REGULATING ECONOMIC GROWTH THROUGH FINANCIAL ORGANISATIONS

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Abstract

Can financial institutions, such as banks and investors, be harnessed by the state as instruments of environmental regulation to control economic growth? So far, environmental law in most countries has had little to say about the financial aspects of sustainable development. Its focus has been on reacting to development initiatives and consequential environmental pressures, but not the underlying market forces that fuel growth. If society is to address the problem of “scale” - keeping aggregate resource use within biosphere limits - it must regulate those strategically-placed market institutions that provide the financial resources which shape development. Institutional investors and banks are among the most significant financial institutions, controlling capital allocation and debt finance. To achieve sustainable development, new legal tools are needed to promote ethical finance that takes account of the environmental and social impacts of investment and lending decisions. The primary means available for this task would appear to be: obligations on financial institutions to undertake environmental appraisals of their investment and lending decisions; providing financial (e.g., tax) incentives to investors and lenders to favour environmentally sound companies; mandating corporate environmental reporting to enable financial institutions to effectively assess corporate environmental performance; and making financial institutions liable for environmental damage caused by companies they sponsor. Already, a number of reforms are emerging in this respect, including requirements for pension funds in Europe to disclose their ethical investment policies; new rules on corporate environmental reporting, and use of tax incentives for environmental investment. The effectiveness of these and other reforms is analysed, in the making of recommendations concerning how regulation can best harness financial institutions as instruments to control economic growth.

I. Sustainable Development, Capital Allocation and Financial Institutions

The biggest environmental impact of private financiers is not their own ecological footprint, but their strategic role in allocating capital to other businesses. Since the financial sector sponsors and profits from economic development, it arguably should share responsibility for ensuring such development does not degrade the environment. A much more holistic perspective is needed in order to understand the web of factors, including financial ones, that produce environmentally degrading development. If economic growth is to be kept within ecological limits, market institutions that finance growth must be fed the right directions, incentives and information so that financial resources shift from polluting industries in favour of environmentally benign activities. If

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this is attained, then financial institutions could, through their lending and investment decisions and conditions, and monitoring of companies, become in effect an instrument of environmental governance. Through their financial leverage, financial organizations are “gate-keepers” to the economy, and so schemes to more effectively diffuse environmental policy through the market must work with those strategically placed financiers that have the capacity to communicate and enforce policy goals and standards.

Financial institutions are gate-keepers principally because they have amassed vast empires of financial assets. The “institutionalization” of financial markets has put these assets increasingly into the control of banks, pension funds and other financial institutions rather than in the hands of individual, retail investors. The contraction of public sector financing for development has also been a factor in shaping the phenomenal rise in private financial institutions. Philanthropic bodies, including religious groups, universities and foundations, also participate in financial markets, but the vast bulk of money flows through traditional private financiers. To illustrate, in 1998 Canadian institutional investors for example had amassed financial assets equal to almost 112 per cent of the country’s GDP, with pension funds holding the largest share. And these investors held almost 31 per cent of the shares of Canadian corporations traded on the Toronto Stock Exchange. Similar figures can be found in other industrialised nations.

Financial markets serve an intermediary function by moving capital from savings to investment. Financial service providers are risk takers, seeking to profit from the transformation of capital into a development resource. Although businesses fund the majority of their investment projects from the income they generate through sales and other activities, new businesses are usually reliant on external financing and major corporate expansion also requires turning to the financial markets. Businesses have two main choices for raising money from the financial markets – debt and equity financing. Debt financing involves the issuance of corporate bonds for purchase or borrowing from lenders. Whilst small companies often rely on bank loans, large companies sometimes issue corporate bonds - although as bonds are often purchased by institutional investors, the bond market does not enable these firms to escape the discipline of financial institutions. Equity financing by public companies involves issuing new shares to raise capital. In recent decades, equity markets in most OECD countries have displaced bank lending as the primary source of capital for large corporations. Whereas debt financing

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2 For elaboration of this theme, see B.J. Richardson, Environmental Regulation through Financial Organisations (Kluwer Law: 2002).
5 Toronto Stock Exchange Review (December 2001).
creates a financial obligation to pay interest and repay principal, equity financing carries no such legal obligation, and thus equity holders incur more risk. In theory, investors will prefer efficient and productive companies by buying their shares, and banks will offer them loans on superior terms. The risk level of a business influences the cost and terms of finance. Firms perceived by financiers to pose a greater risk of business failure or under-performance can expect to pay higher rates of interest than others. Similarly, firms that incur higher financing costs will likely offer lower returns to equity holders, through dividend yield and stock price, and so become less attractive to investors.

