

Banking on sustainability

An analysis of the social and environmental aspects
of international banks

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Summary

Sustainability of banks is important for investors

The banking industry is the biggest sector on the stock market. It accounts for more than a sixth of the total market capitalisation of the MSCI World Index. Banks are also leading issuers of bonds. For investors committed to sustainability, it is important to know how well banks fare when it comes to environmental and social aspects.

The financial services industry does not immediately come to mind when thinking about sustainability. In fact, this theme is closely linked to the activities of banks, not least because of the banking sector's central role in the national economy and due to the leverage effect of the allocation of capital. Based on an analysis of 14 leading international banks, this report examines which environmental and social issues are most relevant to banks, and how they deal with them.

Four key themes

The most important sustainability themes in the banking sector are currently:

- ◆ Clients: provision of adequate information on the risks and costs of financial products, responsible lending policies, access to bank services
- ◆ Products: avoidance of negative environmental and social impacts when providing finance, loans for environmental protection and micro-credits
- ◆ Processes: compliance with all regulations, avoidance of conflicts of interest, energy consumption and CO₂ emissions while running the bank
- ◆ Employees: job security.

Gathering momentum

There are examples of companies that excel in all these things. In terms of practicability, size does not seem to play a role: a good sustainability performance is not limited to small specialist banks with a limited circle of business – large international banking groups are also very adept at meeting the environmental and social challenges associated with their business activity. It must be said, however, that only a handful of banks score highly in every respect. When it comes to environmental and social issues, the banking industry as a whole has continued to develop over the years, but there is still plenty of room for improvement.

Sustainability pays off for investors

In conclusion, our report shows that investors have ample opportunities for broadly diversified investments in banking stocks that are compatible with sustainability principles. Based on past performance, the shares of banks with particularly good sustainability ratings have actually fared better than average.

Introduction

2001 – a disastrous year
for banks

The end of the *New Economy* boom in 2001 left a trail of devastation for banks. On the one hand their revenues nosedived as stock markets crashed and lenders defaulted. At the same time, a series of scandals came to light that perhaps had even more serious consequences. Artificially inflated financial analyses, dubious practices when allocating shares for IPOs and involvement in spectacular corporate failures (Enron, Worldcom, Parmalat) attracted harsh public criticism and undermined general confidence in the banking industry.

Negative headlines

In the years that followed, heavy job cuts across the board in the banking sector made the headlines. Many large banking groups drew negative publicity as they drastically cut jobs or relocated them to countries with low labour costs. Banks also repeatedly attracted criticism from environmental pressure groups and human rights organisations for providing loans for controversial projects in developing and newly industrialised countries (e.g. pipelines, dams, etc.).

Rising like a Phoenix
from the ashes

Now the banking sector is booming again. After intensive restructuring in recent years, many banks now boast very impressive cost-income ratios. As East European countries and China have steadily opened up to private international banks, a gold-digger atmosphere has developed.

And what progress is being
made with sustainability?

The banking sector has also made positive strides when it comes to sustainability. Job cuts now seem to be a thing of the past. Stricter measures to avoid conflicts of interest have led to changes in internal processes and structures, such as the introduction of Chinese walls between financial research and the various other business departments. The banks have also adopted the Equator Principles – global guidelines for environmentally friendly and socially responsible funding of infrastructure projects. In the meantime virtually every bank has made a public commitment to sustainability and backed this up with suitable reports.

Sustainability also brings
financial success

The foundations of the entire financial services industry are built on confidence and trust. More than any other sector, banks have therefore traditionally worked hard to build up trust and preserve their good reputation. Effective management of financial, social and environmental risks is vital here. In this sense, a sustainable business strategy also contributes to a company's long-term financial success.

Banks account for 18.7% of the market capitalisation of the Morgan Stanley Capital International Index (MSCI World), which makes the banking industry the biggest sector on the stock market. Banks are also major issuers of bonds on the capital market. For investors interested in sustainability, it is important to know how well banks fare when it comes to environmental and social aspects. The questions that need to be asked in this context are:

- ♦ What does sustainability mean in the banking industry?
- ♦ How does the industry perform in this respect?
- ♦ What has been achieved in recent years, and what is the way forward?

This report examines these questions and considers the sustainability ratings of 14 large international banks (see Appendix 2). At the same time, we highlight best practices at the candidates chosen.

Four key sustainability issues for banks

The activity of banks is inextricably linked with social and environmental issues in many different ways. Four key issues can be identified, and these are summarised in the table below.

The most important sustainability issues in the banking industry	
Issue	Description
Clients	Providing explanations on financial products (financial literacy) Responsible lending policies Access to bank services
Products	Avoidance of negative environmental and social impacts when offering funding (loans and financing via the capital market) Loans for environmental protection Microcredits
Internal processes	Adherence to all regulations (compliance) Avoidance of conflicts of interest Internal environmental management: Energy consumption and CO ₂ emissions
Employees	Job security and socially responsible redundancy programmes

Source: Bank Sarasin

This report takes a closer look at how well large international banks deal with these issues.

Sustainability ratings ...

We then go on to present the most important results of our sustainability assessment for the 14 international banks studied in the report. When making the final sustainability rating, Bank Sarasin also takes into account a number of other criteria in addition to the key issues highlighted above. Appendix 1 explains the rating methodology we use.

... and share price performance

Having identified the companies with the best sustainability ratings, the question is whether an investment in sustainable banks is also a financially attractive proposition. We discuss this in the chapter "Sustainability rating and share performance."

Sustainability issues in the banking sector

Many different issues affect the sustainability of banks. The banking industry plays a pivotal role in the economy, because of its allocation of capital. This literally produces a leverage effect, which also extends into the social and environmental domain.

This report concentrates on the key issues in the areas of client service, products, internal processes and employees. We look at how large banks get to grips with these key issues.

