

## The Sustainability of Public Financial Institutions

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## Contents

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<b>Summary</b>	<b>4</b>
<hr/>	
<b>Introduction</b>	<b>6</b>
<hr/>	
<b>Overview of the sustainability of public financial institutions</b>	<b>9</b>
<hr/>	
<b>Results for selected institutions</b>	<b>15</b>
Bayerische Landesbank	15
Eksportfinans	16
Österreichische Kontrollbank	17
World Bank	18
<hr/>	
<b>Appendix 1: Environmental and social rating method</b>	<b>19</b>
<hr/>	
<b>Appendix 2: Selection of the institutions assessed</b>	<b>22</b>
<hr/>	
<b>Contacts</b>	<b>24</b>
<hr/>	
<b>Publications</b>	<b>25</b>

## Summary

**Institutions are attractive bond issuers**

In essence, public financial institutions are banks with a specific mandate which enjoy state backing. Their commercial purpose is to provide loans and to perform tasks that are in the public interest.

Public financial institutions are major issuers of low-risk bonds: their financial ratings are geared to the creditworthiness of the public-sector authorities that stand behind them. These bonds are particularly interesting for people looking to invest their assets in an environmentally and socially responsible manner, as they are used to finance undertakings that are for the public good and in some cases are directly linked to sustainable development. This in turn opens up opportunities for progress to be made on the social level and in reducing environmental impacts. However, certain risks may well arise when it comes to the concrete implementation of projects, especially as a result of ineffectual performance of the mandate, and also through lack of transparency or corruption, for example.

**The special characteristics of public institutions ...**

There are a number of important differences between public financial institutions and private banks. Institutions can often count on state guarantees, in many cases they are not subject to the usual bank industry regulation, they have other reporting obligations and are also governed by public service rules. Their supervisory boards and top management posts tend to be filled by political figures.

**... require special methods for assessing sustainability**

Bank Sarasin has developed a two-dimensional sustainability rating for public financial institutions that takes into account their special qualities. One dimension assesses the environmental and social compatibility of the institution's mandate, while the second dimension determines its sustainability performance in implementing its mandate. The decision on whether these bonds are suitable for sustainable portfolios is based on the combination of both aspects.

**The mandate is usually sustainable ...**

Analysis shows that in most cases the public mandate encourages sustainable development, or is at least compatible with it. Particularly positive aspects include combating poverty, funding health and education projects, and a commitment to environmental protection. Of the institutions examined, none have a public mandate that is considered to be incompatible with sustainable development. It is clear, however, that current policy does not fully exploit the opportunities available to public financial institutions to use their financing activities for promoting sustainable growth on the social and environmental front as well.

**... but not always the way in which institutions perform it**

Of the 28 institutions examined, six (including the World Bank and the Council of Europe Development Bank) stand out from the rest when it comes to the sustainability achieved in performing their mandate. On the other side of the spectrum, six institutions were classed as not sustainable. Between the top and bottom there is a large mid-field of institutions whose business activities do meet environmental and social standards, but are still well behind the top six. Overall the monitoring of achievements in this area needs to be improved, not only with respect to meeting targets in the individual projects, but also to the institutions'



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### **The Sustainability of Public Financial Institutions**

overall performance of their mandate. When financing projects in the developing economies of Eastern Europe, for example, more effort should be made to promote the social infrastructure, such as public health and education. Environmental projects, such as renewable energies, should be significantly expanded to take account of political objectives, such as the Kyoto protocol.



## Introduction

**Sustainable investors are showing more interest in bonds**

Investors' appetite for low-risk bonds has grown in recent years. This is also true of investors who base their investment decisions not purely on financial considerations, but on social and environmental aspects. In the fixed-income segment, the main focus in sustainable asset management has been on corporate bonds in the past. But investors' attention has gradually shifted to other groups of issuers due to factors such as issue volume, bond liquidity and the credit rating of issuers. It makes economic sense for investors to consider non-financial information as well, since certain risks (associated with the financing of controversial large-scale projects, for example) are taken into consideration which are not otherwise included in the traditional assessment of creditworthiness.

**Public financial institutions are important bond issuers**

Bank Sarasin has offered sustainable investment products since 1994, covering both equities and bonds. Since then, it has gradually extended the spectrum of the bond issuers it rates for sustainability. In parallel with this, it has also refined the valuation methods used for sustainability analysis. Bank Sarasin now offers comprehensive sustainability ratings for corporate bonds, government bonds and mortgage bonds. This report describes the new methodology and the main results of our sustainability assessment of public financial institutions.

**These institutions are very different from banks**

To some extent public financial institutions implement the political will of the public-sector bodies that stand behind them. They are very different from private banks, both in terms of their structures and areas of business. The main characteristics of public financial institutions are:

- ◆ They are non profit making and enjoy the backing of state departments or government organisations. Either they are directly or indirectly owned by the state, or they are public-sector corporations. Some of them are self-help organisations for the mutual benefit of their members.
- ◆ Their mandate is non profit making: their commercial purpose is to finance projects that serve the public good. This may involve infrastructure projects, such as schools or roads, but also development aid, regional grants or export subsidies. The primary purpose of some institutions is to manage state debt.
- ◆ Many institutions provide loans for projects for which private banks would only offer credit at far less attractive conditions or in some cases would not consider financing at all, due to the risks involved. Some institutions are active in segments close to the market and issue loans at typical market conditions.
- ◆ Since there are no client deposits, the loans are refinanced from the subscribed and paid-up capital of the members or owners and – primarily – by raising funds on the capital markets.<sup>1</sup>
- ◆ Because of explicit or implicit state guarantees, the financial ratings of the institutions reflect the credit standing of the public authorities that stand

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<sup>1</sup> The liabilities of public financial institutions usually count as public debt under the meaning of the Maastricht criteria.