Contrary to economic theory, however, empirical evidence suggests that financial markets do not always allocate capital efficiently, and that unsustainable, speculative bubbles may suck in financial resources whilst under-investment arises at other times or in other sectors. The “herd-mentality” of investors can lead to such distortions, along with a preference for quick profits. In the process, financiers are prone to ignoring the social and environmental effects of company and project investments unless they are perceived as “financially relevant”. Numerous studies highlight market failures to address environmental impacts, including the under-valuation of ecological properties, the discounting of future environmental costs and benefits, and an inability to address the problem of “scale”, that is, keeping aggregate resource use in the economy within biosphere limits.

Even critics, who ignore the ecological weaknesses of financial markets, acknowledge a telling distinction between the “real” economy and “real” investment, on the one hand, and the “financial” economy and its often ephemeral investments, on the other. The real economy involves investments in functional goods and services, such as manufactured products, buildings and transportation, as well as investment in services such as health care and education. But the financial economy, managed by banks and investors, emphasizes securities trading and related activities which may have only a tenuous connection with productive investment. Most stock purchases do not provide new capital for real investment since the bulk of stocks traded are not newly issued corporate shares to raise finance for the issuing company, but rather are traded between investors looking for profit. To illustrate, between 1990 and 1998, new stock issues by the Toronto Stock Exchange-listed companies accounted for merely 5 per cent of the value of all shares traded on the Exchange. And a huge portion of investment by financiers is directed to such securities. For example, some 40 per cent of the total value of occupational pension funds in Canada is invested in stocks and 37 per cent in bonds. Consequently, conclude Baker and Fung, “in so far as the financial sector expands and pulls away more resources from the rest of the economy, it is diminishing the amount of

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10 See generally Damodaran, supra note 7.
13 H. Daly, “Allocation, Distribution and Scale: Towards an Economics that is Efficient, Just and Sustainable” (1992) 6 Ecological Economics 185.
15 Ibid. at 2-3.
resources available to produce goods and services of real value”. Consequently, it can be seen that financial institutions tend to fuel economic growth, and encourage levels of economic activity that are not socially or environmentally optimal.

The following sections look more closely at specific features of institutional investors and banks, in terms of their capacities to promote sustainable development.

II. Institutional Investors

**Opportunities for and constraints to environmental investment**

Environmental issues can alter the economic assumptions that underlie an investor’s decision to commit capital to an enterprise. Systems of capital investment are where primary decisions regarding future development, and thus pressures on the environment, begin. Given that sustainable development stresses maintenance of natural and human capital for posterity, the role of capital markets must be recognized as pivotal to sustainability strategies. Financial markets generally provide capital with the objective that it should ideally grow. Whilst there is a difference between financial capital (i.e., economic assets and income) and the broader concept of capital in sustainable development (i.e., natural resources and ecosystem integrity), financial capital is relevant to the environment as it enables major investments to be undertaken, such as technological innovations, which invariably have environmental effects of some form. Promoting environmentally responsible financing in this sector requires regulators encouraging investors to favour environmentally sound companies and for investors to use their financial leverage to make corporate management and policy more mindful of natural resource use and pollution concerns.

As financial intermediaries, investors assist with risk reduction by pooling and diversifying assets and lowering the transaction costs of contracting and information processing. The institutional investment community has a diverse membership, including public and private pension funds, mutual funds, life insurance companies, university foundations and funds managed by banks. A technical distinction can be made between *institutional* investors per se, involving, for example, the investment actions of pension funds using their beneficiaries’ monies, and *retail* investments, where individuals directly contribute to a mutual fund that specializes in investing in certain market segments. In both cases, however, a specific investment institution is managing investments. Within the OECD area, insurance companies are the largest investors, followed by pension funds. Apart from commercial investors, there is also an assortment of communal financial entities, such credit unions, building societies,
industrial and provident associations and public charities, which can make a worthwhile contribution to social investment and community regeneration.22

The growing institutional character of financial investment markets may be leading to a shift away from ephemeral and short-term trading activities to a preference for long-term, sustainable development. In their book *The Rise of Fiduciary Capitalism*, Hawley and Williams herald the institutional investor as a new voice for promoting corporate social and environmental responsibility.23 This is because institutional investors are “universal owners” holding a broad portfolio of stocks, and possessing an interest in the health and long-term sustainability of the entire economy rather than the profitability of individual businesses. As long-term fiduciary investors and majority shareowners, Hawley and Williams argue that institutional investors are not concerned primarily with short-term returns on investment, but rather long-term performance to meet the needs of their present and future beneficiaries. Similarly, Monks, in *The New Global Investor*, argues that the universal (or “global investor”) “is likely to make good decisions for the long-term of society, because it can afford in most cases to take a long-term view, and a diversified view. An ordinary domestic investor may need to reap profits in the short term”.24

