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Rachel Kyte
Director, Environment and Social Development Department
International Finance Corporation

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***Standards for Capital -
The Challenge for Private Equity***

Good morning ladies and gentlemen. I am honored to be here and for IFC to again sponsor ASrIA's annual conference. Let me begin by recognizing the work of Tessa Tennant, Melissa Brown and their team—not only for organizing this event but especially for their pioneering work in promoting sustainable and responsible investment in Asia. IFC is so proud to be part of this event because of the important work ASrIA is doing.

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Today, I would like to share with you some thoughts on private equity opportunities and challenges in Asia's emerging markets. It was mentioned yesterday that there is a jungle of standards out there. I would propose that IFC is the Tarzan of the investment community in the jungles of the developing world. So today I plan to challenge the private equity industry to sort through the vines and to choose your own. In short, develop your own due diligence standards.

But before I return to this serious challenge, I want to introduce the International Finance Corporation to those who may not be familiar with us. IFC is the private sector arm of the World Bank. We have been investing in

private business in emerging markets since 1956 and we are the largest multilateral investor in the developing world. We provide loan and equity financing for private sector projects, we mobilize additional financing for these projects from other lenders, we invest in funds and we provide advice and technical assistance to businesses and governments. We invest across the full spectrum of an economy, from banks and infrastructure projects, to hospitals and schools, to financial institutions, equity funds and microcredit operations. We are a significant force for development, providing both capital and resources. Last year our investments from our own account approached nearly \$5 billion in direct financing and since 1990 we have leveraged more than \$100 billion from other sources. This level of engagement has given us the opportunity to lead and to learn from our experience.

We are also the largest investor in private equity in developing countries in the world. We have a portfolio of investments in emerging market investment funds representing a commitment of \$1 billion in more than 120 funds, over 80% of which are private equity. IFC also has stakes in about 25 fund management companies. We therefore have a strong interest, and indeed commitment, to seeing this market contribute to a sustainable private sector in the developing world. We believe that sustainable business can be achieved—indeed that investments can provide financial returns—only if the financial sector directs resources toward sustainable and responsible investment opportunities and companies that have adopted a sustainable business model. Development is about expansion of opportunities. It is not a zero sum game and business practices must reflect that. To use a stark example, there just won't be any forests or fish left if we don't invest in companies that are harvesting them in sustainable ways. Ethics aside, the financial sector has the primary motivator to effect change—money.

The time is ripe for the private equity industry to take a leadership role in shaping its future. The industry can do that by adopting common due diligence standards. You should do it because you will reduce risks by directing investments towards companies and funds that meet sound corporate governance, environmental and social practices. You should do it because you will be able to raise more capital for private equity investments in emerging markets because investors will be more confident in investing in these companies. And you should do it because you will achieve higher returns on your investments as these well managed companies prosper.

Now I know that not everyone in this audience is from the private equity industry. But I want to address the challenge to those of you who are, and hopefully get some feedback from those inside AND outside the industry. I also believe that these issues are directly relevant to all institutional investors. The challenge before you is to seize the opportunity that the today's emerging markets offer—and not just in terms of fund expansion. The challenge is to take a leadership role in adopting global standards in environmental and social best practices.

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So where are we now. The climate for international capital flows to emerging markets is changing for all investors and this affects corporations, banks, fund managers and multilateral institutions. Less than a decade ago, IFC adopted a “do no harm” approach to the environment and local communities that helped us integrate social, environmental, and good governance practices into the appraisal and supervision of our investments. Today, we seek to do more, striving to achieve best practices and innovation. We have learned that it is possible to apply social, environmental and governance standards to build successful companies that add value to their local communities and

contribute more broadly to development. We help the private sector to find opportunities in how they address development challenges such involuntary resettlement, labor and working conditions, community health and safety, and biodiversity conservation, to name but a few. Our story illustrates where the financial sector is moving. It exposes the challenging issues that the industry faces as it directs its investments towards companies with sustainable business models.

Standards are the building blocks of IFC's approach to sustainability. Going beyond standards makes financial and reputational sense. Following our guidelines and incorporating safeguards into our investments remains an important means to ensure that the interests of stakeholders are accounted for and that we reduce long term financial risks. Our investments, whether through project finance or private equity, follow IFC's environmental and social safeguard policies and guidelines. We have taken a leadership role in setting standards and I am personally involved in IFC's current review and update of all of our environmental and social policies and guidelines to enhance their effectiveness. It is indicative of our move from viewing standards as primarily a compliance function to one of value creation where we are in a partnership for development with our clients. Our goal is also to improve the clarity of our standards and to ensure that they provide concise and comprehensive, yet flexible, guidance on how to meet basic social and environmental criteria in a complex world.

The first stage in that process is almost complete. These draft Social and Environmental Performance Standards will be available for public comment at the end of July. I hope that many of you here today will attend and comment on them at a regional workshop to be held later this year. Your comments in writing will also be welcomed.

