

## The Sustainability of Covered Bonds

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## Executive Summary

Covered bonds are an important segment of the bond market

Covered bonds (known in German-speaking countries as *Pfandbriefe*) are bonds secured by mortgages or public-sector loans. Because they are governed by special legal provisions, covered bonds are a particularly safe form of investment and attract the highest possible credit ratings. Covered bonds are an important segment of the bond market and account for around 1 billion euros, or 32%, of the volume of outstanding German bond issuance. In 2004 new issues of covered bonds accounted for 12% of the eurobond market.

Sustainability rating depends on the activities being financed

Investors who also take into account environmental and social criteria in their investment decisions are keen to know how much covered bonds contribute to sustainable development. Sustainability is a consideration when it comes to the activities financed by covered bonds. In cases where bonds are used for public-sector finance, for example, it makes sense to invest capital in countries that have a comparatively good social and environmental profile. Where property is concerned, the key sustainability factors include energy-saving construction methods and access to affordable housing (owner-occupied homes, commercial housing developments and rented social housing).

Broader sustainability assessment

Covered bonds are used to refinance huge loan volumes. Because of the leverage effect created by the activities financed, an assessment focusing chiefly on the sustainability performance of the issuer does not go far enough. Bank Sarasin has therefore extended its existing assessment method to give more consideration to the purpose of the financing. Where public-sector finance is concerned, for example, we now also take into account the sustainability rating of the countries in question. Where property is being financed, we consider additional social and ecological aspects, and take into account the parent group of the mortgage banks.

We examined a total of 29 issuers of covered bonds from nine European countries, which together account for 63% of the European covered bond market. Eight banks only issue public covered bonds, another eight only issue mortgage-backed covered bonds, and 13 issue both types of covered bonds.

Public-sector finance: 12 out of 21 issuers are sustainable

According to our research, the cover pools of six of the 21 issuers of covered bonds contain a very high percentage of countries that fail to qualify for investment on sustainability grounds. This level was found to be 43% on average, compared with just 5% for the other 15 issuers. Investors for whom sustainability is a priority should therefore avoid these covered bonds. Another three issuers were disqualified from our investment universe because of poor internal social and environmental performance.

Property finance: 17 out of 21 issuers are sustainable

We rated 17 of the 21 issuers of mortgage-backed covered bonds as sustainable.

In this report we look at four issuers in greater detail, three of them with better than average environmental and social profiles.

## Introduction

Sustainable investors are showing more interest in bonds

Covered bonds are an important segment of the bond market

Demand for low-risk bonds has risen sharply in recent years, particularly among investors who base their decisions not purely on financial criteria, but also on social and environmental aspects. In the fixed income segment, the main focus in sustainable asset management has been on public-sector and corporate bonds in the past. But investors' attention has gradually shifted to other groups of issuers, drawn by factors such as issue volume, bond liquidity and the credit rating of issuers.

Covered bonds have a long tradition in Germany. Covered bonds and government bonds are the most important segments of the German bond market, each worth some EUR 1000 billion and together accounting for 64% of the volume of outstanding paper. German issuers command a 62% share of the European market in covered bonds. However, issuers from other countries are rapidly catching up. Whereas public-sector finance makes up about three-quarters of the business refinanced by covered bonds in the case of German issuers, most issuers from other countries are mainly active in mortgage-backed covered bonds.

Changes to the law governing covered bonds in many European countries<sup>1</sup> have encouraged a number of new, interesting issuers to enter the market and have resulted in much higher issue volumes. There is also some movement in Germany's covered bond market in response to the introduction of a new law on covered bonds on 19 July 2005, which coincides with significant changes for state-owned Landesbanken, who are about to lose their state guarantees.<sup>2</sup> The landscape is also likely to change for German mortgage banks soon, once the specialist bank principle is abandoned. The new capital adequacy requirements (Basel II) are likely to increase the importance of mortgage-backed covered bonds, because the smaller amount of equity capital required as collateral for covered bonds reduces the incentive to remove mortgages from the balance sheet through securitisation.

The overall growth of the covered bond market is very dynamic in many European countries.<sup>3</sup>

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<sup>1</sup> In Italy, for example, a number of important changes were made recently. In future Italian banks can issue *obbligazioni bancarie garantite* by transferring the assets to special-purpose entities that provide the guarantee in favour of the investors.

<sup>2</sup> Austria's provincial mortgage banks (*Landes-Hypothekenbanken*) and their collective issuing body, the *Pfandbriefstelle der österreichischen Landes-Hypothekenbanken*, will cease to be backed by state guarantees as of 1 April 2007.

<sup>3</sup> The existence (or absence) of a covered bond market is a reflection of a country's overall legal framework and historical structures. In the US, for example, mortgages are refinanced mainly through Fannie Mae and Freddie Mac, which are able to refinance at attractive rates on the capital market thanks to their status as a *government-sponsored enterprise*.

What distinguishes covered bonds from other bonds?