This universal owner status, suggests Hawley and Williams, gives institutional investors an interest in public policy issues beyond traditional macroeconomic concerns, such as environment, health and other programs that help build human and physical capital. They state: “a universal owner that really wants to maximize the shareholder value of its portfolio would need to develop public policy-like positions and monitor regulatory developments and legislation on a number of key issues to the economy as a whole”.25 Accordingly, businesses favoured for investment must be operated in a financially, socially and environmentally responsible manner that supports a healthy and sustainable economy. In turn, businesses that pay attention to environmental and social causes are expected to be stronger financial performers over the long term.26

The growth of institutional investment funds has pooled mammoth resources capable of exerting significant leverage over corporate environmental activities. And there are many reasons why the environment might be of interest to institutional investors. Pension funds and life insurance companies in particular have long-term financial liabilities, providing a structural incentive to favour lasting, sustainable investment. Further, fund managers have fiduciary responsibilities in trust law and statute to take an active interest in corporate governance.27 Ethical screening can appeal to investors because it reinforces notions of socially responsible governance. Three is growing evidence of a correlation between corporations that embody socially responsible governance and sustainable

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25 Hawley & Williams, supra note 23 at 170.
development. Good environmental and social performance is often seen as a proxy for a financially well-managed company. In North America, there is growing empirical evidence of a correlation between share price movements and corporate environmental performance. Poor environmental performance that threatens firm profitability is thus a basis for intervention in corporate management or the switching of investments.

There is evidence internationally of a growing niche market for environmental investment products and funds. Environmentally responsible investment is being effected in several ways, most commonly through “ethical screening” involving the inclusion or exclusion of shares in investment portfolios on environmental grounds, “cause” based project investments, and shareholder activism to change corporate policy and practice. In the European Union, there were estimated to be some 250 specialist ethical investment funds, taking account of environmental and other concerns, operating in 2001, up from a mere 50 such funds a decade earlier. The founding of several indices to track ethical investments points to the growing legitimacy of this sector. Leading ethical investment indices include the Dow Jones Sustainability Group Index and the UK’s Financial Times Stock Exchange’s “ethical index”. Yet the total size of ethical investment funds is still small compared to the market capitalization of companies in which they invest; in the UK, ethical investment in September 2001 comprised a mere 3.5 per cent share of the investment market, compared to 13 per cent in the US. But, encouraging, the growth of ethical investments in recent years has tended to exceed other investments. However, whether it will grow out of its “niche” position to a more pervasive feature of financial markets is currently unclear.

But there are countervailing barriers to more environmentally sensitive investment practices. These include investors’ lack of adequate information about corporate environmental performance; the absence of appropriate taxes on environmental resource use and pollution, which can thereby make it difficult to measure environmental performance in financially relevant terms; and structural barriers in corporate governance systems that can impede investor shareholder activism. Investor uncertainty concerning the environmental integrity of a product or company performance is a major barrier. Surveys of the financial services sector have revealed a patchy understanding of the relevance of corporate environmental performance. The lack of corporate reporting on environmental activities and costs is a factor that undoubtedly has contributed to this poor understanding. As discussed later in this paper, mandating some level of environmental reporting by businesses is a necessary reform if investors are to be mobilized as instruments of environmental governance.

In common law jurisdictions such as the US and UK, institutional investor passivity or ignorance may also be explained in terms of the effect of trust law precedents. Trustee investors who are required to invest prudentially on behalf of others (e.g., pension funds) may find the safest course is to adopt investment strategies similar to their peers. Notions of fiduciary responsibility have been interpreted in the seminal British cases of Cowan v Scargill and Martin v City of Edinburgh District Council as constraining pension fund managers from taking into account ethical factors that may detract from securing the optimal financial return for beneficiaries when choosing investments. However, where an investment fund is established explicitly as an ethical investment vehicle, then the trust law constraints against green investment are largely removed so long as the optimal financial returns within the agreed governing framework of environmental or other investment principles are pursued. In continental Europe, quantitative regulation of investment portfolios is typically applied, such as restrictions on particular classes of investment including foreign securities, real estate and loans. Asset type restrictions on where European Union (EU)-based funds can invest appear to be diminishing, such as due to the recent UCITS amendment Directive of 2001.

In many countries, company law rules can be source of constraints to ethically-minded investor activism. Because of legal constraints on concentrated ownership, fiduciary obligations that require extensive diversification to minimize risk and a strong preference for liquidity, institutional investment agents have tended to seek portfolios comprising fragmented holdings across a plethora of companies. This can reduce the influence of an investor or discourage activism because the stakes may be considered too small given the size of the institution’s equity holdings. However, the regulatory trend in Western states has been for securities watchdogs to liberalize rules restricting shareholder proposals from management’s proxy statement and other company law obstacles to shareholder activism. Although EU institutions are increasingly setting standards for corporate governance, innovative reforms are still occurring in a number of EU Member States, such as Britain.

