group of more than 50 banks now owns a controlling interest in Grupo Alfa, Mexico's largest private manufacturing enterprise. Manufacturers Hanover has sizable interests in a Brazilian paper manufacturer, a Mexican steel mill, and a string of hotels in Cancun. Chase Manhattan converted $200 million in debt to invest in a Brazilian automobile manufacturer. Bankers Trust is part owner of a gold mine in the Amazon rain forest. Citibank has partly taken over an uncompleted paper plant in Chile. Pin-striped bankers have in essence become hardhat managers of chemical plants, plastics manufacturing operations, and paper mills.

Banks in Europe and elsewhere often have a longer history of direct ties to the manufacturing sector than do their American counterparts. Deutsche Bank in West Germany has at least a 25% stake in the huge car manufacturing operations of Daimler-Benz. Japanese financiers and industrialists organize into sogoshosha, huge conglomerates of banking, manufacturing, and marketing services. C. Itoh, the largest sogoshosha, is headed up by Dai-Ichi Kangyo Bank, the largest bank in the world; Mitsubishi manufacturing operations are inextricably linked to Mitsubishi Bank.

Concern about Environmental Catastrophes

Mining, paper mills, chemical plants—these are activities that almost involuntarily call to mind images of environmental destruction. Although such destruction is by no means inevitable, neither is it uncommon. What if something were to go dramatically wrong, on the scale of an Exxon Valdez oil spill or worse, a Bhopal-type catastrophe? What if these activities

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10 "Superfund Law Stiffles Credit for Small Businesses," ABA Banker Weekly, April 17, 1990, p. 12 (the article was authored by Congressman John LaFalce, Chairman of the Small Business Committee in the U.S. House of Representatives).


12 Susan George, A Fate Worse Than Debt, Grove Weidenfeld, New York, 1990, p. 204.


become the target of a concerted public interest campaign.

To the extent that any of these commercial activities—or other activities such as financing dams, clear-cutting, nuclear power plants, offshore drilling—lead to environmentally damaging results and can be linked directly to a given bank, then we have exactly the conditions that brought about both the fish deposit and the environmentalists' full court press against the World Bank.

It seems only a matter of time before many of the same pressures are brought to bear on the international banking community. Indeed, Citibank has backed out of a multi-party agreement to finance a Brazilian power sector loan, in part due to very visible opposition from environmentalists.15

ENVIRONMENTALISM AS AN OPPORTUNITY

Not all environmental concerns translate to problems for the banking community. The greening of a bank's customers, whether borrowers or depositors, provides a growing opportunity for benefit. So-called ethical investment funds, those that refuse investments in companies with an environmental or ethical black eye, are an emerging financial service, many of which are establishing quite respectable returns on investment. At last count, there were 17 such funds on the U.K. market; ethical funds in the U.S., by some estimates, have total assets of $500 billion, about 20% of the total market.16

Some U.S. investment funds with a particularly environmental focus are listed on page 9. Note that the largest of these has assets four times the size of the World Bank's annual loan commitments—an indicator, perhaps, of the relative impact of decisions made in the private financial sector on overall environmental concerns.

How Borrowers Fit into the Picture

On the other side of the financial coin is the community of borrowers. The environmental services industry—anything from pollution control equipment, to site clean-up, to help with regulatory paperwork—is growing in the U.S. at a rate of 10-20% a year. Indexes tied to environmental stocks have consistently outpaced the rise in the overall market.17

The Clean Air Act in the U.S. will greatly expand the notion of marketplace pollution control by creating tradable permits for emitting limited amounts of polluting gases—an esoteric but potentially profitable area for the involvement of the financial community. Banks that expect to finance these growing areas will certainly need to develop the appropriate environmental expertise. But beyond that, they will also need to cultivate a sensitivity to the types of public concerns that led to the fish deposit.18

In the simplest of terms, environmental concerns are offering a host of new benefits, in the forms of investment opportunities, and are remolding the notion of risk by introducing environmental and social aspects to conventional economic considerations.