Clients

The risks and side-effects of financial products are not generally recognised

Financial products tend to be very complex, and making the wrong decision can often turn out to be very costly for the client. At the same time, surveys show that many clients only have minimal knowledge in this area and therefore rely on their bank giving them reliable advice and information tailored to their individual circumstances. Here banks have a special responsibility to act in the client's interest. This process starts with a thorough analysis of the client's needs, followed by a full explanation of the risks, costs and contractual conditions.

The “*financial literacy*” of private clients has become a hot topic for UK banks recently following a series of scandals surrounding the sale of unsuitable products, such as income protection policies and investment products designed to repay mortgages. So far, however, there seem to have been no tangible improvements. Most initiatives to date have been

Clients often find financial products difficult to understand



Source: Keystone

limited to providing financial support for debt advisory services. Given the growing liability risk, the notorious small print therefore seems to be becoming even more difficult to read and does not provide clients with assistance in reaching their decisions.

Investment funds improve their cost transparency

Some financial products carry hidden costs that are not immediately apparent to the client. One important step towards improving the cost transparency of investment funds was the introduction of the Total Expense Ratio (TER), which makes it easier to compare the cost of different funds. However, even the TER does not include every single cost, such as performance-based fees and securities dealing charges.

Responsible lending policies

When granting loans to private clients, it is important to achieve the right balance between how much the client wants to borrow and the avoidance of excessive debt. Levels of private debt are increasingly becoming a problem, particularly in Anglo-Saxon countries. Here, banks need to stop thoughtlessly pushing

consumer loans in their advertising and clearly explain to clients the financial burden they are assuming when taking out a loan. The UK bank HBOS, for example, includes calculators in its brochure to help clients work out the interest and capital repayments due on their loan. HBOS also clearly states the interest rate (APR) payable on its convenience cheques (cheques debited from a credit card account).

When providing loans to small and medium-sized enterprises (SMEs), banks have been repeatedly criticised for making it harder for SMEs to borrow money. From the banks' point of view, lending to SMEs is a question of risk management. The Basel Committee has issued tighter capital adequacy requirements for lenders (Basel II), which require more thorough scrutiny of the borrower's creditworthiness.

Access to basic banking services ...

Since cashless payment is now the norm in many areas (salary and welfare payments, bill payments, etc.), basic banking services are no longer a luxury, but a necessity. A bank account has therefore become a basic requirement. In some countries, however, a substantial proportion of the population does not have an account and is forced to use alternatives, which often tend to be more expensive. In the meantime, many banks now offer low-cost, or even free current accounts without an overdraft facility. No credit rating is usually required to open this type of basic account.

One special case is the many illegal immigrants in the US, who currently account for anywhere between 5 and 10% of the population. In many cases they have already been residents for many years and are usually tolerated because they are an indispensable source of labour, even though further immigration is being reined in where possible. In the past, illegal immigrants without a bank account had to use expensive cash remittance companies if they wanted to transfer money back home. Nowadays some banks, such as the Bank of America, allow clients to open accounts as long as they produce a passport from their home country (without asking for social security numbers) and offer free transfers to Latin America as well. Illegal immigrants are now also able to get access to mortgages and other financial services in the US. This enables banks to tap into a new client group.

... and physical access

In the wake of the Internet boom, banks closed down local branches in many countries because the Internet and the telephone were seen as the marketing channels of the future and local branches seemed too expensive. But for older clients especially, Internet banking is not a practical alternative. It has since become clear that the Internet and the phone can only partly replace personal contact with the customer. More recently, many banks, such as JPMorgan Chase, Abbey/Santander, have started to open new branches again. At the same time, physical access to banking services has been improved by upgrading buildings for disabled access. The introduction of ATMs for the visually impaired which can be operated by speech or Braille is progressing more rapidly in the US than in Europe. Citigroup is the leader in this field.

Products

Shared responsibility when financing business projects

Many of the environmental and social effects of banking operations are indirect. One conspicuous area, for example, is the financing of power stations, pipelines, paper factories or dams. In recent years banks have repeatedly come under crossfire from environmental and human rights organisations, which hold them jointly responsible for the negative consequences of controversial projects. This presents a considerable risk to banks' reputation. The next table provides an overview of the different forms of corporate finance and the role played by banks in each case.

Forms of corporate finance		
Type	Characteristics	Banks' role
Project financing	A loan to finance a specific project, where the profits cover the interest and capital repayments	The bank has an advisory capacity and is a creditor. The bank's profit depends on the project's success
Loan	Interest and capital repayments do not depend on the success of an individual project	The bank has an advisory capacity and is a creditor .
Share (IPO, rights issue)	Investors are joint owners of the company and have participation rights in the company	The bank provides pre-IPO advice, supports the IPO and deals in the shares
Bond issue	Investors have no ownership or participation rights in the company	The bank provides pre-issue advice, supports the bond issue on the capital market and deals in the bonds

Source: Bank Sarasin

Especially controversial: project financing in developing and newly industrialised countries

Most of the criticism levelled at banks relates to project financing in developing and newly industrialised countries. These countries usually have less effective environmental protection regulations and the population affected is often more vulnerable as well (e.g. compulsory relocation of communities).

At the same time, the use of the funds is quite clear for project financing, and banks have a special interest in making sure the projects are a financial success, because the interest and capital repayments they receive are directly linked to the profits made on the projects. By granting finance, banks are able to influence the design of the projects. They tend to use this power to make sure the projects subsequently run at a profit.

Nowadays it is virtually impossible for companies to realise large-scale projects that create massive environmental or social problems without encountering resistance from environmental pressure groups or human rights organisations, who put

Environmental organisations are forcing banks to be more sustainable



Source: Greenpeace

them into the public spotlight through intensive campaigning. This presents an enormous risk to banks. First, public protests can cause severe damage to their

Equator principles are an effective form of self-regulation

reputation – no bank wants to be accused of the illegal destruction of the rain forest, for example. In addition, delays or last-minute changes to plans can cause significant extra costs in the project being financed.

