DEBATES ON SOCIAL AND ENVIRONMENTAL RISKS. APPROACHES IN FINANCIAL INSTITUTIONS

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Abstract:
The risk is almost always a major variable in a corporate decision-making, but few can predict with any precision the future. Nevertheless, managers that ignore it are in a real peril. Relevant social and environmental risks and potential impacts should be considered in the process of sustainability policies implementation. Financial institutions play an important role and are able to influence their clients to achieve high degrees of compliance with sustainability requirements. This paper presents a literature review of existing social and environmental risks reporting frameworks and debates the existing reporting models for financial institutions. It establishes the importance of integrated assessment to identify the social and environmental impacts, risks, and opportunities.

Key words: *Environmental, social, risks, reporting, financial institutions.*

JEL classification: *Q56, Q57*

1. INTRODUCTION

Recently, risk reporting has gained interest in financial reporting practice, regulation, and international research. Social and environmental reporting is seen to benefit shareholders more by reducing risk than by increasing return.

Our paper is meant to develop an analysis of specific requirements regarding social and environmental risks. We focus on fundamental research that explain how this world operates, what makes things happen, why social relations are a certain way, or why society changes. This article examines the evolution and current status of social and environmental risks reporting in general and their peculiarities introduces by financial entities reporting. It offers reasons for economic entities to considering an improvement of their businesses reporting.

In this paper, data coming from social and environmental literature and requirements of profession organisms are gathered, analyzed and interpreted in order to bring to light an underlying coherence and sense for the new risk reporting perspective. This kind of analysis will offer us opportunities for deeply research the concepts, the policies and the social and environmental risks.

The lack of information on risks facing companies is one of the main weaknesses in the accounting information disclosed by companies. Current literature assumes corporate risk reporting to be informative for its users. Linsley and Shrives (2006) assert that current analyses of risk are dominated by Beck's notion that a risk society now exists whereby we have become more concerned about our impact upon nature than the impact of nature upon us. Beck (1999) refers to these risks as manufactured uncertainties and observes that they can arise out of a desire to reduce risk.

Worldwide, regulators ask for narrative disclosures as the key to achieving the desired step-change in the quality of corporate reporting, but companies are obliged to issue few items of this kind of information (Lungu et al, 2008). There are opinions that the conflict between relevance and reliability in accounting can never be solved due to the uncertainty of the future (Altenburgeret and Schaffhauser-Linzatti, 2007).

Financial institutions are an important intermediary between sources of capital demand and capital supply; therefore, they have to achieve high degrees of compliance with sustainability requirements. This idea is supported by the fact that an *environmental risk* can very quickly become a *financial risk* due to the fact that poorly managed projects can have serious environmental and social impacts that will need to be mitigated at a cost. *Reputational risks* are an increasing concern for financial institutions that are increasingly held responsible for their clients' actions and activities.

Since 2004, in order to standardize international financial best practice, International Financial Institutions have adopted the Equator Principles designated to ensure that the projects financed by financial institutions are developed in a manner that is socially responsible and reflect sound environmental management practices. By doing so, negative impacts on project-affected ecosystems and communities should be avoided where possible, and if not, they should be reduced, mitigated or compensated.

Current tendencies, especially in the International Financial Reporting Standards, emphasize the increasing inclusion of present and future-oriented information, imposed by risks and uncertainties, in corporate reporting. It is no longer a particularity of the banking and insurance sectors which currently reassess the role of risk reporting for market discipline (Dardis, 2002; Helbok and Wagner, 2006; Crumpton et al., 2006).

2. SOCIAL AND ENVIRONMENTAL REPORTING AND RISK APPROACH

Accounting researchers have increasingly focused their efforts on investigating disclosure and it is now recognised that there is an urgent need to develop disclosure metrics to facilitate research into voluntary disclosure and quality. This was the main theme in much of the early literature on social and environmental accounting (Bebbington and Thompson 1996; Gray et al., 2001) and has been largely responsible for prompting many companies to publish social and environmental reports (Lober et al., 1997).

Changing economic and regulatory environments, more complex business structures and risk management, increasing reliance on financial instruments and international transactions, and prominent corporate crises gave rise to risk reporting in non-financial sectors. In general terms, risk reporting shall allow outsiders to assess the risks of an entity's future economic performance (Schrand and Elliott, 1998; Linsley and Shrives, 2006).

According to Cabedo and Tirado (2004), companies are essentially exposed to two types of risks: nonfinancial risks, which are not directly related to monetary assets and liabilities, although they will have an effect on future cash flow losses (business risk and strategic risk) and financial risks, which do have a direct influence on the loss of value of monetary assets and liabilities (market risk, credit risk, liquidity risk and operational and legal risks). Each one of these risks must be quantified so that financial statements can present information on their equity, financial and economic situations together with the business risks to which they are exposed, thereby providing potential users with the most appropriate information necessary for the decision making process to go ahead.

