# David Carse: Environmental issues and their implications for financial institutions in Hong Kong

Keynote Speech by Mr David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, at the Conference on Environmental Risk Management for Hong Kong Financial Institutions, held in Hong Kong on 29 November 2000.

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Ladies and gentlemen,

I am pleased to be here to deliver the keynote speech for this conference on Environmental Risk Management for Hong Kong Financial Institutions.

I congratulate the various organisers for putting together the conference, which I understand is the first of its kind to be held in Hong Kong. If so, it is long overdue. Environmental issues have come very much to the forefront of public awareness in Hong Kong in recent years, and cleaning up the environment has become one of the Government's main preoccupations. There are all sorts of good reasons for wishing to do this, in terms of improving the quality of life and the long-term health and well-being of the people of Hong Kong. But there is also a growing recognition on the part of business, both here and elsewhere, that economic growth is inextricably linked with a healthy environment. At this year's World Economic Forum in Davos, business leaders voted global climate change the most pressing issue facing the world's business community. It is all the more disappointing therefore that last week's UN summit conference in The Hague on climate change should have ended in failure.

At first sight it might appear that banks and other financial institutions, as service companies, have less responsibility for environmental protection than other companies, notably those whose industrial processes have a direct impact on the environment. However, this would be to ignore the central role in the economy that banks have as financial intermediaries. While they may not be polluters themselves, they will probably have a banking relationship with some companies that are polluters or could be in the future.

This creates a number of risks for the banks, and raises the question of how these risks should be identified, measured, monitored and controlled. This is primarily a matter for banks' management to deal with, and I hope that today's conference will help them to do so. But it is also an issue for banking regulators, particularly with the increased focus on risk-based supervision. In the case of the HKMA, this is a process whereby we try to assess the extent to which banks are exposed to various types of risk and the quality of the systems used for managing these risks. For this purpose, we have identified eight different types of risk: credit, market, interest rate, liquidity, operational, legal, reputation and strategic.

Environmental risk straddles a number of these risks. In particular, it is a subset of credit, legal and reputation risk:

- **Credit risk** can arise indirectly where banks are lending to customers whose businesses are adversely affected by the costs of cleaning up pollution or by changes in environmental regulations. For example, the costs of meeting new requirements on emission levels may be sufficient to put some companies out of business. Banks may also find themselves directly affected if they find that the value of property that they have taken as collateral is impaired by contamination.
- **Legal risk** can take a number of different forms. Most obviously, banks like other companies are at risk if they themselves do not comply with relevant environmental legislation. But more specifically, they are at risk of direct lender liability for clean-up costs or claims for damages if they have actually taken possession of contaminated or pollution-

causing property as a result of realising security. There is also the even more worrying prospect that in some jurisdictions the mere act of lending to a company or project which causes environmental problems may lead to the lender incurring some liability for clean-up costs. Banks may protest, with some justification, that they should not be forced into the role of "environmental police", but this may carry little weight in some courts.

- **Reputation risk** may arise even in the absence of lender liability, particularly if banks are seen as associated with large-scale projects that are viewed as socially or environmentally damaging, such as dam projects. The growth of globalised protest movements and the use of the internet to disseminate information have greatly increased the risk that individual companies will be the subject of concerted campaigns of public criticism.

These are the risks, but it would also be wrong to ignore the opportunities that environmental protection can provide for banks and other financial institutions. Most obviously, the costs of cleaning up pollution and the need to invest in environmentally friendly technology imply the need for finance, either from the banks or the capital markets. Just to take one small example in the Hong Kong context, the Government's initiative to persuade diesel taxi owners to switch to LPG taxis creates the chance for the banks to finance the purchase of the new vehicles. Banks also need to bear in mind that while there will be losers from the drive to cut pollution, there will also be winners in the shape of those companies which can exploit the new technologies to curb emissions.

Another by-product from efforts to combat climate change will be the growth of emissions trading between companies. Such trading allows companies that can reduce their carbon emissions below allotted targets to sell their surplus credits to those companies that cannot reach their targets. Admittedly, the immediate future of emissions trading is in some doubt following the Hague conference, but it still has the potential to become a major commodity market. If so, there will inevitably be a role for financial institutions to broker deals between buyers and sellers of emission credits, and perhaps to take positions themselves.