**Promoting ethical finance**

Among the other reforms that can stimulate environmentally responsible financing in the investment markets, are requirements that investment institutions consider the environmental effects of their own activities and publicly report on their policies in this respect. In the UK, for instance, in July 1999 the government promulgated a regulation under the Pensions Act 1995 requiring occupational pension fund trustees to disclose their policies on socially responsible investment and on the exercise of shareholder

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34 (1984) 2 All ER 750.
enacted pursuant to s 35(3)(f), Pensions Act 1995: Occupational Pension Schemes (Investment, and Assignment, Forfeiture, Bankruptcy etc.), Amendment Regulations 1999, cl. 2(4).


Apart from domestic-sourced rules, the EU Member States are subject increasingly to EU financial law, and, less intrusively, emerging international standards. The EU has issued a plethora of directives and policies to ensure competition in financial services markets. But no EU-wide financial services regulator has been established. Environmental concerns have hardly been a feature of EU services financial regulation to date. The EC’s proposal in 2000 for a directive on the activities of institutions for occupational retirement provision omitted any environmental disclosure provisions, although an amendment to the EC’s proposal was later advanced in the European Parliament to provide an obligation to refer to “ethical and socially responsible investment principles” in the Article 12(1) disclosure of investment policies requirements. Elsewhere, amendments to the EU’s Eco-Management and Audit Scheme and the Eco-Label Regulation have allowed for their extension to financial services, thereby enabling investment and other financial service products to be more readily assessed and compared in terms of their environmental credentials.

One possibility for future financial services law reform would be to authorize establishment of a specific ethical investment institution, that would be free to invest in a range of asset types according to environmental, social and other ethical criteria. Mayo and Mullineux suggest such an institution could function as a mutual investment fund that is open-ended and working under contract law, and thus able to give priority to environmental and social returns over financial returns. Whilst there appears to be some merit in legislating for a specialist ethical financing vehicle, it poses the risk that mainstream investors (e.g., pension funds) would see the environment as an issue not directly relevant to their own operations. For ethical finance to be integrated into financial markets, it must become embedded in the culture of mainstream financiers. At a minimum, this would seem to require maintenance of obligations on investment institutions to appraise their environmental activities and impacts, and to disclose their ethical investment policies.

Besides appropriate financial and information incentives to promote environmental investment, there is the nagging issue of the internal governance of investment institutions. In relation to pension funds, for example, there is debate on the merits of democratising pension fund governance to ensure that worker beneficiaries have more

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55 For analysis, see B.J. Richardson, “Implications of Recent Changes to the EMAS and Eco-label Regulations for the Financial Services Sector” (2002) 14: 2 *Environmental Law and Management* 131.
say in how their monies are invested.\textsuperscript{57} Through worker influence over pension fund investments, there could be a shift away from short-term profit focus to long-term real investment. Some labour movement activists are attempting to acquire greater representation on pension fund boards of trustees either through joint or sole trusteeship, or to establish advisory boards to these bodies. In Canada, for example, Quebec pension legislation establishes mechanisms for employee representation on pension management boards.\textsuperscript{58} Other salient models for democratising pension fund administration exist in Germany and Switzerland. But contrary to the optimism enunciated by Drucker in his book \textit{Unseen Revolution: How Pension Fund Socialism Came to America},\textsuperscript{59} the reality is that pension plan beneficiaries generally do not control where their pension monies are invested.\textsuperscript{60} The question of how the governance of pension funds and other investment entities should be democratized, and the connections between democratic governance and sustainable development, is beyond the scope of this Article. But it will likely become an important pathway for promoting social justice in the context of environmental governance in financial markets.

III. Banks

\textit{Environmental issues in banking}

Whereas institutional investors are relevant to environmental financing through their investments in the equity markets, banks are important for their role in providing project finance for specific developments and in funding small, unlisted businesses. Banks are financial intermediaries for the receipt of deposits from members and deployment of such deposits by way of loans and investments for development and consumption purposes. For banks worldwide, environmental issues are becoming a stronger concern for several reasons.\textsuperscript{61} First, there is the prospect of direct lender liability where a bank becomes responsible for the environmental liabilities of its clients, such as contaminated land cleanup liability.\textsuperscript{62} Second, environmental problems can generate indirect credit risks for lenders where a borrower experiences financial hardship. Third, there is reputational risk for banks when associated with environmentally controversial developments. A number of banks have gone beyond these features of “defensive” banking, involving the avoidance of obvious environmental problems, to the conscious promotion of sustainable development through differential interest rates and other services and incentives provided to encourage environmentally friendly development.\textsuperscript{63} Banks in the latter mould include


UmweltBank in Germany, the Triodos Bank in the Netherlands and the UK’s Co-operative Bank.