Apart from the financial sectors, published research on risk reporting has to date been rather limited. Most efforts are empirical and the conclusions are so different.

Empirical studies find large variations and deficits in risk reporting even in the presence of disclosure rules (Rajgopal, 1999; KPMG, 2008), but incentives matter even in the presence of regulation. This is particularly expected when considering social and environmental risk reporting, because it is subjective and partly non-verifiable, which inherently allows for discretion.

Regulators and other industry associations have recognised the importance of considering the industry setting when determining environmental and social policy and reporting requirements. However, environmental and social impacts vary greatly from industry to industry. Guthrie et al. (2007) find that the sample companies reported more on industry-specific issues than general environmental and social issues. This finding also highlights the need for researchers examining environmental and social disclosures to consider incorporating industry-specific items into their disclosure instruments. The study also finds that the companies tended to use corporate websites for their environmental and social reporting, indicating the need for researchers to consider alternative media (Jackson and Quotes, 2002).

Even some authors who have seen themselves as following a management accounting approach have, in practice, placed considerable emphasis on its role in generating information on environmental and social contingent factors that impose a risk reporting affecting the decisions of external stakeholders. For example, an Israel and Zimiles study (2003) asserts that from 1996 to 2000, 10% of the Fortune 1000 lost over 25% of its shareholder value within a one-month period. Many of these loses can be attributed directly or indirectly to non-financial issues such as social or environmental.

3. DEBATES ON FINANCIAL INSTITUTIONS SPECIFIC GUIDANCE FOR SOCIAL AND ENVIRONMENTAL RISK REPORTING

Companies, in their wide sense are hold financially and legally liable for noncompliance with social and environmental regulations and may be asked *to repair* the damage they do. According to Inter-American Investment Corporation (IIC), the financial institutions that provide these businesses with funding can also be exposed to financial and other environmentally derived liabilities, such as paying to clean up polluted property acquired upon executing loan security. More and more financial institutions are realizing that taking environmental risk into account makes good business sense (www.iic.int).

Over recent years, private sector finance for infrastructure projects, both in the developed and developing countries, has increased in importance. This has exposed financial institutions to increasing pressure from NGO’s for their involvement in a variety of controversial projects. They have called for greater transparency, accountability and tighter standards in the operations of commercial banks (Orr and Kennedy, 2008).

Emphasizing strategic priorities for maximizing its sustainable development impact, the International Finance Corporation (IFC) promotes sustainable private sector investment in developing countries. It is a member of the World Bank Group, the main organism of financial and technical assistance to developing countries around the world. The IFC Policies and Guidelines provide a framework for managing environmental and social risk in project and comprise: a set of baseline safeguard policy requirements, a set of quantitative environmental guidelines (The World Bank Pollution Prevention and Abatement Handbook and IFC guidelines), and an environmental assessment methodology which assigns a level of diligence based on risk (Armstrong, 2003).

According to their web site (www.ifc.org) IFC emphasizes five strategic priorities:

- Strengthening its focus on frontier markets, particularly the SME sector;
- Building long-term partnerships with emerging global players in developing countries;
- Addressing climate change, and environment and social sustainability activities;
- Addressing constraints to private sector investment in infrastructure, health, and education; and
- Developing domestic financial markets through institution building and the use of innovative financial products.

The IFC Performance Standards (previously known as the Safeguards) are based on an assessment process that categorizes the social or environmental impacts according to a three-tiered system:

- Category A – Projects with potential significant adverse social or environmental impacts that are diverse, irreversible or unprecedented;
- Category B – Projects with potential limited adverse social or environmental impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation; and
- Category C – Projects with minimal or no social or environmental impacts (IFC, 2006).

International Finance Corporation applies the Performance Standards to manage social and environmental risks and impacts and to enhance development opportunities in its private sector financing in its member countries eligible for financing. The Performance Standards may also be applied by other financial institution, on voluntary basis.