### The Sustainability of Public Financial Institutions

behind them. They therefore usually enjoy high credit ratings from agencies, and tend to have access to more favourable refinancing facilities than most private banks.<sup>2</sup>

- ◆ Public financial institutions are often governed by a special regulator and special rules regarding solvency requirements, accounting standards and reporting duties. Many institutions do not pay tax.
- ◆ Political factors come into play when filling posts in management and supervisory bodies.
- ◆ Many institutions are subject to public service rules, particularly in the areas of staff employment and procurement.

#### Key themes in the sustainability of institutions

As far as environmental and social issues are concerned, the activities of these institutions present both opportunities and risks. Institutions with a particularly strong sustainability rating are those which make full use of their opportunities for promoting sustainability while at the same time minimising risks from non-sustainable activities.

Key themes in the sustainability of institutions include:

- ◆ **Promoting particularly sustainable initiatives:** The non profit making mandate includes in part the financing of initiatives with a social impact or projects that directly support environmental protection. As well as granting preferential conditions, support can also come through the provision of state subsidies.
- ◆ **Checking environmental and social compatibility:** Infrastructure projects especially – such as large energy supply schemes – can have negative consequences for the environment. An environmental impact study therefore has to be carried out before the project starts. This presents a challenge to lending institutions as well, especially with projects in countries with lax environmental standards or poor enforcement of them.
- ◆ **Effectiveness:** It is important to check that the public institution is fulfilling its mandate, since this is after all what defines their right to exist.
- ◆ **Transparency and efficiency:** It is not uncommon for public financial institutions to have inappropriate self-momentum, which can take the form of an overbearing attitude, lack of transparency towards the general public or the state, inefficiency, corruption and nepotism.
- ◆ **Competition:** Where institutions are engaged in activities close to the market and are thus competing with private banks, there is a danger of competition being distorted by state guarantees, tax exemption and the special relationship with the owners.
- ◆ **Stakeholder dialogue:** When financing projects in newly industrialised and developing countries, a dialogue with affected parties and other stakeholder groups can be very important.

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<sup>2</sup> For many sustainable investors, a bond must be at least investment grade (BBB rating or higher) before they consider investing.



### **The Sustainability of Public Financial Institutions**

In contrast to private banks, shedding jobs is only of secondary importance for institutions, with the exception of German state-owned regional banks (*Landesbanken*).

#### **New sustainability rating with special criteria**

Up to now valuation measures used in the sustainability analysis of public financial institutions have been based on those applied to the private banking sector. Bank Sarasin's new sustainability rating takes into consideration the special characteristics of the institutions. It comprises two dimensions:

1. Rating the environmental and social compatibility of the mandate
2. Comparative assessment of the institutions' sustainability in performing their mandate

The decision on whether the bonds in question are suitable for sustainable portfolios is based on the combination of both these aspects. The rating method is described in detail in Appendix 1.

#### **28 institutions assessed**

As well as switching to new rating methods, Sarasin has expanded the circle of institutions analysed to 28, spread over 16 countries. The selection criteria are described in Appendix 2, which also contains an overview of the institutions rated.

## Overview of the sustainability of public financial institutions

### **Mandate is often broadly defined**

The mandates of public financial institutions are usually defined in their articles of association when they are founded. Most of the institutions analysed pursue a number of different finance objectives. Their financing activities are concentrated in the areas of regional, economic and export subsidies, community financing and house building (see table in Appendix 2). Other important areas include public infrastructure in emerging economies and development aid. Some of the institutions are active in specialist segments such as the financing of rolling stock for railways.

Institutions' tasks and goals change over time. One striking example is the KfW Banking Group (formerly Kreditanstalt für Wiederaufbau, Reconstruction Loan Bank), whose original purpose was to distribute the funds from the Marshall Plan in post-war Germany. Some of the change is often down to an expansion in the fields of activity, which can lead an institution away from its original mandate.

### **Institutions have plenty of room for interpretation**

Institutions have plenty of room for interpretation when it comes to actually performing their mandates. Some of them mention environmental protection and social issues in their articles of association, but in most cases no concrete mandate can be derived from this. As far as social and environmental aspects are concerned, the conditions imposed by the founders are often limited to general objectives and blanket statements such as the projects financed should contribute to social development and environmental protection. While the financing of projects with a social dimension (e.g. social housing) plays a prominent role with several institutions, not a single one of them is actually dedicated to projects specifically geared to environmental protection.<sup>3</sup>

Strategies for dealing with social and environmental issues arising in their business activities are left to the discretion of the institutions themselves, and in this respect there is very little monitoring from the political bodies that stand behind them.

### **Only very few institutions are publicly committed to sustainability**

Only a handful of institutions (such as the Österreichische Kontrollbank) have a public commitment to sustainability and have developed strategies for dealing with the social and environmental issues that affect them most. This is closely linked to business activity: Institutions that finance large projects or are involved in development aid have for a long time attracted criticism from international non-governmental organisations. Pressure on institutions that are dragging their feet in this area (such as the World Bank) has led to noticeable efforts to develop strategies for dealing with social and environmental issues and to improve transparency.

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<sup>3</sup> Austria's Environmental and Water Management Fund no longer provides active financing (with a few exceptions), but simply manages liabilities from previous funding provided for water management and environmental protection projects.