Most banks active in project financing are now aware of the risks and their shared responsibility, and apply the Equator Principles when granting funding for large-scale projects. These guidelines require them to comply with the environmental and social standards laid down by the World Bank. In practice this means more attention is paid to an analysis of the environmental and social impact of the projects before work starts. This often results in projects being modified or loan applications even being turned down. In reality, however, there are big differences in how strictly individual banks apply the World Bank standards.

Recently, the threshold for applying the World Bank standards was reduced from project costs of USD 50 million to USD 10 million. The Equator Principles are a success because almost every bank involved in project financing has adopted them. It is difficult to circumvent them by opting for a different lender, since the guidelines apply even if just one member of the financing consortium has signed up to the Equator Principles.

Risk management for general business loans

Unlike project financing, the use of the funds borrowed under general business loans cannot always be earmarked for a specific project or activity. In addition, the banks' default risk is measured in terms of the overall creditworthiness of the borrower, rather than the success of an individual project. Banks are interested in minimising any conspicuous environmental and social risks associated with the loans they make to business clients not so much because of the risk of default, but rather the risks to their own reputation. The only rough check that many banks perform is to make sure that the borrower has no prior record of violating regulations. Another important factor is whether the borrower has an ISO 14001-certified environmental management system in place. Some banks refuse to give loans to companies operating in certain industries. The Dutch bank ABN AMRO is especially progressive when it comes to risk management: it has developed risk filters to identify environmental, social and ethical risks before completing a deal.

Setting concrete environmental targets when granting loans is not very common

To date no large bank has so far formulated concrete environmental targets that apply to its loans, with one exception: in 2004 Bank of America committed itself to cutting the CO₂ emissions associated with the financing it provides in the areas of energy and power stations by 7% up to 2008. So far, the first step has been to record the initial data. But no further details have been published to date. It therefore remains to be seen what measures Bank of America will take, and whether it will achieve its goal.

First initiatives in Investment Banking

When it comes to financing companies through the capital market, i.e. where banks support companies with IPOs and bond issues, giving due consideration to environmental and social risks is still not a very common practice. UBS, for example, checks environmental, health and safety risks, based on the external ratings of companies. However, these analyses are nowhere near as detailed as those performed when project financing is provided. Citigroup has announced plans to assess the environmental and social risks of all capital market transactions in excess of USD 50 million, as long as the intended use of the funds is

known. Likewise the US bank JPMorgan Chase intends to take environmental aspects into account in future when considering investments in unlisted companies (private equity). The internal guidelines of the UK/Asian banking group HSBC for companies in industries with a known exposure to environmental risks (e.g. mining of raw materials and energy supply) not only cover loans, but also investment banking and asset management. The common thread to all these intentions is that no specific details are known so far, and it is impossible to assess their effectiveness at the moment.

Loans for renewable energies:
participating in the boom

Providing finance for projects that directly enhance environmental protection and the conservation of resources is obviously linked to sustainable development. Some banks, such as Japan's Mitsubishi UFJ, have developed a particular expertise in this area and built up their own departments.

In the past, banks often viewed financing for renewable energies as too risky or unprofitable. Due to high energy prices and political support, renewable energies and energy conservation measures are currently experiencing a tremendous boom, thereby fuelling demand for financing in this sector. Many of the technologies and projects considered until recently to be unprofitable are now deemed creditworthy. There has been a sharp increase in the number of stock market flotations of companies active in the field of renewable energies. This creates attractive markets for banks. An increasing number of banks are thus expected to enter the fray.

Microcredits generate income

Microcredits are very much in vogue at the moment. These are small loans to entrepreneurs who cannot offer the collateral usually required. These loans often enable entrepreneurs to take the first step towards independence. They are providing a source of income in less developed countries in particular, and are usually issued by local organisations. Microfinance initiatives are currently experiencing a boom. Many large banks, such as Credit Suisse and Santander, have now entered this field, by refinancing local lenders. It has been shown that microfinance is not automatically a loss-making business for banks. The concept has now become established and is being publicly recognised this year with the award of the Nobel peace prize to the microfinance pioneer Mohammed Junus from Bangladesh, founder of the Grameen Bank.

Sustainable asset management
also on the rise

There is also a huge boom in demand for asset management products that not only take financial aspects into account when selecting stocks and bonds, but also social and environmental criteria. According to a market survey conducted by the European Social Investment Forum (www.eurosif.org), total assets managed in accordance with sustainable principles amounted to EUR 105 billion in Europe at the end of 2005 (2002: EUR 34 billion). Many large banks now offer sustainable asset management products. Initial initiatives are also being made in the industry, by UBS for example, to consider environmental and social aspects in "conventional" asset management as well, to the extent that these may be financially relevant in the long term.

First steps in offering clients advice with sustainable investment decisions

More and more banks, such as Citigroup and UBS, now offer large clients advisory services that include not just than the usual financial research but also information on sustainability aspects of the companies whose shares or bonds the client is investing in. This provides clients with a wider range of information on which to base their decisions. However, clients usually only receive this information if they specifically request it. Furthermore, the information is not usually made available to small clients.

Internal processes

Compliance: a perennial problem

The banking industry is subject to a higher level of regulation, although so far there has been very little harmonisation of these rules across national borders. Within the European Union, for example, there are still no uniform regulations on consumer protection for loans. Large international banks have to respect all the regulations in a huge number of different legal systems (legal compliance). This is a permanent challenge, because these regulations tend to change rapidly.

Preventing money laundering is still a high priority

Scandals involving money siphoned off by dictators and the laundering of mafia funds create adverse publicity and pose a considerable risk to a bank's reputation. As a result of this and in response to tougher regulatory requirements, banks have in recent years stepped up measures to prevent money laundering. These focus on identifying customers ("know your customer" principle), determining the origin of funds and automatically checking suspicious transactions. Even greater emphasis is being placed on these activities in the global fight against terrorism.