Interest by private banks in environmental matters is also being shaped by reforms to the provision of public development finance. Notably, there have been extensive changes to the operations of the multilateral development banks (MDBs), which have adopted environmental procedures and standards that clients must satisfy for project approvals.\(^{64}\) The European Bank of Reconstruction and Development has gone the furthest in this respect and is the only MDB to be given a specific environmental mandate in its charter.\(^{65}\) Multilateral development bank environmental lending standards can provide benchmarks for private banks interested in environmental issues.\(^{66}\) Of course, many private banks have not been inspired by the MDB reforms or other reasons to consider the environment because of differences in their loan portfolio, clientele and other aspects of the financial markets they work in, and differences in the regulatory structures by which they are governed. The challenge for policy reformers is first to identify areas of banking operations in which environmental policy concerns can be relevant and can be feasibly embedded into governance regimes.

The relationship between borrowers and lenders is one of the critical points at which the interests of the environment can be factored into economic decision-making. Lenders often face a long payback period, and their concern for repayment creates in theory an interest in the sustainability of the borrower’s activities. This interest can be articulated where institutional processes are available that allow banks to share their expertise with and give guidance to their borrowers. In the US, threats of contaminated site liabilities under the so-called Superfund legislation\(^{67}\) has helped catapult environmental concerns to the forefront of banks’ analysis of credit arrangements. Many banks insist on indemnity agreements in loan contracts or demand that borrowers obtain liability insurance.\(^{68}\) Nonetheless, such liabilities may lower the credit worthiness of the debtor (or guarantor) or reduce the value of any security. Appraising the environmental sequelae of loan proposals helps protect a bank’s financially; projects that incur environmental liabilities may adversely affect a borrower’s cash flows and thereby compromise loan repayments. A more ambitious role for banks involves going beyond the mere vetoing of projects posing environmental liabilities, to being a facilitator, whereby companies and industries are steered towards best environmental practice. The greatest reach of the banking sector here is in its relationship to smaller, private companies reliant on debt financing, as they are not listed on the stock market. Bank can be influential here through lending practices, by providing information, and offering specialist environmental financial services (e.g., energy efficiency loans). Banks may be in a position to compel borrowers to conform to new global industry standards with respect to product quality, production processes and


\(^{65}\) Article 21(vii) requires the Bank to “promote in the full range of its activities environmentally sound and sustainable development”: *Agreement establishing the European Bank for Reconstruction and Development*, [1990] OJ L 372.


labelling. But without government intervention to embed environmental standards in banking regulation, this sector may be disinclined to voluntarily undertake such a role except where it relates to avoidance of potential environmental liabilities or achievement of more profits.

Reforming the banking sector

Recent EU developments point to some ways in which this problem could be corrected. The EU’s Eco-management and Audit Scheme (EMAS) Regulation and Eco-label Regulation, both voluntary schemes for businesses, have been amended to encompass financial institutions and products. The need to open the EMAS Regulation to the financial sector has been acknowledged for several years, as the site-based focus of the original 1993 EMAS Regulation made it not readily adaptable for encompassing the environmental effects of the clients of banks and other financial entities. The EMAS Regulation was revised in March 2001 to extend the scheme to all sectors of economic activity with a focus on company operations as a whole rather than on specific industrial sites. There is more emphasis on “indirect environmental aspects”, defined as including “capital investments, granting loans and insurance services”. In addition, the 1992 Eco-Label Regulation was amended in 2000 to redefine “products” to include “any goods and services”, thus implementing earlier European proposals to expand the Eco-Label scheme to the financial services sector. This reform means that banking and investment products can be more readily assessed and compared in terms of their environmental credentials, and this should facilitate marketing and reward innovation. These EU innovations point to a style of shared environmental governance that relies on voluntary approaches and market incentives for corporate participation, such as an improved environmental profile among environmentally conscious consumers and productivity gains through reduced waste and resource consumption.