There are two types of covered bonds:

1. Public covered bonds
2. Mortgage-backed covered bonds

Public covered bonds are secured by loans to state authorities (central governments, federal states or cantons, municipalities, local authorities, etc.), publicly owned companies and public-sector banks. Collateral can also be in the form of loans to companies guaranteed by public bodies, or public-sector bonds. Only the covered bonds of specific countries are eligible for sustainable portfolios.

Mortgage-backed covered bonds are secured by loans that in turn are backed by mortgages as collateral. In addition other bonds, with mortgages serving as collateral, can also be used as a security under certain conditions. The maximum loan to value ratio is fixed by law. In Germany, for example, it is set at 60% of the loan value of the property.

One rule that applies to both types of covered bond is that the collateral – known as the cover pool – must be entered in the cover register and must therefore be reported separately. Unlike other covered bonds, the loans remain as assets on the balance sheet of the issuer, who thus continues to carry the credit risk. In the event of insolvency, investors in covered bonds not only have recourse to the cover pool, but also to the issuer's equity capital as seizable assets. The segregation of the cover pool allows covered bonds to be given a credit rating that is quite separate from the issuer's own rating. Because of the mechanisms described, covered bonds offer investors a very high level of security compared with other types of bond.

Most European countries have a special law governing covered bonds. In some countries, only certain financial institutions are permitted to issue covered bonds (specialist bank principle).

The expression *covered bond* is now an internationally accepted term. Some countries have their own names, such as *Obligations foncières* (France), *Cédulas hipotecarias* and *Cédulas territoriales* (Spain), *Realkreditobligationer* (Denmark) and *Asset-covered securities* (Ireland).

What is the connection between covered bonds and sustainability?

For investors who give priority to environmental and social aspects, the question is to what extent covered bonds contribute to sustainable development. Sustainability is a consideration when it comes to the activities financed by covered bonds. In the case where bonds are used for public-sector financing, for example, it makes sense to invest capital in countries that have a comparatively good social and environmental profile. On the one hand these countries seek to control the environmental and social risks that could otherwise have a negative impact on their development over the long run. On the other hand, experience shows that these countries tend to be better at exploiting opportunities arising from the use of innovative and environmentally friendly technologies. Social stability and an effective education and health system are other uncontested factors for a country's long-term prosperity.



Credit ratings can be improved by a good sustainability profile

Taking social criteria into consideration when purchasing bonds also makes economic sense for investors, as it minimises their risks. Recent examples, such as Argentina, show how social inequality and political mismanagement can have serious economic implications, putting public coffers under such strain that the government eventually defaults on its debt. Creditors suffered substantial losses.

Environmental risks can also have serious consequences for credit ratings. In some Eastern European countries, for example, air and groundwater pollution is obstructing development and growth. The need to modernise purification systems for drinking water, sewage treatment plants and waste disposal facilities is putting enormous pressure on public budgets. Sharp rises in the price of fossil fuels highlight the importance of energy efficiency. Another example is the cost of clearing up long-standing environmental problems, which will be enormous in some cases. One only has to think of the contamination of the soil and the use of harmful asbestos in buildings to realise how important it is to minimise risks in real estate.

These types of environmental and social risks are usually long term in nature and so far have not been fully factored into the credit ratings. But it is vital to do this, particularly if the investment is to run over a long time frame.

Key themes in the sustainability of covered bonds

The main environmental and social aspects associated with covered bonds relate to the activities they are used to finance. The countries indirectly financed by covered bonds should reach a minimum level when it comes to environmental and social components, as well as quality of life:

- ◆ The social component includes the education and health system, unemployment and poverty, political representation and treatment of minorities.
- ◆ The affordability of the public debt is not just an economic indicator, but also affects social stability. A high level of state debt and other liabilities (such as those arising from pay-as-you-go pension schemes) in some cases already constrict the state's room for manoeuvre, potentially imposing a huge burden on future generations.<sup>4</sup>
- ◆ Efficient use of natural resources and the amount of environmental pollution are the main criteria for assessing countries' environmental profiles.

With the financing of property, the following criteria are also important:

- ◆ The biggest environmental impact where property is concerned comes from energy consumption for heating, hot water and air conditioning, as well as the building's long service life. Other aspects include transport links and the use of environmentally friendly building materials.
- ◆ Residual pollution, such as the contamination of a building plot during its former use, can considerably reduce the value of the property and the

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<sup>4</sup> Projections by Standard & Poor's show that the credit rating of countries such as Germany, the UK and the US could sink to the same level as emerging countries in the long run unless they change their budget policy.

borrower's solvency due to the clean-up costs, which the owner usually bears. Taking these criteria into account when assessing the credit risk is therefore not just in the interest of the bank granting the loan, but also of the borrower.