Source: Plain Pictures

The banks' defence measures have now reached a very high level and involve considerable time and effort. It is a constant challenge for banks to raise staff awareness about the prevention of money laundering. Despite all the technical resources available, bank employees' alertness to suspicious customers continues to play a key role.

The problem of conflicts of interest has improved slightly

Some aspects of a bank's activities may give rise to conflicts of interest that are detrimental to its customers. One example is pushing the sale of certain financial products, such as investment funds or life insurance policies, which offer the highest commissions, but may not necessarily be best suited to the client's needs. Such sales are often driven by a complex web of incentives that usually remain hidden to outsiders. Even so, most banks that market investment funds have introduced open architectures in recent years, i.e. they also sell third-party funds alongside their own. This extended product choice for clients does at least partly alleviate potential conflicts of interest. However, the customer does not

receive any information about the commission paid to the bank by third-party providers (sales and servicing commissions).

Some conflicts of interest have been resolved by increasing the degree of separation between financial analysis (the department that issues buy recommendations for securities) and securities trading. This has occurred amid pressure from regulators after serious failings came to light in the US several years ago.

Frequently underestimated:
internal environmental impacts

Most banks started to get to grips with sustainability issues as a result of their internal environmental management. This is now very widespread and firmly established. At the same time, banks' efforts to reduce their own environmental impacts drew criticism from environmental organisations, which claimed it was purely a gimmick to divert attention away from the more serious environmental burden presented by the industrial companies financed by the banks (see previous section). Irrespective of whether such criticism is justified, and contrary to popular belief, it must be said that even the business activities of service companies also cause substantial energy consumption and associated negative CO₂ emissions.

Electricity consumption,
heating and business travel ...

It is not uncommon for large banks to have an average annual electricity consumption of 10,000 kWh per employee. By way of comparison, this is roughly equivalent to the energy consumed by two households with four people in each family. The biggest electricity guzzlers at banks are the PCs and computing centres (incl. the associated cooling systems), along with the air conditioning for offices. Heating energy is also important, but to a slightly lesser degree. Business travel is also a huge factor for large multinational banks: average annual travel in excess of 5,000 km a year per employee is not uncommon, usually by plane or car.

... often result in substantial
CO₂ emissions

Overall, electricity consumption and business travel produce substantial CO₂ emissions. Average annual emissions of four to five tonnes of CO₂ per employee are common.

Technical solutions, green
electricity and CO₂
compensation

Banks tend to favour technical solutions such as building insulation, ventilation control, etc. as a way of reducing energy consumption. These certainly do promise ample savings potential. Energy efficiency is high on the agenda when banks construct and renovate office buildings. HSBC, for example, plans to invest EUR 150 million worldwide over the next few years to make its bank buildings more environmentally friendly.

Banks generally follow two strategies to reduce their CO₂ emissions: On the one hand procuring electricity from renewable sources, and on the other trying to compensate by financing measures to reduce the greenhouse gas emissions of third parties. HSBC is the first large bank to achieve a neutral carbon footprint in its business operations by these means. Most large banks have also set targets for reducing their CO₂ emissions, but HSBC and Credit Suisse are the only two committed to achieving total carbon neutrality.

Sustainability reporting

At this point it is worth making a few comments on sustainability reporting. Banks' financial products and business activities are becoming increasingly complex, making the banks themselves less transparent to outsiders. Adequate reporting on all financially relevant activities and potential risks is thus all the

more important. Although company reports are becoming increasingly detailed, important aspects (such as details of how conflicts of interest are handled) often remain submerged in the flood of information. It is encouraging to see a trend towards sustainability reports that are shorter and to the point. Despite all the efforts at standardisation, however, it is still impossible to compare the environmental indicators reported. The reports tend to focus on demonstrable initiatives, but often avoid controversial issues.

Employees

High salaries, but no job security

Banks are generally considered to be attractive employers, as they offer relatively high pay, favourable terms of employment and good fringe benefits. However, various factors are creating ongoing pressure to rationalise and consolidate. In recent years this has led to regular waves of job cuts. The number of people employed in the banking sector has been in steady decline as a result. Although this trend seems to have bottomed out now, redundancies are still an issue in the banking industry as it continues to consolidate.

Job cuts halted for the time being



Source: Keystone

redundancies are still an issue in the banking industry as it continues to consolidate.

Jobs cut in a socially responsible way ...

Many banks have tried to cut their headcount by putting a freeze on recruitment and reallocating staff internally, along with early retirement schemes and financial incentives for employees volunteering to leave the company of their own accord. In Europe at least, banks seldom revert to cutting jobs by compulsory redundancies. When they do, they generally offer staff relatively generous redundancy payments and support in hunting for a new job (outplacement consulting).

... and not particularly innovative solutions

Considering how expensive it is to lay off employees and recruit new ones, it is astonishing that the banking sector has so far made little use of innovative models to scale back their personnel requirements. These include, for example, a temporary reduction in working hours, sabbaticals or release for professional training.

For social reasons and also in view of the anticipated demographic changes, it would be advantageous for banks to recruit more women. The banks' managerial positions in particular continue to be occupied by men. Improvements in this area need to start with changing the prevailing mentality that gives priority to men. The work-life balance also needs to be improved. In general the possibilities for part-time working in banks are excellent, although this does not apply to management positions.

Early retirement will soon be a thing of the past

For demographic and social reasons it would also be preferable if the workforce had a higher percentage of older employees. Older customers quite often prefer to be served by older members of staff. In the latest wave of redundancies, one of the most common socially responsible ways of cutting back on staff in many companies – not just banks – was to offer early retirement packages. This is normally quite acceptable to those affected, because early retirement packages in the banking sector tend to be extremely generous. But these costs seldom come to light, as they are partly absorbed by the company's pension scheme.

So far only a few banks have tackled the issue of older members of staff. HBOS is one of them, raising their previous strictly imposed upper age limit of 62 for retirement. For some time now HBOS has not imposed any age limits in its job descriptions, pre-empting recent UK legislation in this area. The bank is also trying not to discriminate against older employees when it comes to professional development and promotion within the company.