In relation to national banking regulation, no serious consideration has yet been made by governments as to whether environmental policy concerns should be grafted into control systems. Banks are incorporated entities and hence subject to company law controls. Because of their responsibilities as repositories for people’s savings, banks are subject to additional prudential regulation which addresses a range of public policy concerns, principally investor-protection and consumer service standards, through capital adequacy and liquidity requirements. Money laundering controls, requiring financial institutions to report suspicious transactions, illustrates the ability of government to harness banks as co-regulators in furtherance of policy objectives. Banks are also in a position to use contract law mechanisms to demand environmental information about the development projects they fund, and banks often retain considerable environmental

72 Ibid, Annex. cl. 6.3(b).
74 R. Lastra, Central Banking and Banking Regulation, (Financial Markets Group, 1996).
expertise in-house or have access to it via consultants to evaluate such information. Although banks should not be a substitute for environmental appraisal activities currently discharged by state authorities - because of the opportunities for public participation that commonly exist in such government supervised appraisal systems – it would be fruitful for regulators to explore ways in which bank-based environmental assessments could be integrated into state-based assessments. In any event, banks could at least expect their borrowers to comply with environmental legislation, and to provide lending on preferential terms to clients that demonstrate a high standard of legislative compliance that poses fewer liability risks.

There could be scope within existing regulatory parameters for financial regulators to introduce environmental standards as conditions of banking authorizations. One potentially powerful measure would be to offer financial incentives for banks to introduce differential interest rates (and hence cost of availability of capital) to reflect the environmental risks of different types of development. In any event, banks could at least expect their borrowers to comply with environmental legislation, and to provide lending on preferential terms to clients that demonstrate a high standard of legislative compliance that poses fewer liability risks.

Governments could encourage banks to give preferential treatment to projects that meet sustainability criteria by providing tax relief for profits earned on environmentally friendly development loans. The Netherlands has explored the taxation option, and in January 1995 the Dutch government introduced a green investment scheme that allows banks to offer depositors funds whose interest or dividends are exempt from personal taxation. In order to qualify, the fund must invest at least 70 per cent of its assets in environmentally friendly projects (e.g., renewable energy and organic agriculture). Because of this initiative, several Dutch banks moved to set up their own green investment funds, which have been heavily subscribed. The attractive interest rates for investors result in more funding of progressive new projects that were formerly perceived as risky with limited return. Although these unique reforms may be explained by the fact that the Netherlands is a country with a relatively high level of environmental awareness, and a strong tradition of environmental law innovation, other countries may now follow suit given emerging evidence that the Dutch green investment scheme is encouraging sustainable development projects.

Beyond controls on the operation of banks, governments can promote environmentally responsible lending through appropriately directed liability legislation. Increased lender liability may eventually lead to a reduction in the number of environmentally damaging activities that are financed and thereby eliminate industries

75 See, e.g., S. Brady, “Fannie Mae/NAHB Launch Effort to Develop ‘Green’ Mortgages” (1999) 6 Professional Builder 1.
and businesses associated with environmental problems in the market. Environmental lender liability has become a grievance in various industrial economies because of legislative changes or judicial precedents.\textsuperscript{79} The potential environmental liability of lenders arises from the definitions of “owner”, “operator”, “permits” or “causes” found in pollution control legislation. A wide interpretation of such words may implicate lenders despite the fact that they had no direct role in causing the contamination. Liability could occur by being the potential owner of a contaminated property through the right to realize the borrower’s security, or providing guarantees for firms with potential or actual environmental liability (e.g., firms handling hazardous wastes).

The most persuasive evidence of the effect of government intervention into financial markets is in the US where the behaviour of banks has been profoundly influenced by the implementation of the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) 1980, which may make a lender vicariously liable for contaminated site remediation.\textsuperscript{80} According to a survey by the American Bankers’ Association, 62 per cent of community commercial banks had rejected loan applications or potential borrowers because of the possibility of environmental liability and 45 per cent had withdrawn from lending in known hazardous sectors because of similar concerns.\textsuperscript{81} The US experience has been followed with interest in Europe, where the European Commission released in early 2002 a draft environmental liability directive.\textsuperscript{82} The Commission’s proposals avoids specifically attaching liability to financial sponsors but leaves open the possibility of lender liability where banks exercise operational control over polluting facilities or sites.

More research is needed into the optimal liability regime - one that provides appropriate incentives for banks to eschew funding environmentally contentious developments without stifling potentially socially valuable investments. For instance, whilst the retroactive nature of some environmental liability regimes may further environmental compensation goals, there is little deterrence effect from the penalising of organizations for unforeseeable, non-negligent contamination caused by distant activities, except to the extent that actors predict future changes in liability regimes that would provide for such retroactive liability.\textsuperscript{83} This situation can be compounded by joint and several liability. The latter is a mechanism for mutual regulation, encouraging each party to only contract with other reputable parties and creating strong incentives for parties to


monitor one another’s behaviour. Joint and several liability rules are at odds with the polluter pays principle in that they encourage the channelling of liability to the deepest pockets, namely financial lenders, rather than the actual contributor of environmental harm. Although there is a need for further empirical evidence to clarify, it appears that joint and several liability can cause “over-deterrence” by deep pocket parties and “under-deterrence” by less solvent parties who may believe that no claims will be brought against them for environmental harm. Joint and several liability can also pose problems to the functioning of insurance markets, as discussed later in this Article. Allowing deep pocket parties to recover contributions from joint tortfeasors generates additional transaction costs and is of little value if the joint tortfeasors are insolvent. Current economic theory suggests partial lender liability for borrowers’ environmental harms is appropriate.