Finally, banks and other financial institutions can profit from the growing public awareness of environmental issues by offering "green" investment products.

How do banks in Hong Kong measure up in terms of environmental issues? As an international financial centre, Hong Kong provides a base for a number of multinational banks that have developed detailed environmental policies and procedures. In the case of local and regional banks, I would say that environmental issues are less highly articulated. This is why I welcome this conference and the involvement in it of the Hong Kong Association of Banks.

It is not my purpose in this speech to anticipate the more detailed advice that subsequent speakers are going to offer. But I would like to offer a few general recommendations that banks should take into account in dealing with environmental issues.

**First, banks should keep themselves informed about international and regional initiatives on the environment, particularly those that directly concern financial institutions.**

In this connection, I would draw the attention of those institutions that are not already aware of it to the work of the United Nations Environment Programme ("UNEP"). This is the main UN institution that deals with environmental questions. As part of its work, it has established a Financial Institutions Initiative on the Environment which is a partnership between UNEP and leading banking and insurance companies to promote sustainable development and environmentally sound business practices. The basic role of the Initiative is to promote the integration of environmental considerations into all aspects of the financial sector's operations and services.

One of the products of the Initiative is a "Statement by Financial Institutions on the Environment and Sustainable Development" (which is appended to this speech). The Statement includes a commitment by financial institutions to contribute towards sustainable development, to adopt a precautionary approach to environmental management and to foster public awareness and communication of their environmental policies. Over 160 institutions have signed up to the statement, but none I regret from Hong Kong, except those which have done so by virtue of being part of international banking groups. I would therefore urge banks in Hong Kong to consider becoming signatories to the Statement, and to familiarise themselves with the work of the Initiative more generally. You will find that the various components of the work of the Initiative, including annual roundtable meetings, provide much useful practical guidance to financial institutions on how to tackle environmental issues.

**Secondly, in line with the UNEP Statement referred to above, banks should consider producing a formal environmental policy statement and making this publicly available.**

Such a statement should represent an acknowledgement by the bank that it must take environmental implications into account in its business operations, decisions and processes. This should include its own use of energy and resources and how it interacts with customers. However, on its own, a policy runs the risk of becoming a "motherhood" statement. Policies should therefore be backed up by management structures and systems, specific objectives, action plans and monitoring procedures to ensure that concrete results are achieved. Banks should also issue regular environmental reports that inform the outside world of their progress in meeting their environmental objectives. This is one area where the public sector has taken the lead in Hong Kong. Following the Chief Executive's 1998 Policy Address all Government bureaux and departments (including the HKMA) are now required to publish annual reports on their environmental policies and actions.

**Thirdly, banks should where appropriate build environmental risk assessments into their credit decisions.**

This follows from my earlier comments about environment and credit risk. Of course, detailed environmental risk assessment will not be appropriate in all cases. At its most general, environmental considerations are simply part of the process of "know your customer" - in other words, being aware of the nature of his business and industrial operations, and being alive to the possibility that that there may be an environmental angle. In particular cases, however, more detailed assessment and quantification of the environmental risks will be required. This will be the case, for example, where land is being taken as security or where the borrower is involved in a high-risk industry such as chemicals. Obviously, the larger the bank's exposure, the more important the environmental risk assessment becomes. Taken to the extreme, where the bank is involved in the financing of a large-scale project such as the construction of a power plant, a full environmental impact assessment should be obtained from a professional and independent expert.

One point that is particularly relevant to banks that finance companies or projects in countries like China is that the rules of the environmental game can change very quickly. The authorities in China are getting serious about cutting emissions and pollution, as the requirement by the Beijing Municipal Government on the Shougang Steel Group to cut back its output has shown. The problem in China is that regulations are not always strictly enforced. But this can change overnight, resulting in major compliance problems for the companies concerned and increased risk for the banks that have lent to them. Hong Kong banks which lend into China would therefore be well advised to keep this in mind.