Outsourcing to low-wage countries ...

Relocating jobs and services in countries with low wages is also an issue in the banking sector. In English-speaking countries, the "offshoring" of services to call centres abroad has made the headlines. This is not only because of the job losses at home, but because customers often feel they are misunderstood by the people serving them. This has since caused a backlash. Having relocated 1,000 call centre jobs to India after taking over Abbey National, Santander Central Hispano has subsequently moved them back to the UK.

... now includes the back office

While it seems that the move to shift call centres abroad is now over, it looks as if activities that do not involve any direct contact with the client will be increasingly relocated abroad. This includes areas such as information technology and payments clearance.

Outlook

Future issues

It's hard to make accurate predictions about the future. Even so, in this section we try to identify those issues that will be at the centre of the sustainability debate for banks over the next few years.

Evergreens ...

We are likely to continue to encounter the following pressing issues:

- ◆ Improving the information given to small clients about the risks and costs associated with financial products
- ◆ The avoidance of money laundering, compliance with all regulations
- ◆ Consideration given to environmental and social aspects in corporate banking
- ◆ Sustainable asset management
- ◆ Internal CO₂ emissions and compensation measures.

Anchoring the principles of sustainability in corporate culture and making them part of the daily business will continue to be a constant challenge for all large banks.

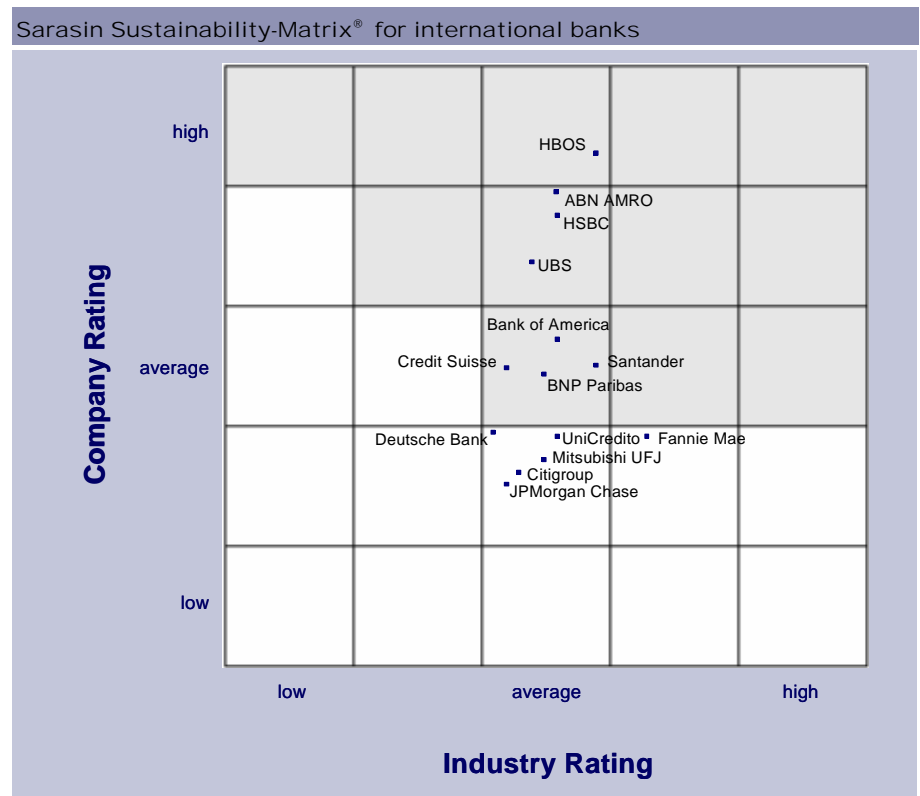
... and some new focal points

The following issues are also likely to be focused upon in future:

- ◆ Employment of older staff. One of the challenges facing banks in a climate of rapid change is to ensure its personnel receive ongoing professional training
- ◆ Relocation of services to countries with low wage costs. This particularly concerns IT and back-office operations
- ◆ The banking industry in developing and newly industrialised countries is gradually opening up to foreign competition. Improved access to financial services in these countries
- ◆ More meaningful sustainability reporting, increased standardisation, and also addressing difficult and controversial topics.

Results of the company evaluation

The results of the sustainability assessment of 14 large international banks are summarised in the Sarasin Sustainability-Matrix® below.



Source: Bank Sarasin

HBOS leading large bank

The bank that comes top of Bank Sarasin's sustainability ratings is Britain's HBOS. This is the only bank to achieve higher than average ratings in every area (see Appendix 1: "Sustainability analysis methodology"). HBOS offers private clients and small and medium-sized enterprises (SMEs) significantly higher rates of interest for deposits, and at the same time more favourable lending terms than any other UK High Street bank. The company is also heavily involved in financing the construction of social housing. It also finances projects in the use of renewable energies. HBOS does not offer finance for potentially controversial large-scale projects. The company has a fully functioning sustainability management system that is co-ordinated by the Corporate Responsibility Forum, on which senior executives sit. The bank has an effective environmental strategy and its internal environmental management system is certified to ISO 14001. When the Halifax Group merged with the Bank of Scotland to form HBOS in 2001, it managed to avoid compulsory redundancies.

ABN AMRO, HSBC and UBS
above average

Other strong all-round performers are ABN AMRO, HSBC and UBS, all of whom command much higher than average sustainability ratings. Unlike HBOS, these banks have a far higher proportion of international activities and are therefore exposed to much bigger legal risks. HSBC, for example, is present in 76 different

countries. Given this fact, it is quite surprising that the bank has not been involved in any significant scandals in recent years. This must be down to the efficient risk management system it has in place. There have been a number of irregularities at ABN AMRO, by contrast. In response to this, however, the company has significantly improved its measures to ensure compliance with the regulations in the different legal systems. Among other things, the bank has created a new post, Global Head Compliance, and recruited more people to its legal departments.