## The Sustainability of Public Financial Institutions

### **Financing activities with a social purpose**

Institutions provide major financing for public infrastructure. This includes projects that have a direct social impact. Social purpose is particularly important in the case of development aid. Financing social facilities such as schools or hospitals, and social housing, also has a clear social purpose.

It is difficult to assess the extent to which institutions provide funding for projects with explicit social objectives, since local authorities are often responsible for such undertakings. Loans for this sort of community infrastructure are often part of the general budget of local authorities that cannot be quantified in more detail. This means not even the institutions providing the financing necessarily know exactly how the funds will be used.

### **Financing of environmental projects**

In this context, environmental projects are those whose primary goal is to save resources and reduce toxic emissions. This includes in particular the use of renewable energies, wastewater treatment, reduction of emissions into the air, water and soil and the avoidance and recycling of waste. Projects not primarily concerned with environmental protection can of course help to save resources or reduce emissions as well.

On the basis of available information, it is impossible to assess what proportion of the institutions' financing volume is allocated to such projects. This is because of the way the institutions themselves classify environmental projects: rail transport, for example, is usually lumped into this general category.

### **Shared responsibility for environmental and social compatibility**

There is growing awareness that lenders have a shared responsibility for the social and environmental compatibility of the projects they finance. This is particularly true in countries where legal requirements are very lax or very badly enforced. Lenders have a collective responsibility to ensure that minimum standards are upheld.

The detailed criteria defined by the World Bank for the financing of large projects set the standard for international projects. Even though these standards are not above criticism and in particular leave room for interpretation in their practical implementation, they have since become an industry standard which even private banks increasingly defer to. Not all public financial institutions active in the international project financing business have signed up to the World Bank standards. Many of the financed projects with environmental impacts, for example in the areas of transport infrastructure or energy supply, are realised in Europe. Here financial institutions refer to the existing legal requirements and insist that it is the responsibility of the project sponsor to comply with them.

The extent to which institutions check the environmental compatibility of projects varies significantly: some of them have their own dedicated staff for this purpose (such as the Asian Development Bank), while others at best perform only formal checks (e.g. to make sure documents are complete). Very few public financial institutions have in-house teams trained to assess social aspects.

### **Success needs to be monitored more carefully**

Public financial institutions act on the basis of a public mandate and pursue objectives for the public good. An independent check therefore needs to be carried out not only on the success of the individual project being financed, but also on the overall performance of the mandate by the institution. There are serious shortcomings here. Only a few institutions (e.g. EBRD) go back and



## The Sustainability of Public Financial Institutions

assess the success of their projects. Where ex-post assessments are made, they usually only take in selected projects. Furthermore, it is not always clear whether conclusions are drawn from the results of the assessment for the institution's future financing activities.

The second aspect of the control procedure – checking how effectively the mandate is carried out – is often reduced to a description of the financed project and key financial figures. Admittedly it is difficult to provide a meaningful review of mandate performance because the targets are defined so broadly. But because of their public character, institutions owe their supervisory boards, and the public, a full report on the success of their activity.

### Greater transparency

The question of monitoring success is linked to the transparency of the institution. The public authorities that stand behind the institutions, and the respective auditors, are entitled to information about the activity of a public financial institution, a right that is shared by the general public and investors as well. Rating agencies cater extensively for the information requirements of many investors. Reporting should also include the publication of underlying strategies and important internal regulations (such as anti-corruption measures). Meaningful information should also be published about the projects being financed (project descriptions, details of environmental and social compatibility, results of ex-post evaluations). There is a very broad range of information supplied to the public, from institutions that provide great detail to those with poor transparency.

### No corruption in the institutions

Only very few cases of corruption in public financial institutions have come to light in recent years. It seems reasonable to assume that not all cases are publicised. Even so, corruption in the institutions does not appear to be a big problem. This is probably due to the risk of being caught and disciplinary measures being taken against the offending employee.

The issue of corruption in the projects being financed seems to be a more important question – especially in the area of procurement. The responsibility for combating corruption cannot be entirely passed off onto the project sponsor. Lenders can at least require measures to prevent corruption, since financial considerations make this very much in their own interest. It is impossible to judge to what extent these conditions are actually imposed in practice.

### EU competition authority tries to create a level playing field

In a number of areas public financial institutions are in direct competition with private banks. In these segments it is important to make sure that state guarantees, exemptions to capital solvency requirements and tax privileges do not give rise to unfair competitive advantages. In recent years, initiatives by the EU competition authority have defined illegal subvention of institutions and introduced measures to counteract it. Those most affected were Germany's state-owned regional banks (*Landesbanken*), whose business model has been under fire from private competition for years. Following a compromise with the EU competition authority, they are being forced to restructure in order to provide clearer separation between their promotional (public funding) and commercial activities. Some *Landesbanken* also have to reimburse retrospectively any public assets transferred to them in the past by their owners. The KfW Banking Group is also affected, and is outsourcing its export financing activities.



## The Sustainability of Public Financial Institutions

### Stakeholder dialogue

Large-scale projects in particular are often controversial and can carry substantial drawbacks for those directly affected. There are also environmental protection issues, which are frequently championed by environmental agencies. Open dialogue with the affected parties and with environmental organisations is particularly important if the law does not give the local population the right of consultation. In such cases a dialogue has to be established that attempts to reconcile differences in what are often complex situations. This is handled in a number of ways in practice. With projects evaluated according to World Bank standards, there are formal mechanisms for including the public in the consultation process.