III. Reforms for Improving the Broader Context of Financial Markets

Some reforms to the context in which financial institutions operate are arguably necessary if an effective reorientation of investment and lending patterns towards sustainable development is to be achieved. Investors and lenders would appear to need much stronger financial incentives, clearer environmental information and means of leverage in corporate affairs.

As a priority, governments should introduce a wider array of economic instruments, notably pollution taxes and tradeable emission permits, so that the financial costs or benefits of corporate environmental behaviour are made more transparent and relevant to the calculations of private financiers. Asset prices need to reflect environmental performance if environmental financing is to have an objective basis. Economic instruments should also be applied directly to environmental friendly investments to create tax advantages for such practices. The success of the Dutch tax incentives to promote investment in environmental businesses has already been noted. Eco-taxes directly affect company balance sheets, and financial institutions should support polluter pay charges since as low-energy users they would not be heavily penalized by new charges. With tradeable permits, companies that are able to generate cost savings through

trade in pollution permits could become more attractive investment opportunities for financial organizations. Creating new markets for environmental goods could significantly augment ethical financing. The UK government’s recent Climate Change Levy and Emissions Trading Scheme are in this respect welcome initiatives, but more extensive use of economic instruments as a means of environmental policy is lacking in many countries. Until equity and debt prices reflect environmental performance, then ethical investment and lending will remain somewhat arbitrary in determining which businesses are favoured or rejected.

A second area for reform should be imposition of corporate environmental reporting obligations so as to help generate reliable and comprehensive information regarding corporate environmental performance for investors and insurers. Reliable information is crucial to the proper functioning of capital markets, improving accurate pricing of securities and so enabling the market to allocate capital efficiently. Without material information, investment and insurance decisions are likely to be distorted. Disclosure of environmental information can help inform consumers and investors about a firm’s level of resource use, emissions and other environmental impacts. Not only does such information feed the ethical concerns of investors, but it also affects the market value of an enterprise by disclosing liabilities and other factors that affect earnings and profitability. Better environmental information is also crucial for insurers if they are to assess and monitor environmental risks and price premiums accordingly.

Extending requirements for disclosure of environmental costs under securities laws and other company-directed law can facilitate investors’ and other stakeholders’ scrutiny of the environmental behaviour of firms. Traditional corporate reporting statements have not adequately captured the financial consequences of a company’s environmental management. Corporate accounting has been associated with myopic, profit-centred performance measurement. However, disclosure is a central tenet of emerging voluntary standards such as the CERES Principles and the ISO 14000 series. In Europe, recently the EC published a Communication on Corporate Social Responsibility, which refers to the desirability of corporate environmental reporting standards. Among EU states, mandatory environmental reporting has been instituted in various forms in France, the Netherlands, Sweden and Denmark, and is planned for in the UK. Only in the US are environmental reporting requirements well integrated into mainstream company law through regulations promulgated by the federal Securities and Exchange Commission.

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96 UK, Department of Trade & Industry (DTI), Modernising Company Law, Cm. 5553 (DTI, 2002), cls 4.13.
One reason why the SEC (set up in the 1930s) has gone further in corporate disclosure requirements than other jurisdictions is because US policy-makers have long traced the causes of the Great Depression to the failure to establish adequate regulations to ensure investors and other stakeholders have adequate information regarding corporate performance. Environmental reporting requirements are most likely to succeed when regulators provide detailed guidance on reporting criteria and ensure that reports reflect an enterprise’s full range of operations, including relationships with subsidiaries and franchisees that may otherwise be exploited by the parent company to disguise its overall environmental impacts.

Thirdly, liability rules can be used to make those that financially sponsor development jointly responsible for any ensuring environmental harm. Without loans from banks or equity purchases from investors, many companies would be unable to continue financing their activities without major adjustment. By making financial sponsors partly liable for such harms, there should exist a potent disincentive to have financial relationships with polluting industries. In relation to banks, as already noted in this paper, there is already the possibility in some jurisdictions of lenders being directly liable for the environmental liabilities of its client. In addition to the question of lender environmental liability, there is the older and more heated debate on shareholder liability. The cardinal principle in Western systems of company law is that the company is a separate legal person from the members who comprise it. Thus, investors (i.e., shareholders) in the company are not liable beyond the amount they invest. Corporate limited liability has the side-effect of transferring business risks to creditors, and it can undermine the polluter pays principle to the extent that insolvent firms are able to abandon environmental debts. The realities, however are that to legislate for shareholder liability would be politically contentious and it could create major disincentives to new investment.