ABN AMRO has an excellent track record when it comes to the preservation of forests. The bank's guidelines apply to all loans that could affect forests (including mining projects, for example). ABN AMRO also has suitable internal procedures that have to be followed for the financing of dams and other potentially controversial projects. These conditions only apply to loans, however. So far the bank has not imposed similar rules on the financing of companies via the capital market. In this respect UBS is already one step ahead, and takes environmental aspects (at least in part) into consideration in its investment banking business as well.

HSBC is one of the leaders when it comes to internal environmental management. HSBC was the first big bank to become carbon neutral: it has cut its CO₂ emissions through energy-saving measures and the use of renewable energy sources. The remaining CO₂ emissions (especially those generated by business travel) are offset by carefully chosen compensation projects, such as planting forests.

When it comes to job security, the banks in the top group show a mixed picture. UBS scores well here because of its strategy of not buying foreign banks simply in order to restructure them or even strip out their assets. It was precisely such restructuring programmes conducted on newly acquired foreign subsidiaries that caused so many job losses in the past. HSBC has made job cuts in the UK, but it also reached an agreement with the trade union UNIFI to avoid redundancies as a result of relocating jobs abroad. In recent years ABN AMRO has carried out several cost-cutting programmes, some of them quite radical, which has reduced its global workforce by around 15% in total.

Middle of the field: Bank of America, BNP Paribas, Credit Suisse and Santander

Bank of America, BNP Paribas, Credit Suisse and Santander Central Hispano also qualify for Bank Sarasin's universe of sustainable investments. These companies score average sustainability ratings. They show no particular strengths or weaknesses when it comes to the environmental and social aspects of their business operations. One unusual development worth noting is the announcement by Bank of America that it will also include its equity holdings (e.g. in power stations) in its CO₂ reduction targets. This year Credit Suisse became carbon neutral as regards the buildings and air travel in its Swiss business units. It plans to make the entire group carbon neutral by 2012.

The stragglers are catching up

Six of the 14 banks studied in our report achieve lower than average sustainability ratings: Citigroup, Deutsche Bank, Fannie Mae, JPMorgan Chase, Mitsubishi UFJ Financial Group and UniCredito Italiano. These companies need to improve in a number of respects before they qualify for Bank Sarasin's sustainable investment funds and portfolios.

It should be stressed, however, that these banks have made substantial progress in some cases during the last years. One example is the new environmental strategy which Citigroup has drawn up in collaboration with environmental organisations that have a reputation for being highly critical of banks. In the case of business loans for purposes already known to the bank, Citigroup now has internal guidelines in place for assessing the environmental and social risks associated not only with loans but also with share and bond issues, and with its investment advisory services. However, it will take a while before these measures show their effects in practice. The same applies to JPMorgan Chase, which launched a similar initiative in 2005.

Deutsche Bank only narrowly misses qualifying for Bank Sarasin's universe of sustainable investments. Although there is a well-structured sustainability management system overall, it seems to have very little impact on Deutsche Bank's strategic decisions and business processes. In recent years, for example, the company was involved in a series of scandals and has been repeatedly forced to pay fines and legal settlements. This implies that the bank needs to improve its risk management. Although the bank's guidelines do mention social, ethical, and environmental factors, these seem comparatively superficial. The concrete implementation of these guidelines lacks transparency. There has been repeated restructuring at Deutsche Bank in recent years, with about a quarter of the workforce cut since 2001 (although completed mainly in a socially acceptable way, and seldom by compulsory redundancies).

The sustainability of banks is improving, but there is still a long way to go

The following general conclusions can be drawn from our analysis of companies: Sustainable corporate stewardship requires more than a declaration of commitment from management. It is not enough to set up a sustainability department and publish sustainability reports. There are numerous activities contributing to a gradual improvement in sustainability in the banking sector. These are not so much the result of systematic and integral sustainability strategies as the sum total of individual activities. So far, only the fruit on the low hanging branches has been picked. In other words, efforts need to be redoubled if further progress is to be made.

Sustainability management means minimising risk

Risk considerations are often what motivate banks to take sustainability initiatives, especially the attempt to reduce risks to their reputation. At the same time, banks are increasingly aware that customers now have higher expectations when it comes to sustainable corporate governance. This pressure is clearly raising awareness of sustainability at management level.

Very few banks are prepared to take the bull by the horns

One common feature of all the leading banks is that they do attempt to incorporate sustainable thinking into their business processes. To establish sustainability in a systematic and determined manner, banks must have a suitable corporate culture and continuously raise staff awareness of the problems. They must also show a willingness to refrain from dubious practices where necessary. But the industry as a whole still finds it hard to tackle controversial topics head-on, such as potential conflicts of interest resulting from undisclosed commissions when selling financial products, exorbitant bonuses for employees in certain business domains, etc.

Sustainability rating and share performance

Are sustainable banks attractive when it comes to investment returns?

We have already shown that a good sustainability performance is not limited to small specialist banks with a limited circle of business – large international banking groups are also very adept at meeting the environmental and social challenges associated with their business activity. Because banks are generally such heavyweights in stock indexes, it is virtually impossible for investors to avoid them if they are to maintain adequate diversification. The key question, therefore, is whether sustainable banks are also financially attractive for investors.

Are environmental and social risks “non-financial risks”?

As far as financial analysts are concerned, environmental and social risks are classed as “non-financial risks”, i.e. they have no impact on the share price in the short term. In the long run, however, they may well affect social development, and consequently share prices as well. To this extent the term “non-financial risk” is misleading.

Reputation risks and their financial consequences

Banks live off their reputation to a large extent. Previous scandals, such as money siphoned off and deposited in banks by dictators, or the accusation of dormant accounts holding money belonging to Jewish Holocaust victims, can do enormous damage to a bank’s public image. Banks therefore put a lot of effort into preserving a good reputation. Prevention is much better than cure. For the banking industry, this means on the one hand ensuring that all regulations in all countries are fully complied with. In addition, banks should avoid dubious business practices, even if they are not actually illegal. The misselling of life insurance policies in the UK, for example, prompted clients to desert the banks that sold them the policies.