The complaints procedure established by the ERBD is probably unique: It gives any person or group with a justified interest the opportunity to appeal to an independent authority.

### Job cuts now an issue for the first time

Public financial institutions offer their permanent employees jobs with very attractive salaries and social benefits. Job cuts have not been an issue in the past. But further redundancies are expected in the wake of the restructuring of Germany's *Landesbanken*, once the public-sector bodies that back them cease to assume liability for their debts and stop acting as guarantors in July 2005. In this situation the *Landesbanken* not only have to take the usual measures (recruitment freeze and early retirement), but also have to find creative solutions to avoid as far as possible lay-offs.

### Internal environmental management could be improved

The environmental impacts of service providers' business activity often tend to be underestimated. The main problems with financial institutions are business trips and the energy consumption of buildings and office equipment. In most cases initiatives to reduce the environmental impacts of business activity are limited to the recycling of wastepaper and used office equipment, and the use of advanced building management systems when refurbishing or building new bank premises.

Only a few institutions, such as Bayerische Landesbank – have a proper internal environmental management system consisting of a strategy, concrete goals and suitable organisational structures, as well as procedures for monitoring success and reporting. Almost all the bigger institutions (more than 1,000 employees) lag private banks in this area.

### Sustainability assessment in detail: two-dimensional approach

Bank Sarasin's new sustainability rating takes into consideration the special characteristics of public financial institutions. The two dimensions are:

1. Rating the environmental and social compatibility of the mandate
2. Comparative assessment of the institutions' sustainability in performing their mandate

The decision on whether the bonds in question are suitable for Sarasin's sustainable portfolios is based on the combination of both these aspects. The rating method is described in detail in Appendix 1.

### Mandate: Untapped potential to promote sustainable growth

Our analysis of the mandate's environmental and social compatibility shows that none of the 28 institutions examined have a mandate that could basically be described as incompatible with sustainable development. Viewed overall,



### **The Sustainability of Public Financial Institutions**

however, there should be more emphasis on unequivocal environmental projects, such as renewable energies and wastewater treatment. The same applies for the expansion of the social infrastructure (education, health and cultural facilities) in the transition economies of Eastern Europe. In many cases the political bodies that stand behind the institutions give priority to the economic development and the development of a transport infrastructure.

Overall, however, it is clear that policy does not fully exploit the opportunities that public financial institutions have to use their financing activities to promote sustainable development in the social and environmental dimension as well. To achieve this would require clear objectives and independent monitoring of success. In some cases the original mandate no longer matches current criteria, or institutions have moved away from the mandate in their concrete activities. This can be seen particularly with institutions that do not have a precisely defined task, such as providing municipal finance.

#### **Implementation: six leaders, a big mid-field and six stragglers**

Even though the mandate of an institution may be sustainable in principle, the institution still has a responsibility to make their business activity as environmentally and socially compatible as possible. Enormous differences can be found here. Of the 28 institutions examined, six (including the World Bank and the Council of Europe Development Bank) stand out from the rest when it comes to the sustainability achieved in performing their mandate. On the other side of the spectrum, six institutions were classed as not sustainable. Between the top and bottom group there is a large mid-field of institutions whose business activities do meet environmental and social standards, but are still well behind the top six. None of the institutions invoke the exclusion criteria applied by the retail funds Sarasin OekoSar Portfolio and Sarasin Sustainable Bond Euro (see Appendix 1 for a definition of the exclusion criteria).

**Overview: The institutions compared**

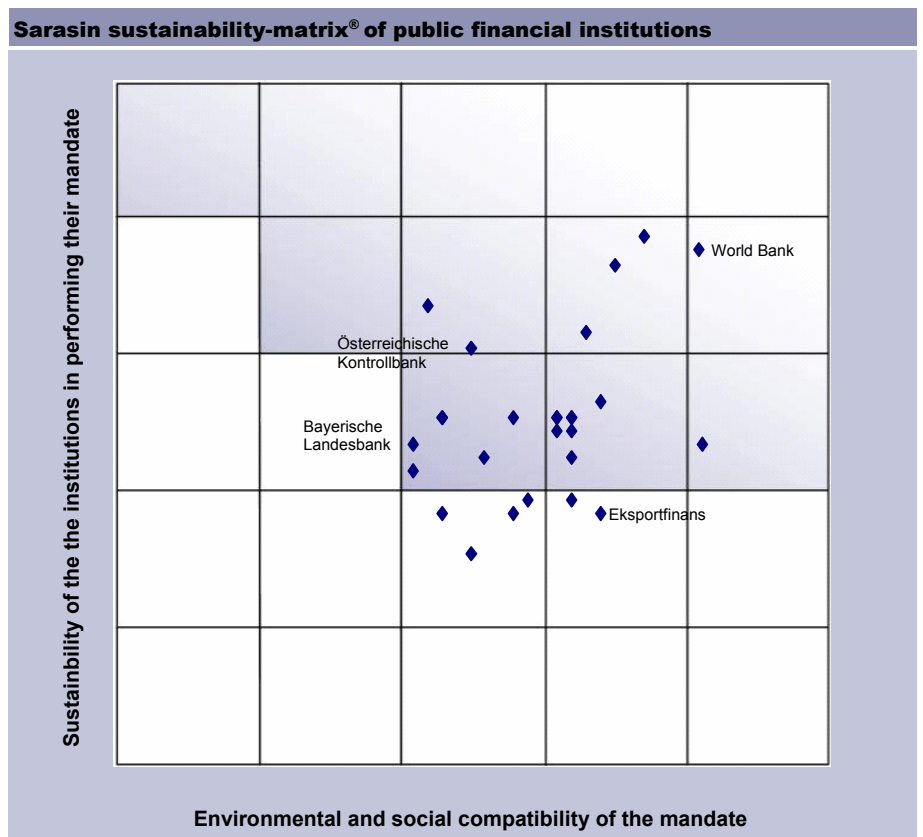
**The Sustainability of Public Financial Institutions**