A Steady Breeze of Change

Might all these factors converge to alter the nature of the banking business? We live in remarkable times, and it has become commonplace to say: A few years ago, no one would have predicted that . . . Environmentalism has certainly been one of those remarkable things; no one could have predicted that the summit meeting for the leaders of the western world would be dubbed "The Green Summit," or that environmental problems would substantially fan the fires of protest in Eastern Europe, or that the world's industrialists would voluntarily agree to phase out the manufacture of profitable chemicals that are destroying the ozone layer. We don't know, of course, what the future holds in store for the financial community, but it does seem that the winds of change, if not quite a gale, are certainly blowing with a steady breeze.

But what sort of change? Given our contention that environmentalism will become an important focus for managers in the financial community, what sort of actions make sense? What should a bank president, a loan officer, an investment fund manager be doing?

World Bank as Model?

One model of change has already been created by the World Bank. The Bank has embraced the environmental ethic and, in doing so, has made it a legitimate area of banking activity. Environmental expertise has been greatly expanded, both in the "big picture" areas of Bank policy, as well as in the nuts and bolts design and oversight of individual projects. Environmental review is an integral part of loan assessments and, in some cases, can override more conventional economic assessments regarding the viability of a given project. A growing proportion of the Bank's dollars are being lent directly to environmental improvement activities.

We want to be careful about appealing to the World Bank as a model for the entire financial community. For one thing, environmentalists are still very critical of activities at the Bank, often decrying the Bank's new focus as more fluff than substance.19

Some of the criticism seems justified. At the same time, it is doubtless a difficult task to translate principle into practice successfully, especially when

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15 March 8, 1989 press release from Friends of the Earth, an international environmental group. The press release was retrieved from "Ecomet," a computer bulletin board and networking operation.


the momentum of an entire institutional juggernaut must be oriented in a new direction. The World Bank's environmental focus—its success in the field notwithstanding—strikes us as genuine.

Transferable Features

What is appropriate for the World Bank is not necessarily appropriate for the entire financial community. There are several features which do seem broadly transferable, however:

1. The bank president should carry the flag. Upper management sets the tone for an institution's priorities. If every speech, policy statement, and memo is about currency swaps, deregulation, debt conversion—in short, about everything except the environment—it conveys an unmistakable message of the environment as a nonissue. With the environment as a very visible priority of CEO and presidential concern, it begins to become a legitimate area for management thought and action.

2. Recognize the environment as a factor in conventional banking decisions. Projects which at one time seemed highly desirable may no longer be so due to environmental considerations. Providing loans to a highly polluting manufacturing plant, an ill-considered dam, or a destructive clear-cutting project in a tropical forest may not be as attractive now as a decade past due to the increased likelihood that organized opposition to the project may render it unprofitable or even unable to function altogether. Certainly, banks would (or should) hesitate to finance a nuclear power plant in many countries, given the high probability that the plant may never go on-line. The same factors that constrain the nuclear power industry are being brought to bear elsewhere as well.

3. Also recognize the environment as an unconventional but legitimate area of banking concerns. Rather than merely being reactive to public environmental concern, banks can take the lead in orienting their activities to more environmentally beneficial projects. There is no reason to suppose that environmentally less destructive activities are incompatible with a bank's responsibilities to its customers and shareholders. Financial institutions can actively explore means of achieving both, without sacrificing either.

4. Create an institutional framework. For some people, environmentalism is both a cause and a profession. They should be brought into the financial community as a way of actively fostering all of the areas just mentioned.

CONCLUSION

"Sustainable development" is the latest buzzword in the arena where environmental and economic concerns overlap. It refers to the need to develop our global society in a manner which provides for the current generation, without robbing future generations of their right to a livable environment. If we are to achieve sustainable development, we must be prepared to finance it.

Certainly, the environmental devastation of Eastern Europe and the pressing need to rebuild its infrastructure and economy speak to the interconnectedness of environment and economics and the need for sustain-