

IS SRI THE ANSWER TO THE CRISIS?

Back in 2006, when launching the Principles for Responsible Investments, Kofi Annan, then UN Secretary-General, declared: "... while finance fuels the global economy, investment decision-making and ownership practices do not sufficiently reflect social and environmental considerations... One of the main problems has long been the troubling disconnect between corporate responsibility as a broadly stated management imperative, and the actual behavior of financial markets, which are too often guided primarily by short-term considerations at the expense of long-term objectives." His declaration continued as follows:

"It is my hope that the Principles will help to align investment practices with the goals of the United Nations, thereby contributing to a **more stable and inclusive global economy**... By acting collectively on the basis of the Principles for Responsible Investment, we can help protect all the world's precious assets."

Whilst in 2008, 360 financial institutions had signed the Principles for Responsible Investment, declaring their interest for sustainable investment, the ESG criteria have not yet been taken into consideration in a pervasive manner across the financial industry – and here we are, with a major financial crisis, having major, prejudicial social impact.

So, was the declaration of Kofi Anan premonitory?

Currently the "vox populi" requires more ethics, more governance, more sustainability and more transparency in finance. Let's have a look at the events that led to this situation.

| SUBPRIME CRISIS

The financial crisis started with the subprime crisis, loans being made to low income borrowers, with insufficient consideration of their repayment ability. The loans were then repackaged into non-transparent structured products, which were then purchased by institutions that did not carefully consider the underlying of the product purchased nor its sustain-

ability, concentrating mainly on the Yield/Rating factors. Neither the initiator nor the purchaser considered the social impact of the underlying loans (i.e. the impact for the deeply in debt borrower). And no one imagine the impact that such products would have on the financial market liquidity and stability in 2007/2008. The motivation (at least at the initiator level) was appetite for short term profit, arguably combined with lack of ethics allowing them to take advantage of less transparent structures.

| FINANCIAL CRISIS

As the subprime crisis was affecting financial liquidity overall and, as a knock-on effect, the going concern of large financial institutions, governments were asked to rescue the institutions representing a systemic risk for the economy and consequently invested large amounts in distressed financial institutions. This then led to the "remuneration" scandal, tax payers being shocked to hear the level of remuneration, bonuses or indemnity paid to the management of these institutions as these managers were perceived to have failed in their managerial responsibilities. This situation affected the image of the financial industry as evidenced by the repetitive use of the terms "greed" (a word which had been absent from the financial literature until then), governance or ethics in the press.

| ECONOMIC CRISIS

The financial institutions, weakened by the financial crisis, then drastically sharpened their lending criteria. The severe reduction in credit facilities spread the crisis to the "real economy", exacerbating the social impact of the crisis.

| GLOBAL CRISIS

We can fear, with the emergence of protectionism attitude, that the next phase of

the crisis will hit weaker countries and economies most severely.

| RESOURCES CRISIS

Another angle of analysis is to consider that the subprime issue was not the origin but only a symptom of the crisis, which is the consequence of the unsustainable growth enjoyed over the past decades. This growth was unsustainable because:

- it was largely built on a high level of leverage;
- financial returns were partially derived from virtual asset appreciation rather than actual, tangible wealth creation;
- and, last but not least, such growth leading to natural resources scarcity and degradation could not be sustained in the long term.

As a result, the perceived causes of the crisis are: lack of ethics, poor governance, unsustainable growth, lack of long term view, insufficient consideration of environmental and social impacts. Therefore, there is a drastic demand for more transparency, more ethics and more governance.

| CAN SRI BE THE ANSWER?

The inclusion of ESG (Environmental, Social, Governance) factors in the investment decision certainly address several of these concerns: natural resources protection, social impact consideration, adequate governance and ethics. Transparency is also a key component for SRI actors.

Systematic inclusion of Responsible Investment Principles as a natural constituent of the investment process, as supported by the UNPRI initiative is certainly an answer to those requesting a different financial model, a model whereby the society challenges (climate change, resources scarcity, poor social conditions) are reconciled with long term and sustainable financial performance objectives.

In the meantime, SRI funds are certainly an answer to those looking urgently for more sustainable financial products.