The results of the environmental and social analysis of the public financial institutions can be plotted on the Sarasin sustainability matrix®:

Horizontal: Rating the environmental and social compatibility of the mandate

Vertical: Comparative assessment of the institutions' sustainability in performing their mandate

The next figure provides an overview of the rating of the public financial institutions examined. Those positioned on the shaded area qualify for their bonds to be included in Bank Sarasin's sustainable portfolios.



Source: Bank Sarasin

## Results for selected institutions

In this section we present the results for four institutions. This selection is meant to illustrate the different finance objectives of institutions and the scope of their attention to sustainability themes.



### Bayerische Landesbank

#### Description

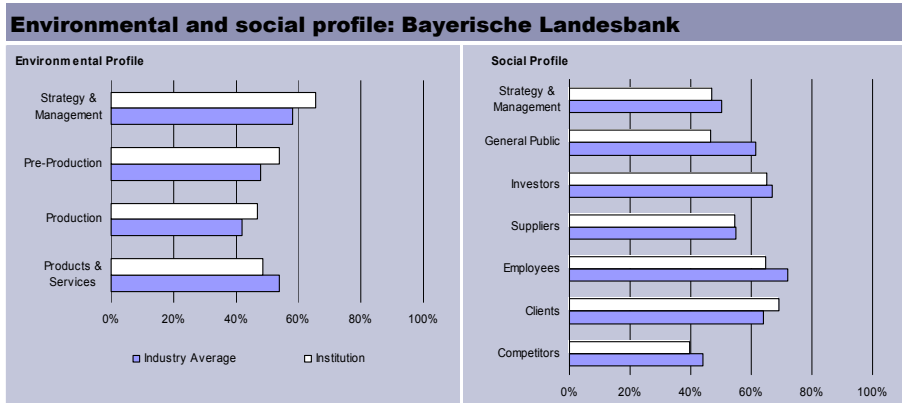
Bayerische Landesbank (BayernLB) is the principal bank of the Federal State of Bavaria and acts as the central bank for Bavaria's savings banks. It also focuses on corporate clients and the public sector, mainly in Bavaria, Germany and neighbouring regions. BayernLB is also involved in the real estate business. Landesbodenkreditanstalt (LABO) and Bayerische Landesbausparkasse (LBS) also belong to the group. Ownership is split equally between the Bavarian Association of Savings Banks and the State of Bavaria. BayernLB employs about 9,000 people.

#### Environmental profile

BayernLB has realised that previous financing practices for problematic projects in developing countries are no longer workable. The structures and skills needed to put into practice the World Bank standards (Equator principles) are still only being developed, however. The bank does not want to finance critical projects in future. On the other hand, it is currently involved in financing the projected Finnish nuclear power plant. BayernLB's green products include advice relating to climate protection risks and emissions trading, information on energy-saving measures for real estate and brokering loans for public subsidies. Its subsidiary Bauland is a property development company that is committed to building in an environmentally friendly way. BayernLB has a well structured internal environmental management system in place at its Munich head office.

#### Social profile

The bank has improved its risk management following losses caused by high-risk financing projects, some of them politically motivated. LABO provides loans at subsidised interest rates to low-income client groups who want to build their own homes and also brokers state subsidies for residential building. In Germany BayernLB has so far managed to cut its headcount without redundancies for operational reasons. This is not the case with job cuts made abroad, nor for future redundancies in Germany. Corporate Governance reporting could be improved.



Source: Bank Sarasin



### Eksportfinans

**Description**

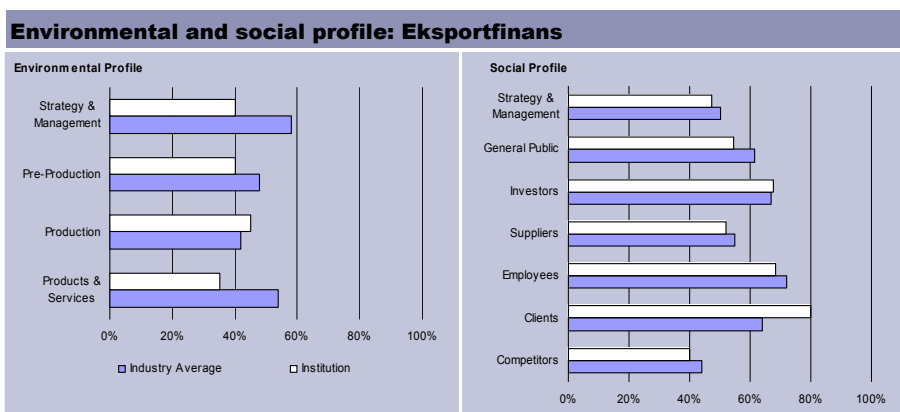
Eksportfinans was founded in 1962 as a limited liability company on the initiative of the Norwegian government and the Norwegian Bankers' Association. It is collectively owned by the state, which has direct and indirect holdings of 40%, and several Norwegian banks. Eksportfinans is mainly active in the financing of Norwegian municipalities (62% of the loan portfolio) and export financing (38%). Eksportfinans has sole responsibility for managing Norway's state subsidies for exports. Almost a fifth of export credits are subsidised by the state, the rest are provided at current market conditions. Eksportfinans deals with loans granted for aid projects by NORAD, the state development aid agency. The company employs around 100 people.

