

# SRI Are we blind to risk in the financial sector?

SRI investors are accused of applying their principles of transparency and accountability to industries where the issues are easily identified while the financial sector escapes examination



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The extraordinary economic events of the past year have created a unique opportunity for shareholders to re-examine their investment process, and to consider both the merits and the shortcomings of environmental, social and governance (ESG) analysis, especially in respect to financial institutions.

The guiding principles of responsible investment are transparency and accountability. Critics charge, however, that SRI investors have been applying these most stringently in industries where the issues are most easily identified. While they have long been scrutinising natural resource companies because their extraction methods are visible and environmentally suspect, or manufacturing companies where working conditions are sub-standard, it seems that much of the financial sector has been escaping examination.

Thus, during 2008, ESG analysts were giving top ratings to the financial institutions that packaged and traded the mortgage-backed securities that underpinned the financial crisis. A review at Southern Illinois University in September last year, of the 41 largest SRI funds in the US, found that three of the top eight holdings were financials: AIG, Bank of America and Citigroup.

It could be argued that the focus of ethical investors has been disproportionately on social and environmental issues, which has allowed companies to win approval by putting in place visible social initiatives, without addressing the wider operations of the business. For example, in 2008 AIG was praised for its retirement benefits and sexual diversity policies, at the same time as its securities portfolio was weighed down by paper that even its own accountants could not fathom.

In the early days of SRI, it was perhaps inevitable that analysts focused on whatever data was in practice available, even if that information sometimes addressed relatively peripheral issues, especially for financial service companies. As ESG analysis has become more mainstream – and responsible investors believe that this discipline enables them to be particularly skilled at identifying risk – it is imperative that ESG professionals identify the material issues of concern to companies, rather than overweight-



**Concern on ethical issues may mask what's going on inside**

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ing what may be more symbolic concerns, such as announced programmes to combat climate change or support the local community.

A key challenge in analysing financial institutions is their complexity, and, in hindsight, it has become clear that many bankers and internal auditors did not always understand the risks of their own products or their financial exposures. Before the crisis, however, it should have been apparent to analysts that where the central operations of a business are not transparent – and distribution of many of these arcane securities was not – there is a reasonable possibility that significant risks are involved.

*At risk? – How companies manage ESG issues at board level*, a report published in April by Ethical Investment Research Services, analysed the ESG risk management strategies of listed companies between 2005 and 2008. Of the industry sectors analysed in the report, the weakest performance was in the financial sector, where a quarter of companies surveyed showed no evidence of ESG risk management at all. This indicates poor disclosure and the failure of financial institutions to recognise the relevance of ESG. It also suggests that the SRI industry needs to rethink how it defines ESG risk for this sector, and to clarify the importance of governance issues.

While environmental and social factors remain important, ESG analysts and fund managers are beginning to focus more on key operational issues, including risk management, reporting and incentive structures, and on the overall degree of professionalism of an organisation. The financial crisis is forcing companies to allocate resources to managing financial and compliance risks, but broader strategic and business risk must still be managed.

In addition to credit risk and market risk, it is also important to recognise that operational risk makes up around 30% of a bank's typical risk portfolio, much of it bound up with governance and oversight. No matter how well the work procedures are defined, if execution is careless or inappropriate, the bank will be exposed to reputational risk and potential financial liability.

The damage done has been most obvious in the retail financial products market, where banks in Hong Kong and Singapore sold complex products, including the Lehman minibonds, to hundreds of retail investors – many of whom did not understand what they were buying and who were dealing with salesmen who probably did not understand them either. Some banks were marketing the products as ‘low risk’, even in September 2008 when Lehman Brothers was already in severe trouble.

After months of protest, threatened legal action and controversy, a HK\$6.3bn (US\$813m) settlement has been agreed between the regulators in Hong Kong and the banks that distributed the minibonds in the territory, under which banks must repay customers at least 60% of their initial investment. Several of the banks have significant exposure, for which they must make provision this year. Bank of China (Hong Kong), the largest minibond distributor, is thought to be liable for approximately US\$400m in repayments.

The financial outlook is stabilising, and markets in Asia have bounced back with vigour. Indeed, highly structured ‘accumulator’ products are again starting to become popular with buyers in Hong Kong. As investors prepare themselves for economic recovery, the SRI community must take this opportunity to reconsider its priorities for research and oversight of the financial sector. ESG analysis of this industry is challenging – it is also essential.

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