Regulation of Socially Responsible Investment in the Financial Services Sector: Global Trends and Lessons

Ben Richardson

Osgoode Hall Law School, Toronto

The era of ‘finance capitalism’

- Massive growth of institutional investment
- Growth in businesses’ need for external financing
- Differences among countries in terms of businesses’ reliance on loans, corporate bonds and equity financing.
- Corporate managers’ sensitivity to their company’s stock prices.

Problems of financial markets from an SRI perspective

- Prevalence of short-term over long-term investment horizons
- Excessive speculative, unproductive investment
- Insufficient attention to the environmental and social costs / benefits of financing
- Insufficient shareholder activism and corporate engagement

What is socially responsible investment (SRI)?

SRI is a financing process that considers the social, environmental and ethical consequences of investments and loans, both positive and negative.

Primary functions and aims of SRI

1. Traditional ‘ethical’ investment (religious roots) driven essentially by ethics, regardless of financial risks and returns.

2. SRI motivated by desire to maximise shareholder value by addressing misbehaviour of corporate managers.

3. SRI to address market failures, where there is no or incomplete state regulation or social sanctions.

Who is participating in SRI?

- Church-based ethical investment
- Mutual ethical funds for individual ‘retail’ investors
- Institutional investors (eg pension funds) interested in long-term sustainable development
- Commercial banks considering social and environmental risks in project finance and mortgage lending

What are the methods of SRI?

- SRI screens - to include or exclude companies from loans or equity investments on social and environmental criteria
- ‘Best of sector’ selections - giving preference to firms that perform best in their sector according to SRI indicators
- ‘Index-based’ method - constructing investment portfolios using established SRI indices such as the Dow Jones Sustainability Index
- Shareholder activism and corporate engagement

How extensive is SRI today?

- Some 350 SRI ‘retail’ funds in the European Union = 0.5% of the total assets managed by retail funds in EU
- Some 3 - 5% of institutional investor finance worldwide tied to SRI criteria
- Emergence of specialist environmental banks and credit unions: eg Co-operative Bank (UK), Citizens Bank (Canada) and Triodos (Netherlands)

Non-state regulation: Global voluntary standards and codes

- UN Principles of Responsible Investment (2006)
- Equator Principles (2003)
- London Principles of Sustainable Finance (2002)
- Global Environmental Reporting: financial sector reporting supplement (2002)
- UNEP Statement by Financial Institutions on the Environment & Sustainable Development (1994)

Other non-state governance mechanisms

- SRI think-tanks, industry associations and lobbyist groups:
  - Association for Sustainable and Responsible Investment in Asia (ASrIA)
  - Social Investment Forum (USA)
  - Ethical Investment Research Service - EIRIS (UK)

- SRI stock market indices:
  - Dow Jones Sustainability Index
  - FTSE4GOOD Series Indices

Lender liability for environmental damage

- Comprehensive Environmental Response, Compensation & Liability Act, 1980 (US)
- Asset Conservation, Lender Liability and Deposit Insurance Protection Act 1996 (US)
- EU Directive on Environmental Liability 2004

Informational policy instruments

- **Obligations on occupational pension funds to disclose their policies for ethical, social and environmental investment :**

  - adopted in Australia, Austria and Belgium, Germany and UK since 2000

UK’s Pensions Act 1995: regs of 1999

“… trustees must state their policy in their statement of investment principles [on] -

(a) the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and

(b) their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to investments".

Australia's Financial Services Reform Act, 2001: section 1013D

"If the product has an investment component, (the Act requires a statement by its provider of) the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment".

Corporate non-financial reporting

- Mandatory corporate non-financial reporting legislation introduced in:

  - Australia, Denmark, France, Germany Norway, Sweden and US

Other informational policy instruments

- **Environmental management systems:**

  - European Union's Eco-Management Audit Scheme (EMAS) amended in 2001 to include the financial sector.

- **Eco-labeling regimes:**

  - European Union's Eco-Labeling Directive amended in 2000 to include the financial sector.

Incentive policy instruments

- Green Investment Directive 1995 (Netherlands)
- Community Investment Tax Relief 2002 (UK)

Corporate governance reforms

- Reforms to improve shareholder rights and voting to enable shareholder activism:
  - France's Economic Regulations Act of 2001
  - Germany's German Corporate Governance Code
  - Canada Business Corporations Act 1975 (amendments of 2001)

New Zealand Superannuation Act 2001: subsection 61(d)

“Contents of statements of investment policies, standards, and procedures:

A statement of investment policies, standards, and procedures must cover (but is not limited to) - …

(d) ethical investment, including policies, standards, or procedures for avoiding prejudice to New Zealand’s reputation as a responsible member of the world community; … “

Some future policy and regulatory challenges for SRI governance

1. What evidence is there that SRI actually influences and improves corporate behaviour?
2. Do we need to authoritatively define what qualifies as "socially responsible investment"?
3. Are informational and monetary incentive-based policy instruments adequate to stimulate SRI?

Some future policy and regulatory challenges for SRI governance

4. **How do differences in the institutional characteristics of financiers (eg pension vs mutual funds) influence their capacity or willingness to respond to SRI causes?**

5. **How do differences in the character of SRI concerns (eg climate change vs child labour) influence the response of financiers?**

Some policy and regulatory challenges for SRI governance

6. Should governments become more directly involved in capital allocation for SRI causes?

7. How can effective SRI governance be achieved in the context of transnational financial markets?

Further selected reading

- R. Sullivan & C. MacKenzie, *Responsible Investment* (Greenleaf Publishing, 2005).
- P. Ali & K. Yano, *Eco-Finance: Legal Design and Regulation of Market-based Environmental Instruments* (Kluwer, 2004).
- R. Sparkes, *Socially Responsible Investment: A Global Revolution* (John Wiley & Sons 2002).
- S Labatt & RR White, *Environmental Finance:* (John Wiley & Sons 2002)
- M. Jeucken, *Sustainable Finance and Banking* (Earthscan, 2001).