We have learned a lot from this process of standard setting and we believe that this experience can provide useful lessons and opportunities for others.

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IFC is well positioned to understand and respond to the challenges facing the private equity industry and indeed to challenge the industry to develop its own standards. I mentioned earlier that we are the world's largest fund investor in emerging markets. We are also a trainer and an innovator to the industry through the leadership of our Private Equity and Investment Funds Department. Our Sustainable Financial Markets Facility has been supporting innovators in the field such as ASrIA, mentoring private equity fund managers and conducting research to demonstrate the business case for sustainability in emerging markets. We are also working with the Emerging Markets Private Equity Association, known as EMPEA, to build the capacity of the association to offer training to fund managers.

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But the bottom line is this: Funds needs to find ways to better ensure the upside of working in markets with high growth potential. They need to better manage risk in order to grow in these markets. Clear and appropriately focused standards are the means achieving this. The opportunities are clear. Growth is again high across the region. Recent economic figures out of India shows it rivaling China's growth. Here in Singapore, the days of double digit growth are back, according to figures released just this week. While China is awash in direct investment, other big markets in this region are hungry for funds. There are huge consumer markets, with more than half of people on the planet live in China, India and Indonesia.

But the challenges are equally clear. The region's cities are being expanded at the rate of 40 million people every year. People are migrating from the country because they want take part in a growing economy and create a better life for their children. But these new city dwellers also make heavy demands on resources—creating challenges and opportunities that will only be met if private companies are up to the tasks that await Asia in the coming decades.

Often private companies are not up to the challenge on their own, but smart companies understand they have to adapt to the changing marketplace. That's where funds can play a big role. Private equity managers, in our experience, play an enormously positive role in helping “professionalize” their investee companies. They do this by improving their corporate governance, financial, environmental and social performance, often in preparation for an initial public offering. Yet institutional investors remain wary of the risks in emerging markets, ranging from political unrest and labor standards to SARS and overheating in the Chinese economy. In launching their 2004 seminar series, Insight Investment and Moreley Fund Management acknowledged that “recent developments in China present a huge opportunity for companies and investors,” but added that they “are wary that the business conditions peculiar to China need to be effectively assessed to ensure that companies make the best of the opportunity while avoiding unnecessary risks.” Sadly, it is a sentiment that could be applied to too many emerging markets today.

The result is missed opportunities on an enormous scale. Companies are either failing to adopt sustainable practices or to communicate good practices to potential investors. Last year, ASrIA released an IFC-sponsored study that found a huge pool of potential capital waiting to be invested in Asian companies that can satisfy the requirements of socially responsible

investment funds. The size of the funds using SRI criteria is huge. Another IFC-sponsored study estimates there is \$2.4 trillion in socially responsible investment assets in the world. A mere one tenth of one percent is invested in the world's emerging markets, including Asia.

The job of fund managers to make the case for improved standards to Asian companies, should become easier as sustainable and responsible behavior becomes mainstream globally. A recent survey of CEOs and CFOs, conducted by the World Economic Forum's Corporate Citizenship Initiative, found that 70 percent of the respondents from its member companies "expect to see increased interest in environmental, social and governance issues by mainstream investors in the future."¹ This view is also shared by fund managers, analysts, and investor relations officers. A survey conducted by CSR Europe, Deloitte and Euronext, found that 78 percent of European fund managers and analysts believed that the management of environmental and social risk has a positive impact on a company's long-term market value. Thirty two percent believed this was also the case over a 3-12 months time horizon.²

A key development challenge for emerging markets in Asia is to increase capital flows to the private sector. More than two-thirds of the world's capital is flowing to the United States. Yet among the capital flows to emerging markets, half of the equity investment goes to Asia. There is a tremendous opportunity to increase investments into emerging markets, and particularly in Asia, by reducing investment risk and improving investment upside. The best way to realize that opportunity is through sustainable business practices.

¹ World Economic Forum: Values and Value – Communicating the strategic importance of corporate citizenship to investors, 2003 CEO Survey.

² CSR Europe, Deloitte and Euronext: Investing in Responsible Business. The 2003 survey of European fund managers, financial analysts and investor relations officers, 2003.

IFC's experience around the world has shown that by mainstreaming the assessment of governance, environmental and social risks into our investment decision-making, investment risks are greatly reduced. Analysis of our portfolio has shown that the companies with the lowest risk ratings provide better financial returns and have the greatest development impact. This correlation was also explored in the research we conducted in our *Developing Value* report and we are currently undertaking another study that is assessing the business case for sustainability in our funds and investee companies. We are finding over and over that investment risk in emerging markets can be greatly reduced, and investor confidence increased, through the adoption of consistent due diligence standards.

So the issue, in my view, is not whether higher standards will become the norm. It is how we get there. This is not only a challenge but an imperative because institutional investors face the same set of issues. And if you don't seize the initiative, you will likely face a far more complex problem of standards being forced on you from outside the industry. Private equity has to find a way to voluntarily adapt the changes occurring in the global financial sector. And with the world hanging around you, the challenge may become a burden if it is not accepted.