SHOULD ESG BE THE CONCERN OF THE INVESTMENT MANAGEMENT INDUSTRY?

The investment manager has the fiduciary duty to generate financial return for its investors. We often hear that including ESG criteria is counterproductive as it limits the investable universe and thus affects the potential return for investors. According to this theory, investment managers should only focus on financial criteria and let the politics deal with governance, social and environmental matters. These arguments neglect the following aspects:

- numerous studies have compared SRI returns and non SRI returns; the diversity in results fails to demonstrate a systematic underperformance of the SRI approach;
- the current crisis illustrates the limits of the traditional investment model;
- politicians have enough challenges to address for the time being;
- last, but not least, investors expect that the changes and the ethics will come from within the financial system rather than be imposed from the outside.

Environmental and social considerations are becoming an increasing component of consumers' purchase decisions (as evidenced by the increasing demand for organic and fair trade products). Why would they behave differently when purchasing financial products?

THE NEED FOR EDUCATION

So far, SRI remains predominantly an Institutional Investors product with limited investment from High Net Worth Individuals and retail investors. Indeed, very few know that they can invest in products managed under principles reconciling their performance objectives with their long term values. Those who have approached their advisors for SRI products can testify that very few advisors spontaneously propose these products to their clients - indeed, the client appetite for SRI products is not yet part of standard KYC screening and, moreover, advisors themselves very often lack the knowledge to sell SRI to their clients with confidence. With a little effort of education, in an environment where the clients are now looking for different products and where the financial industry is looking to reinvent itself, this gap could easily be filled.

IS SRI A RISK-FREE ANSWER?

If SRI becomes more popular, as it surely will, some risks may arise:

- "green-washing" or using some of the SRI criteria such as environmental consideration as pure marketing arguments, without implementing them seriously;
- "overselling" or using the sale argument that SRI will systematically generate additional financial performance; even worse, selling SRI on the grounds that being more sustainable, these investments are less risky;
- "green bubbling" or the risk that popular theme funds such as climate changes or renewable energy become the next financial bubble.

Indeed, these risks are not intrinsic to SRI but arise whenever an asset class becomes popular: SRI would not be different to any other asset class in this regard. One could anyhow hope that the transparency and ethical principles claimed by the SRI actors will limit the risk of an inadequate selling approach.

IS SRI AN OPPORTUNITY FOR THE LUXEMBOURG FINANCIAL SECTOR?

Although still a niche market, SRI products have been and are enjoying steady inflows and Luxembourg is already a leading domicile for SRI funds:

- The unique position of Luxembourg as the leading domicile of umbrella UCITS makes it the natural domicile for large SRI funds investing in quoted securities, such as the funds applying "best-in-class" screening or theme funds such as climate change or water funds with SRI components;
 - The complete and flexible suite of vehicles adapted to private equity investments (SICAR, SIF, Part 2 funds) makes it the perfect domicile for funds investing in development projects, renewable energy projects...;
 - The unique combination of vehicles on offer, political willingness and expertise have led Luxembourg to become the domicile for Microfinance investment funds.
- In addition its prominent position as a fund domicile, Luxembourg also enjoys two largely untapped potentials:
- A (rather small in number but) affluent and well educated population, who could certainly invest much more in SRI, if the products were actively offered to them;

- An access to a large base of HNWI's through the private banking industry. Increased education effort, corporate and political willingness are the keys to exploit this potential. The recent creation of the Luxembourg Institute for Global Financial Integrity is certainly an encouraging step.

CONCLUSION

SRI will not save the planet nor will it rescue the financial sector.

But pervasive and systematic inclusion of responsive investment principles will surely contribute in the long run to the financial stability and a vision of finance more aligned with community development objectives. In the short term, SRI funds could address the demand of investors for more sustainable and ethical financial products as a transition for an investment model that would systematically incorporate the UNPRI long term principles into each investment decision.

Luxembourg enjoys a unique position in this regard, both in terms of product offering and potential investors' access. Exploiting this potential will certainly help to rebuild the image of a finance sector that has suffered over the last months.

The opportunities are here, it is now up to the actors of the financial community to make it happen. ■

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