Various mechanisms have been devised to neutralize the adverse effects of limited liability short of its wholesale abandonment. These include equitable corporate-veil piercing rules and statutory exceptions where actions inconsistent with the separate personality of entity and owners have been taken.

Fourthly reforms should be made to systems of corporate governance to enable or direct investee shareholders to be more active in corporate decision-making. Most EU ethical funds use a screening approach, which tends to reduce their influence on corporate

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101 Easterbrook & Fischel, supra note 99 at 89.
environmental practice. As Miller suggests, “the main arguments against [ethical investment] are that: one cannot hope to change the ways of a major institution simply by buying or selling its shares”. Shareholder proposals sponsored by institutional investors are a key means by which institutions can influence company policy. In some jurisdictions, significant barriers to shareholder activism persist, such as investor portfolio diversification obligations and proxy contest rules. The Enron scandal has highlighted the potential huge damage that malfunctioning corporate governance can inflict on pension savings. Various reforms are possible, although the subject raises thorny economic and political concerns to overcome. In theory, financial regulators could require investment institutions to register their share votes, so as to encourage institutions to formulate and express a view on all issues put to a vote at shareholder meetings. Another possibility is the appointment of minority independent directors to corporate boards, nominated by institutional investor groups rather than enterprise management. Beyond measures to stimulate accountability and shareholder involvement, there is the persistent question of whether corporate liability should be broadened, so as to discourage environmentally risky activities. Thus, in principle, imposing liability on institutional shareholding investors for the environmental impacts of their portfolio companies could promote environmentally-responsible investment because of the lower liability risks offered by green companies.

The UK government, for instance, has proposed legislation imposing a fiduciary duty on pension funds to watch over the companies they have invested in, following findings of a government inquiry of a “culture of non-intervention” among UK institutional investors. But how this requirement would be reconciled with the EU’s conservative UCITS Directive is unclear, which stipulates that an investment entity may not acquire shares carrying voting rights that would enable it to exercise significant influence over the management of the investee company. Although a limited obligation to “watch over” investee companies would appear to have merit, amplifying this to full shareholder liability would be politically contentious and would create major economic disincentives to new investment. But for the banking sector, as earlier noted, it is feasible to legislate for some level of lender liability for borrowers’ environmental harms given that banks generally have a superior capacity to monitor clients’ projects.

Conclusions

This paper has argued that because of their gate-keeping role within the economy, financial organizations could be able to act as instruments for promoting environmentally sound economic growth. It has also highlighted differences in the roles of banks, investors in this respect. Banks providing debt finance have greatest leverage over small,
private companies, whereas the presence of institutional investors occurs mainly in the capital financing markets for public companies. Throughout the financial services sector in various countries, there will be a need for government intervention in some cases to maximize the environmental management potential of financial markets. This intervention may be of a more direct, “command” style where liability rules and mandatory insurance are required, for instance. In other contexts, where an appropriate response from financial institutions seems more dependent upon the right fiscal incentives and environmental information, then less invasive instruments should be used. In both cases, however, the role of the state is to conscript the financial services sector as an instrument for promoting improved corporate environmental performance. In essence, the future of effective environmental law resides not only in governments continuing to direct and influence corporations to meet desired environmental standards, but also for governments to influence those that financially sponsor corporate activity to use their economic influence to encourage corporations to behave in a more environmentally responsible manner. By manipulating the rules, incentives and information that shape decision-making in financial markets, governments will in effect make banks, investors and insurers part of the web of environmental governance.

Whilst such reforms may seem politically naive, the exponential rise in the gravity of our environmental predicament combined with the potential financial advantages from favouring environmentally responsible financing, should in due course improve the prospects for a new style of environmental law. There are, however, a number of specific factors that would appear to be necessary or important for improving the prospects for reform. Mature financial markets and the presence of rigorous financial regulatory structures that address problems of information disclosure and risk management are crucial conditions, for they provide a framework onto which environmental concerns (e.g., pollution liabilities) can be effectively grafted. Secondly, the presence of specialist financial institutions attempting to cater to niche markets (e.g., ethical investment funds) can provide a platform of experience and knowledge to feed more mainstream changes in this sector. The most advanced reforms have tended to occur in countries with a history of such specialist institutions. Thirdly, the performance of traditional environmental law systems is important; countries with a long history of environmental regulation with well-developed systems, such as the US and Netherlands, are more likely to be aware of the pitfalls and limitations of current approaches and the concomitant need to explore new styles of governance in order to promote sustainability.