One particular danger area is the financing of large-scale controversial projects (such as pipelines) in developing and newly industrialised countries, as these tend to be closely monitored by environmental pressure groups and human rights organisations. Protests by local populations can also delay projects, require costly last-minute adjustments or even block them entirely. It therefore makes financial sense as well to address potential environmental and social risks early on, in the planning phase.

Environmental and social criteria also create opportunities

Conversely, efficient sustainability management can also improve a company’s competitive edge. The benefit of an excellent reputation is obvious when acquiring new clients and retaining existing ones.

On the product side, the boom in renewable energies is creating numerous business opportunities. Banks that have built up expertise in this area early on are seeing their client base grow rapidly in the areas of lending and financial markets (IPOs, bond placements, investment funds).

Another success factor is how attractive a bank is as an employer. Given the high cost of recruiting personnel and settling them into the business, avoiding unwanted staff fluctuation obviously makes financial sense. The economic advantages of a highly motivated workforce are, by their nature, difficult to quantify. Employees need to have increasingly high qualifications in the banking industry.

Companies that have a reputation for being good employers find it easier to attract talented staff. This is likely to become an even more important aspect in view of demographic trends.

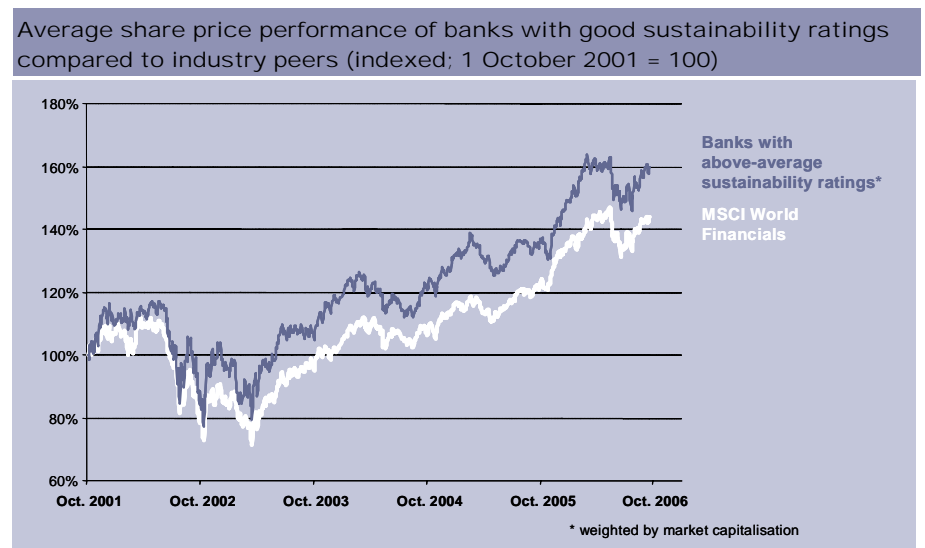
Financial risks and opportunities associated with sustainability		
Issue	Risks	Opportunities
Quality of services and customer support	Exodus of clients Bad reputation makes it harder to acquire new clients	Attractiveness for clients
Environmental and social impacts of financing	Controversial large-scale projects present risk to reputation Increased default risk (e.g. if inherited environmental problems are identified too late) Inadequate cash flow for project financing	"Renewable energies" business segment (loans, IPOs)
Internal processes geared to sustainable principles	Susceptibility to scandals Costs of legal action, fines and compensation Losses through rogue transactions (as exemplified by Barings Bank scandal)	Lower energy costs
Job security and approach to redundancies	Poor workforce productivity	High workforce motivation Lower staff turnover Easier to recruit good staff

Source: Bank Sarasin

Share prices of sustainable banks have outperformed

It is admittedly difficult to quantify the financial consequences of a management style that gives priority to sustainable business practices, as there are numerous superimposed effects that distort the more long-term view. On the other hand, it is at least easier to put a fairly accurate figure on the costs for legal action, fines and compensation.

The share price performance is a useful indicator in this respect. If we compare the past share price performance of the banks studied in this report, it is clear that those with very good sustainability ratings (above average or high, see page 18) have done better in previous years than the other banks and better than the MSCI World Index "Banks and Diversified Financials": Over the period October 2001 to October 2006 these banks gained 62%, while the benchmark index only rose 44% (see chart below).



Source: Datastream

Sustainability pays off

To summarise, there are good opportunities for broadly diversified investments in liquid shares of banks that adhere to sustainable business practices. In the past, the share prices of those banks identified as having a higher than average sustainability rating have performed very well compared to the banking sector as a whole. This gives weight to the argument that successfully tackling the environmental and social risks associated with a company's business activity can also result in financial benefits for investors.

Appendix 1

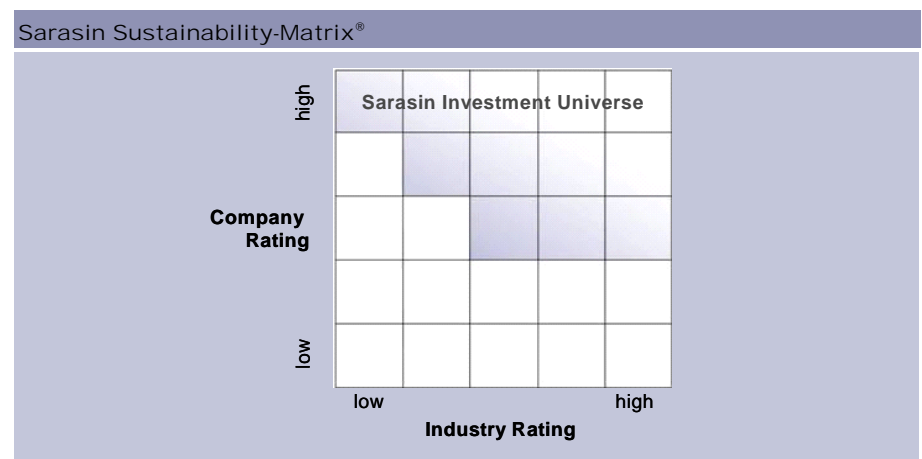
Sustainability analysis methodology

Matrix combines industry and company rating

Our environmental and social analysis of companies is based on a proprietary valuation method developed by Bank Sarasin. It incorporates two dimensions which are combined in the Sarasin Sustainability Matrix®:

- ♦ **Industry rating:** Comparative assessment of industries using selected environmental and social criteria.
- ♦ **Company rating:** Comparative environmental and social analysis of companies within their sector.