**Environmental profile**

Eksportfinans has an internal environmental management system. It does not undertake any environmental audits in its main area of activity, the financing of Norway's municipal authorities. The bank assumes that municipalities check projects with potential environmental impact to ensure they comply with Norwegian requirements. Guarantees for export credits are provided by Norway's state agency GIEK. It performs environmental audits in line with OECD guidelines for export credit financing. Eksportfinans does not offer special conditions for environmental protection projects or the export of environmental protection technology.

**Social profile**

The loans provided to local authorities are classed as general budget financing (as opposed to project-related loans), so that it is not clear to what extent social facilities such as kindergartens are financed. The company does not have an explicit commitment to sustainability, but has at least passed a code of ethics for employees, which it says cover aspects such as the prevention of discrimination, corruption and conflicts of interest. It does not publish this code of ethics, however. Although Eksportfinans does not have a banking licence, it is still regulated by the State Commission for Banks, Insurances and Securities.



Source: Bank Sarasin



### Österreichische Kontrollbank

**Description**

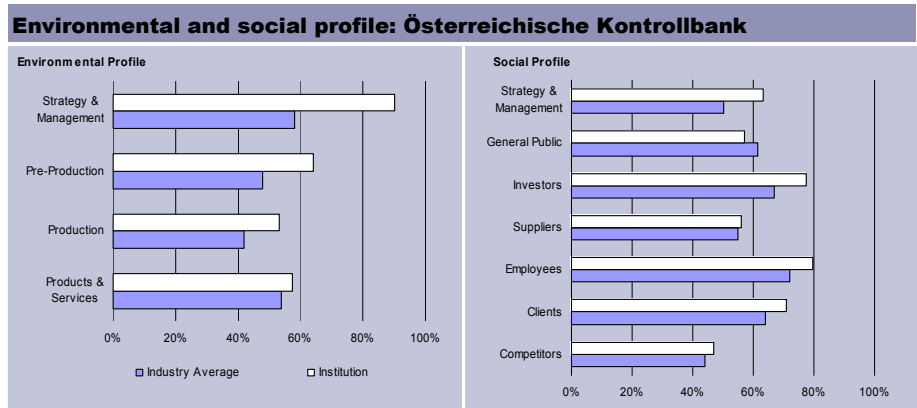
Österreichische Kontrollbank (OeKB) is Austria's central finance and information services provider for export and the capital market. It is the authority which manages state export guarantees. OeKB also grants loans to importers of Austrian products and to banks for refinancing export credits. OeKB also functions as a reporting office in accordance with the capital markets law and as a securities clearing bank, and also organises the issue of Austrian government bonds. OeKB is owned by private banks, but is regarded as a public financial institution because of its functions. The company employs 354 people.

**Environmental profile**

OeKB performs environmental audits for all state-guaranteed export credits, in accordance with the OECD guidelines for export credit agencies. OeKB has its own in-house environmental experts for this purpose. OeKB takes into consideration sustainability criteria when making investment decisions for its own securities portfolio. OeKB has an internal environmental management system that is certified to EMAS and EN ISO 14001 standard. The implementation of OeKB's environmental policy is extensively documented.

**Social profile**

OeKB has a comprehensive and credible internal sustainability strategy. In line with Austria's export subsidy policy, no funds are provided for exports relating to nuclear energy and military goods. Great importance is attached to a dialogue with stakeholders (e.g. in the form of workshops with NGOs). Women occupy an impressive 38% of management posts. The export credits issued by OeKB and the bonds put up for refinancing carry state guarantees. OeKB makes a charge for this. Since the export subsidy law was updated in 2003, the management of state export guarantees is in principle open to competition.



Source: Bank Sarasin



**World Bank**

**Description**

The World Bank was founded in 1944 at the Bretton Woods conference. It is built around two key aid organisations: the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). They provide loans and credit guarantees to promote economic development in developing and emerging countries. They also offer analytical and advisory services. The IDA provides low-interest loans and advances to particularly impoverished countries. The World Bank employs around 10,000 people.

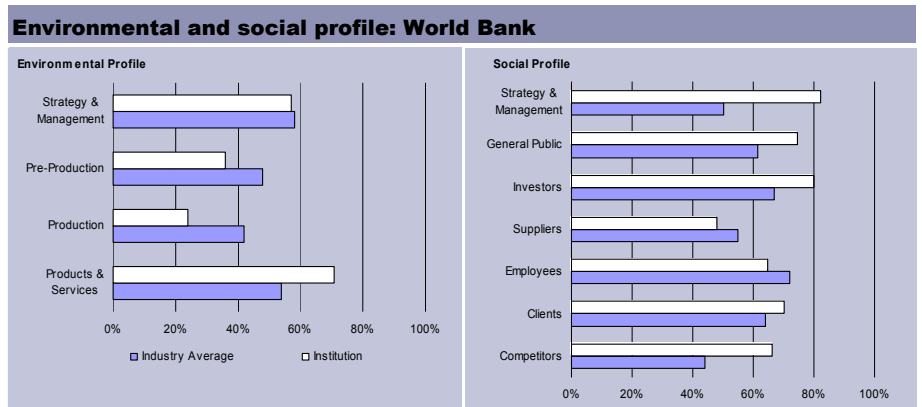
Sarasin’s sustainability analysis does not cover the following agencies, which also belong to the World Bank Group: the International Finance Corporation (IFC), the International Centre for the Settlement of Investment Disputes (ICSID) and the Multilateral Investment Guarantee Agency (MIGA).