Private equity is not alone in needing to face up to the new economic, social, and environmental realities. IFC's own environmental and social standards have already become the de facto standard of the banking industry. The so-called Equator Principles have been adopted by over 25 leading banks. These banks include large institutions like ABN Ambro and Citibank but also Brazil's Unibanco, the first to join from an emerging market, and Denmark's EKF, an export credit agency. We hope the next emerging market bank to rise to this challenge will be in Asia.

These standards, which have been adopted by the Equator banks, require lenders to screen the level of environmental and social risk in each project and assign a risk category. For higher risk projects, the borrower completes an Environmental Assessment and an Environmental Management Plan and consults with affected groups. Loan agreements include covenants committing the borrower to comply with the EMP. These plans include measures to address potential environmental impacts, which are now becoming more straightforward to address. They also include measures to address social issues, including labor rights and community development, which by their very nature can be more challenging, less predictable, and thereby potentially pose more serious reputational risks to the investor.

Together these Equator banks arranged about 80% of the project financing in developing countries in 2003. It is no longer speculative to say that large infrastructure or other private projects must have adequate environmental and social safeguards to be financially viable. Banks simply are not willing to take huge financial risks unless they are more certain that other risks have been contained. These banks have also realized that the financial and reputational risks arising from investments could be mitigated through common due diligence standards. It is important to stress that while the Equator Principles were first seen as a risk mitigation tool, this was not the sole motivator. As you well know, financial institutions are very competitive animals not known for having collaborative instincts. However they came together to collaborate as they saw the adoption of common standards as a way to maintain their competitive niche.

Is this the approach for private equity? I don't think so. The industry is different. But there is an important lesson—indeed a challenge—for private equity funds. The Equator banks' experience provides a useful risk reduction

model for consideration by the private equity industry. It also demonstrates that common standards are increasingly viewed as a means to improve business performance and investment returns.

We are already finding that IFC's participation in new private equity funds helps to attract additional capital. Secure that IFC will require high standards, other investors feel comfortable in joining in. Other multilaterals are applying due diligence screens similar to those used by IFC in emerging market investments. Some institutional investors believe that this is the only way to avoid risky investments in emerging markets. A study conducted by McKinsey found that good corporate governance practices raised the value of listed companies by a premium of 25%.

So it is clear that robust risk assessment standards can reduce the perception of risk, channel capital towards viable opportunities and improve the performance of investee companies. It is also easier to communicate key data to markets and institutional investors when performance is measured against known standards. It also levels the playing field, making it easier to conduct due diligence of individual companies and to realize the benefits of doing the right thing.

The pressure for changes in the private equity industry, and indeed the whole financial sector, is coming from all directions and will only intensify. The drive from the top comes from financial analysts and investors who are demanding that fund managers better predict the risks of their investments. There is also pressure from the bottom, from companies themselves that wants more predictability in the demands from fund managers, in the screens that they use and in the requirements that they place on capital.

So, how can the industry meet the demands? An initiative to create common standards for screening such investments can be facilitated by leaders in the

private equity industry or associations that are well placed to take the lead, such as EMPEA. This initiative will need to adopt a combination of screens and performance standards that can be applied to all types of companies and sectors, with a particular focus on the corporate governance, environmental and social issues facing the private equity companies and funds. This will provide clearer information to investors and provide companies with the predictability that they want from a set of consistent screens and standards.

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By adopting higher standards, the industry can contribute to better performance for equity investments in emerging markets, thereby increasing the confidence of investors and capital flows towards development. The pressure to move in this direction is inevitable. This is not speculative, it is real and it is affecting other parts of the financial sector. The issue, in my view, is not whether better standards are right. It is how the private equity industry will get there.

In Hong Kong last October, IFC's Executive Vice President, Peter Woicke, challenged institutional investors to adopt common standards for sustainable and responsible investment. The financial sector is grappling with a number of complex challenges that will only grow. For example, how can the financial sector address human rights and labour standards in developing countries or the impacts of climate change? And how far should companies drill down the supply chain to assess environmental and social compliance?

Based on our experience with the Equator Banks, we view an industry-led approach as far preferable to something that is imposed from the outside. If private equity players do not step up and lead their industry, I suspect you will end up with standards anyway—maybe later, but maybe sooner than you

think. But you will have less say in the process and undoubtedly will be unhappy with the way standards are imposed.

IFC will continue to support a dialogue on standards at the annual Emerging Markets Private Equity Conference hosted by IFC and scheduled for the Spring of 2005, and through our ongoing support of EMPEA.

Today, the ball is in the court of the industry. To those leaders in private equity industry in the audience, I challenge you. Seize this opportunity. Work together to develop a common approach. Focus on the upside. Reduce your risks across the private equity industry. And lead the development of a sustainable private sector in Asia. The private equity industry itself has the most to gain from such an approach.