Only the companies positioned in the Sarasin investment universe (shaded) qualify for Sarasin sustainability funds.



Source: Bank Sarasin

Main criteria for the industry rating

The industry rating is an aggregated assessment of the extent to which an industry creates environmental and social risks. We examine a total of four risk categories:

- ♦ Consumption of resources: Use of natural resources (especially fossil fuels and water)
- ♦ Emissions: emission of air pollutants and creation of waste
- ♦ Internal potential sources of social conflict: Influence on employment and work conditions (health & safety, salaries, employee rights)
- ♦ Other potential sources of social conflict: impacts on society as a whole, especially harmful and ethically controversial production methods and products, political lobbying and exercising of financial power, corruption and business ethics, activity in countries with low social standards.

The industry risk exposure is derived from the characteristic product spectrum of an industry. We take the entire life cycle of products into account here, from the production of raw materials to the manufacture, use and eventual disposal of the product.

Environmental and social risks of the banking industry			
Phase in the product life cycle			
Risks:	Pre-production	Production	Use & Disposal
Consumption of resources		●	●
Emissions			●
Internal conflict potential		●	
External conflict potential		●●	●●

Source: Bank Sarasin

Overall industry rating

The industry rating of banks compared with other sectors is *average*. The impact that the banking industry has on society and the environment derives mainly from the projects financed by banks (i.e. from the products as far as the life cycle approach for the industry rating goes). During production – i.e. in the course of business activity – the main potential for internal conflict comes from job losses and the resulting lack of job security. Dubious business practices, such as poor advice to customers, lack of transparency in the costs associated with financial products, manipulated recommendations to buy shares or unfair treatment when allocating shares for IPOs all constitute risks as far as external conflict potential is concerned.

The fine-tuning of the industry rating for each company is geared to the circle of business activity in question.

Methodology for company rating

Criteria and weightings used for the environmental assessment of banks			
	Main criteria	Weighting	Key indicators
Environmental assessment 30%	Strategy and management	20%	Integration of environmental responsibility into business strategy, organisational structure and management processes; quality of reporting on environmental issues
	Pre-production	10%	Taking environmental criteria into account when purchasing office equipment and materials, as well as when constructing or renovating bank buildings
	Production	10%	Energy consumption and CO ₂ emissions from business activities (buildings, business travel, office equipment); environmental protection measures.
	Products & Services	60%	Taking environmental criteria into account in business financing; financing of environmentally friendly projects (e.g. alternative energies); sustainable asset management

Source: Bank Sarasin

Criteria and weightings used for the social assessment of banks			
	Main criteria	Weighting	Key indicators
Social assessment 70%	Strategy and management	20%	Integration of social responsibility into business strategy, organisational structure and management processes, quality of reporting
	Govt. and general public	30%	Integration of social criteria into project financing; measures to prevent money laundering
	Investors	5%	Independence and suitability of supervisory bodies; voting rights; remuneration for top executives and non-executive directors; quality of financial reporting
	Suppliers	5%	Transparency of selection process for suppliers
	Employees	10%	Job security and approach to handling redundancies; balance between work and private life; salaries and fringe benefits; training and professional development opportunities
	Clients	25%	Product quality; marketing practices; dealing with conflict of interest; price fixing; measures to improve access to financial services and financial literacy
	Competitors	5%	Competitive strategy; hostile takeovers; participation in industry initiatives

Source: Bank Sarasin

Controversial activities

Certain business activities not considered to be compatible with sustainable development (e.g. armaments, nuclear energy, tobacco, pornography) can lead to the exclusion of companies from the Sarasin sustainable investment universe. The Fund's Advisory Council makes this selection for our retail funds. In the case of the banking industry, no exclusion criteria apply.

Information sources

The company rating is based on the company's own details, a worldwide press search and information from independent institutions. We do not use standardised questionnaires.

Appendix 2

Overview of companies studied

Selection criteria

This report compares 14 large international banks quoted on the stock exchange. The selection is based mainly on company size, as measured by market capitalisation. Geographical considerations were taken into account as well.

Companies studied			
Company	Country	Employees (2005)	Market capitalisation (USD m)*
ABN AMRO	NL	97'523	55'641
Bank of America	US	176'638	244'467
BNP Paribas	FR	109'780	99'384
Citigroup	US	299'938	246'921
Credit Suisse	CH	63'523	71'992
Deutsche Bank	DE	63'427	62'396
Fannie Mae	US	5'500	54'243
HBOS	UK	71'985	75'040
HSBC	UK	268'471	208'790
JPMorgan Chase & Co	US	168'847	163'165
Misubishi UFJ Financial Group	JP	81'046	138'550
Santander Central Hispano	ES	129'196	98'795
UBS	CH	69'569	129'977
UniCredito Italiano	IT	132'917	86'288

Source: Morgan Stanley Capital International

* Status: 1 October 2006

Index coverage

The 14 banks studied belong to the "Banks" and "Diversified Financials" industry groups in the MSCI Index. Their combined market capitalisation comes to 36.4% of these two industry groups. Together, the industry groups "Banks" and "Diversified Financials" account for 18.7% of the market capitalisation value of the MSCI World Index.

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The reports can be downloaded from our website www.sarasin.ch/sustainability.

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