Table 1. IFC Performance standards

Performance standards (PS)	Objective
PS1: Social and Environmental Assessment and Management System	▪ Underscores the importance of managing social and environmental performance throughout the life of a project
PS2: Labor and Working Conditions	▪ Recognizes that the pursuit of economic growth through employment creation and income generation should be balanced with protection of basic rights of workers
PS3: Pollution Prevention and Abatement	▪ Recognizes that increased industrial activity and urbanization often generate higher levels of air, water and land pollution
PS4: Community Health, Safety and Security	▪ Recognizes that projects can bring benefits to communities, but can also increase potential exposure to risks and impacts from accidents, structural failures and hazardous materials
PS5: Land Acquisition and Involuntary Resettlement	▪ Applies to physical or economic displacement resulting from land transactions as expropriation or negotiated settlements
PS6: Biodiversity Conservation and Sustainable Natural Resource Management	▪ Promotes the protection of biodiversity and the sustainable management of natural resources
PS7: Indigenous Peoples	▪ Aims to ensure that the developement process fosters full respect for indigenous peoples

PS8: Cultural Heritage	▪ Aims to protect cultural heritage from adverse impacts of project activities and support its preservation

(Source: IFC, 2006)

Based on the environmental and social policies and guidelines of the International Finance Corporation (IFC), the Equator Principles are a set of policies and procedures for assessing, managing and monitoring environmental and social risk in project finance lending. The objective of the Equator Principles is to manage environmental and social risks in project financing cost effectively-get the right information in the right place at the right time.

The history of the EP is described by Esty at al. (2005). This dates back to the late 1990s, when financial institutions first approached the IFC with concerns that there were no established principles to guide lending decisions when it came to social and environmental risks (Scholters and Dam, 2007).

These Principles are intended to serve as a common baseline and framework for the implementation by each financial institution that adopted Equator Principles (referred further as EPFI) of its own internal social and environmental policies, procedures and standards related to its project financing activities.

Meeting at IFC in 2003, ten top international banks adopt the Equator Principles, applying new environmental and social development standards to their project finance lending based on IFC's own standards. By 2009, 68 participating banks had adopted the Equator Principles, representing 90 percent of all global projects financing (WB, 2010). These statistics confer representativeness for our study and support our initiative to discuss the main issues addressed by them.

Table 2. Equator principles and the reference to IFC categories

Equator principles (EP)	Objective	IFC categories
EP 1: Review and Categorization	▪ Each Project is categorized in respect of the magnitude of it environmental and social impact	▪ A, B, C
EP 2: Social and Environmental Assessment	▪ the Borrower must conduct a Social and Environmental Assessment, prepared by the Borrower or by suitably skilled independent third parties, to identify any impacts caused by the project	▪ A, B
EP 3: Applicable Social and Environmental Standards	▪ IFC Performance Standards, and ▪ compliance with relevant host country laws, regulations and permits that pertain to social and environmental matters	▪ A, B, C
EP 4: Action Plan and Management System	▪ the Borrower must complete an Action Plan to describe, prioritize and implement mitigation measures, corrective actions for any impacts identified in the Social and Environmental Assessment	▪ A, B
EP 5: Consultation and Disclosure	▪ timely consultation of the non-technical findings is to be made available in the local language to encourage early dialogue with stakeholders	▪ all A, most B
EP 6: Grievance Mechanism	▪ procedures to be implemented to allow affected stakeholders the ability to raise and resolve issues of concern	▪ all A, most B

EP 7: Independent Review	▪ an independent third party review is required for the Assessment, Action Plan and other documentation	▪ all A, most B
EP 8: Covenants	▪ The Borrower will covenant (a) to comply with all local social and environmental laws, permits and standards, (b) to implement the Action Plan, (c) to provide periodic reports to the Banks confirming compliance with required standard, and (d) to decommission the project (where applicable) in accordance with a decommissioning plan	▪ A, B, C
EP 9: Independent Monitoring and Reporting	▪ an independent third party review is required to verify the Action Plan and other obligations	▪ all A, most B
EP 10: Public Reporting	▪ Each Bank must provide annual updates of its own compliance with the Equator Principles	▪ A, B, C

(Source: www.equator-principles.com/documents/Equator_Principles.pdf)

Even if there are authors criticising Equator Principles (Watchman, 2005; BankTrack, 2005), for not going far enough in the direction of achieving sustainable development or for using them to greening their operations in developing countries, IFC's Safeguard Policies are currently being updated. IFC is currently reviewing experience with the implementation of its performance standards and it is consulting with the Equator financial institutions, as well as other stakeholders such as governments, clients, and NGOs, as part of the update process. The results from this review will be reflected in the World Bank Strategy (WB, 2010).

CONCLUSIONS

Both the accounting literature and the main international accounting organisations recognize the need to complement the information currently supplied by companies with reports on the levels of risk they assume, in order to serve the purposes of users in their decision making processes. However, a formal framework has still not been established within which companies can operate when it comes to deciding which risks they should report, how these risks should be quantified and where they should be presented.

The Equator Principles are the instrument of standardization that will ensure the movement towards globally recognized environmental and social standards that financial institution would apply in their reporting process. As environmental and social responsibility has grown, so has the expectation that companies will report on these issues. For the financial institutions that adopted Equator Principles, transparency will be the key to promoting accountability. In the future, reporting on social and environmental risks will become an important responsibility for each bank.

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