**Environmental profile**

The World Bank has detailed and comprehensive environmental standards in place for the financing of projects in newly industrialised and developing countries, and these are also applied by other institutions and private banks. To this extent they define the industry standard. The indirect environmental impact of projects is also taken into account in their planning and implementation. In future more consideration will be given to environmental protection and the prevention of corruption when financing projects involving fossil fuels. Approximately 6% of its lending volume in 2003 went to projects whose primary aim is to protect nature and the environment, such as water resource management. A follow-up check on compliance with and implementation of the relevant environmental standards is carried out for all projects. The World Bank still has shortcomings in its own internal environmental management.

**Social profile**

Most of the lending volume (approx. 56%) goes to projects to promote social development (e.g. rural development, social inclusion and security). The auditing of projects is influenced by social criteria, e.g. health and equal opportunities. However, the World Bank attracts frequent criticism from non-governmental organisations and other groups. They claim that the interests of those affected are not always taken into consideration, which in the past has led to negative social consequences, such as the long-standing indigenous population losing their living space when dams are built. After years of outside criticism, there has been a significant improvement in dealing with social and environmental issues, and in the transparency of the organisation.



Source: Bank Sarasin

## Appendix 1: Environmental and social rating method

### Combined assessment of the mandate and its performance by the institution

Up to now, valuation measures used in the sustainability analysis of public financial institutions were based on those applied to the private banking sector. Bank Sarasin's new sustainability rating takes into consideration the special characteristics of the institutions.

These include:

1. Rating the environmental and social compatibility of the mandate
2. Comparative assessment of the institutions' sustainability in performing their mandate

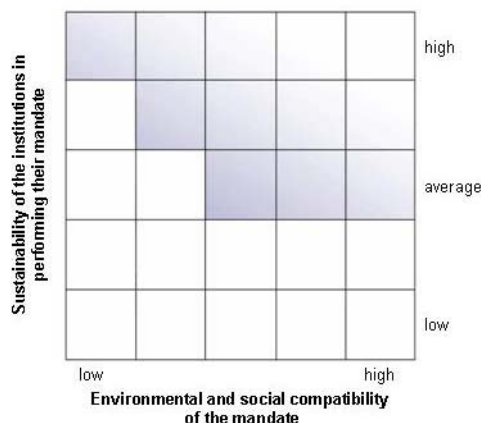
The mandate is defined in the articles of association by the founders or members of the bank, and the institution itself is unable to influence it. Separate consideration is therefore given to the way an institution fulfils the mandate prescribed for it.

The decision on whether the bonds are suitable for Sarasin's sustainable portfolio is based on the combination of both of these dimensions. Exclusion criteria may possibly also play a part (see below).

### Sarasin sustainability matrix®

Every institution is positioned within the Sarasin sustainability matrix® on the basis of its assessment in relation to both dimensions. Those positioned on the shaded area of the figure below (Sarasin investment universe) qualify for their bonds to be included in Bank Sarasin's sustainable portfolios. The less sustainable the mandate, the higher are the demands in relation to environmental aspects that an institution must meet in order to qualify for the sustainable investment universe.

### Sarasin sustainability-matrix®



### Environmental and social compatibility of the mandate

The environmental and social compatibility of the mandate is rated on the basis of five categories of finance objectives, which indicate how compatible it is with sustainable development:

### The Sustainability of Public Financial Institutions

High	Combating poverty, promoting education, health, renewable energy sources and other projects explicitly aimed at environmental protection
Above average	Municipal finance (inasmuch as the funds are used for investments in infrastructure that serves the public good), sponsoring private social housing construction
Average	Railway infrastructure, economic and export subsidies, general housing construction, roads (provided they have a general development function, e.g. to create links with Eastern European countries)
Below average	Fossil fuel based energy supply
Low	Air transport and mining

Generally speaking, institutions finance different types of projects. The mandate is rated using the rules defined in its articles of association, and takes into account the areas of concentration of the current loan portfolio.

#### Exclusion criteria

Certain activities are not considered to be compatible with sustainable development. In the case of public financial institutions, nuclear power may be a relevant exclusion criterion. The fund advisory board has defined the exclusion criteria for of the retail funds Sarasin OekoSar Portfolio and Sarasin Sustainable Bond Euro. Bonds issued by institutions which make a significant contribution towards the financing of excluded activities, or whose loan portfolio includes over 5% of such loans in total, may not be included in the investment universe of these two funds.

#### Comparative assessment of the institutions' sustainability in performing their mandate

When rating this dimension, the institution is compared against all the other institutions under consideration. The analysis comprises environmental and social elements. With each element, the quality of both the objectives and the organisational structures are examined under the criterion strategy and management systems. The other criteria relate in each case to actual performance and progress, including factors such as the way in which the environmental and social compatibility of the financed projects is examined or the granting of preferential conditions for projects that are especially environmentally friendly. The performance criteria within the environment element are structured on the basis of the life cycle concept, meaning that environmental aspects are examined in conjunction with procurement, internal environmental management and the projects financed. The main emphasis of the environmental assessment is on financed projects, which carry a weighting of 60%. Internal environmental management carries a total weighting of 40%. Under the social element, the performance criteria are considered in relation to the principal stakeholder groups, with the emphasis on the state and public sectors.