**Finally, banks should pay close regard to their own "corporate ecology".**

Banks can contribute to environmental protection by the way in which they manage their use of resources in their own operations. In this way banks can be responsible corporate citizens while at the same time reducing business costs. The type of measures that can be adopted include saving on energy consumption, recycling of paper, waste management, purchasing environmentally friendly products and use of video conferencing to cut down on unnecessary travel. Use of office automation such as email can also help to reduce the consumption of paper, provided of course that staff can be encouraged not to print out the messages. The important aspect of this, as with other areas of environmental management, is to try to set measurable objectives for green initiatives, to assign management responsibility for monitoring performance and to offer staff guidance and training on how to achieve the desired results. As noted earlier, the progress should be communicated to the outside world in the bank's environmental report.

I would like to close by expressing my appreciation for being allowed the opportunity to speak to you today on this important topic. Doing the research for my speech has certainly helped to raise my own awareness of the importance of environmental issues in general and the implications of these for financial institutions in particular. I hope that you will find this conference to be useful and informative, and that you will pick up lessons and advice on environmental issues that you can take back with you to build into your business operations and decisions. The need to do this is the keynote of my speech and the main theme of this conference.

# UNEP Statement by Financial Institutions on the Environment & Sustainable Development

# (As Revised - May 1997 )

We members of the financial services industry recognize that sustainable development depends upon a positive interaction between economic and social development, and environmental protection, to balance the interests of this and future generations. We further recognize that sustainable development is the collective responsibility of government, business, and individuals. We are committed to working cooperatively with these sectors within the framework of market mechanisms toward common environmental goals.

1. Commitment to Sustainable Development

    1.1. We regard sustainable development as a fundamental aspect of sound business management.
    1.2. We believe that sustainable development can best be achieved by allowing markets to work within an appropriate framework of cost-efficient regulations and economic instruments. Governments in all countries have a leadership role in establishing and enforcing long-term common environmental priorities and values.
    1.3. We regard the financial services sector as an important contributor towards sustainable development, in association with other economic sectors.
    1.4. We recognize that sustainable development is a corporate commitment and an integral part of our pursuit of good corporate citizenship.

2. Environmental Management and Financial Institutions

    2.1. We support the precautionary approach to environmental management, which strives to anticipate and prevent potential environmental degradation.
    2.2. We are committed to complying with local, national, and international environmental regulations applicable to our operations and business services. We will work towards integrating environmental considerations into our operations, asset management, and other business decisions, in all markets.
    2.3. We recognize that identifying and quantifying environmental risks should be part of the normal process of risk assessment and management, both in domestic and international operations. With regard to our customers, we regard compliance with applicable environmental regulations and the use of sound environmental practices as important factors in demonstrating effective corporate management.
    2.4. We will endeavor to pursue the best practice in environmental management, including energy efficiency, recycling and waste reduction. We will seek to

form business relations with partners, suppliers, and subcontractors who follow similarly high environmental standards.

2.5. We intend to update our practices periodically to incorporate relevant developments in environmental management. We encourage the industry to undertake research in these and related areas.

2.6. We recognize the need to conduct internal environmental reviews on a periodic basis, and to measure our activities against our environmental goals.

2.7. We encourage the financial services sector to develop products and services which will promote environmental protection.

3. Public Awareness and Communication

3.1. We recommend that financial institutions develop and publish a statement of their environmental policy and periodically report on the steps they have taken to promote integration of environmental considerations into their operations.

3.2. We will share information with customers, as appropriate, so that they may strengthen their own capacity to reduce environmental risk and promote sustainable development.

3.3. We will foster openness and dialogue relating to environmental matters with relevant audiences, including shareholders, employees, customers, governments, and the public.

3.4. We ask the United Nations Environment Programme (UNEP) to assist the industry to further the principles and goals of this Statement by providing, within its capacity, relevant information relating to sustainable development.

3.5. We will encourage other financial institutions to support this Statement. We are committed to share with them our experiences and knowledge in order to extend best practices.

3.6. We will work with UNEP periodically to review the success in implementing this Statement and will revise it as appropriate.

4. We, the undersigned, endorse the principles set forth in the above statement and will endeavor to ensure that our policies and business actions promote the consideration of the environment and sustainable development.