**The Sustainability of Public Financial Institutions**

The table below provides an overview of the main assessment criteria and their weightings.

<b>Criteria and weightings used in the assessment of public financial institutions</b>			
	<b>Criterion</b>	<b>Weighting</b>	<b>Important indicators</b>
<b>Environmental assessment</b> 40%	Strategy and management	20%	Quality of the environmental policy, integration into business strategy and organisational structure, planning and control processes, quality of reporting
	Pre-production	5%	Environmental requirements of bought-in products and of suppliers, consideration of environmental aspects during building projects involving bank buildings
	Production	15%	Efforts and successes in relation to the reduction of energy consumption (buildings, traffic, office equipment) and volumes of waste generated by the business
	Products & Services	60%	Quality of the examination of environmental compatibility, promotion of especially environmentally friendly projects, financing of environmentally harmful projects
<b>Social assessment</b> 60%	Strategy and management	15%	Commitment to socially responsible business, integration into the business, quality of reporting
	General public	40%	Quality of the examination of social compatibility, monitoring the success of the mandate, special promotion of social projects, right of consultation of those affected
	Investors	5%	Transparency of financial reporting, independence of the controlling and management bodies
	Suppliers	5%	Transparency of the processes for the selection of suppliers
	Employees	10%	Measures aimed at avoiding discrimination, opportunities of achieving a balance between professional and private life, training opportunities
	Clients	15%	Meeting client requirements, range of complementary services (especially advice), cost-efficiency
	Competitors	10%	Exploiting benefits in activities close to the market, cooperation with other banks / institutions

Source: Bank Sarasin

**Information sources**

The environmental and social analysis is based on information published by the institutions and the bodies that stand behind them (articles of association, financial, environmental and social reporting, website). Great emphasis is additionally placed on sources that are independent of the institutions and their members, including global press research and NGOs. We contact the companies to clarify any unresolved questions or contradictions.

## Appendix 2: Selection of the institutions assessed

### **Selection criteria**

As well as switching to new valuation methods, Sarasin has expanded the circle of institutions analysed to 28, spread over 16 countries. The new institutions to be assessed are generally selected on the basis of the nature of the mandate (development aid, financing projects with social impact or particular environmental benefit and other infrastructural projects) and their importance as bond issuers. This last criterion has been assessed on the basis of the volumes, currencies and liquidity of their bond issues. Only institutions whose bonds are rated at least BBB (investment grade) were considered.

### **Special cases**

The ownership structure of Österreichische Kontrollbank and the Norwegian bank Eksportfinans make them special cases. Although their mandate means that their character is similar to that of a public company, they are in fact fully/partially under public ownership.

### **Demarcation between the public and private bank sectors**

Savings banks, cantonal banks and other banks whose business fields are similar to those of private banks are not included within the category of public financial institutions for the purposes of this study. This is due to their market-determined business activity, which puts them in direct competition with private banks. Despite their public mandate and implicit state guarantees, the private US government-sponsored enterprises Fannie Mae and Freddie Mac are still classified within the private bank sector. In contrast, the German state-owned regional banks will remain classified as public financial institutions for the time being, inasmuch as they continue to function as state promotional banks after the public-sector bodies that back them cease to assume liability for their debts and stop acting as guarantors in July 2005.



Overview of the institutions assessed			
Agence Française de Développement	FR	Development aid	Developing countries
Asian Development Bank	PH	Development aid	Southeast Asia
Bank Nederlandse Gemeenten	NL	Housing construction, municipal finance	Netherlands
Bayerische Landesbank	DE	Economic development, public sector	Germany
Caisse d'Amortissement de la Dette Sociale	FR	Social security	France
Corporacion Andina de Fomento	VE	Economic development, development aid	Andes area, Caribbean
Council of Europe Bank	FR	Housing construction, education, health	Europe
Development Bank of the Philippines	PH	Economic development, development aid	Philippines
Eksportfinans	NO	Municipal finance, export subsidies	Norway
Eurofima	CH:	Railway rolling stock	Western Europe
European Investment Bank (EIB)	LU	Infrastructure	EU, Africa
European Bank for Reconstruction and Development (EBRD)	UK	Infrastructure	Central & E. Europe
Instituto de Crédito Oficial (ICO)	ES	Social and environmental programme, econ. development	Spain, Latin America
KfW Banking Group	DE	Housing construction, economic development & export subsidies	Germany
Kommunalbanken	NO	Municipal finance	Norway
KommuneKredit	DK	Municipal finance	Denmark
Kommuninvest	SE	Municipal finance	Sweden
L-Bank	DE	Housing construction, economic development and export subsidies	Germany
Landesbank Baden-Württemberg	DE	Economic development, public sector	Germany
Landesbank Hessen-Thüringen	DE	Economic development, public sector	Germany
Landwirtschaftliche Rentenbank	DE	Agriculture and forestry, fisheries	Germany
Municipality Finance	FI	Municipal finance	Finland
Nederlandse Waterschapsbank	NL	Housing construction, municipal finance, hydro engineering	Netherlands
NRW.Bank	DE	Economic development, public sector	Germany
Österreichische Kontrollbank (OeKB)	AU	Export subsidies	Austria
Svensk Exportkredit	SE	Infrastructure, export subsidies	Sweden
Umwelt- und Wasserwirtschaftsfonds	AU	Water management, environmental protection	Austria
World Bank (IBRD and IDA)	US	Development aid	Developing countries

Source: Bank Sarasin

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