- ◆ Social aspects are also linked to residential properties. They include, for example, the opportunity for broad sections of the population to purchase their own homes. Due to the problems associated with state pension systems, property ownership has become an important part of private retirement provision.
- ◆ In view of the many different providers and variants of mortgage product, it is important for the borrower to be able to compare different offers. This requires standardised product information.
- ◆ Covered bonds are typically used to refinance rented properties. Low-cost financing makes commercial housing developments more attractive for investors and thereby supports the construction of rented properties.
- ◆ Social housing is a special segment of the rented housing market, and also benefits from attractive sources of financing.

Other factors linked to sustainability concern the actual issuers of the covered bonds:

- ◆ In view of the massive restructuring and consolidation that has affected Germany's state-owned Landesbanken and mortgage banks in particular, job security – or at least a social plan for laying off employees – has been high on the agenda for some time, and will continue to be. Cost pressure on the *Landesbanken* due to the loss of state guarantees is leading to further redundancies.
- ◆ Thorough assessment of the credit risk is essential for controlling banks' risk exposure. Poor risk management can jeopardise the bank's existence.
- ◆ Investors can expect issuers of covered bonds to demonstrate a suitable degree of transparency. This applies in particular to information about the cover pool.

More criteria added to the sustainability rating of covered bonds

Covered bonds have a number of special characteristics that influence their sustainability rating:

- ◆ Their purpose is precisely defined, in the sense that they may only be used to refinance public-sector finance or loans for property.
- ◆ Covered bonds are an important instrument of state financing, along with public-sector bonds. Bank Sarasin's country ratings prevent the purchase of certain sovereign bonds for its own sustainability funds in cases where these countries have environmental or social shortcomings. These same exclusion criteria apply even to the indirect financing of such countries.
- ◆ Mortgage banks are often subsidiaries of large banking groups. In such cases they are primarily attractive sources of refinancing for the public-sector and mortgage business of their parent companies. In this case, the assessment of the sustainability profile of mortgage-backed covered bonds starts with the parent company.

Given these special characteristics, when assessing covered bonds we not only look at the issuer's sustainability rating but pay special attention to the lending business that is being refinanced via covered bonds:

- ◆ **Sustainability of the countries financed:** Bank Sarasin's country rating method is now used to assess the public cover pool as well.
- ◆ **Environmental and social aspects in property financing:** Positive criteria here include in particular social and environmental initiatives within the framework of the mortgage business. These include the promotion of green building methods and access to home ownership for families.
- ◆ **Affiliation to a parent group:** To the extent that issuers are mainly refinancing vehicles for the parent company, the issuer's rating is based on the assessment of the parent company's sustainability profile.

The rating method is described in detail in Appendix 1.

29 issuers assessed

We examined a total of 29 issuers of covered bonds from nine European countries. They represent 63% of the European covered bond market, with a volume outstanding of EUR 1,033 billion at y/e 2004. The German issuers assessed account for 77% of Germany's covered bonds market, with a volume of EUR 776 billion.

Thirteen of the financial institutions examined issue both public and mortgage-backed covered bonds. Eight of them only issue public covered bonds, and another eight are only active in the mortgage-backed covered bonds segment. Appendix 2 provides an overview of the issuers assessed and their volumes outstanding.

## Overview of the sustainability profile of covered bonds

Only very few institutions are publicly committed to sustainability

Compared with the banking sector as a whole, one conspicuous difference is that very few issuers of covered bonds have expressed a public commitment to sustainability and have taken credible measures in this direction. One exception is Kommunalkredit Austria, which has a highly developed environmental management system. The fact is that specialist mortgage banks in particular are often relatively small institutions that cannot be expected to produce either detailed sustainability strategies or comprehensive environmental reports. Even so, it is astonishing that so little effort is made on the environmental front, where initiatives are often limited to separating paper in the waste and using energy-saving light bulbs. Mortgage banks are less in the public spotlight than other branches of the banking industry, and as a result perhaps clients are less interested in their sustainability performance. As many mortgage banks are not listed companies, there are no demands from shareholders in this respect. Another striking point is that mortgage banks that belong to a bigger banking group are not usually included in their parent company's sustainability management systems.

The issuers that perform better than average when it comes to internal sustainability strategies are HBOS, la Caixa and Landesbank Baden-Württemberg. The next chapter provides more detailed analysis of these institutions, in the form of case studies. Northern Rock and Kommunalkredit Austria also have a higher than average profile.

Job security and socially responsible redundancy programmes still central themes

Many issuers of covered bonds have responded to tough competition and the pressure to consolidate by laying off employees, or plan to cut their workforce in the near future. In Germany, the situation for mortgage banks is exacerbated by the cessation of the specialist bank principle. The simultaneous withdrawal of state guarantees for *Landesbanken* is likely to cause further job losses there as well.

The preferred solutions for cutting the workforce usually involve a recruitment freeze and early retirement. Once these options have been exhausted, companies revert to redundancies based on operational efficiencies. More creative solutions, as practised in the past by HypoVereinsbank, for example (carefully planned expansion of part-time working and sabbaticals), are seldom employed.

A few successful financial services companies, such as la Caixa and Northern Rock, have resisted the general trend in the banking sector and expanded their workforce in recent years. In both cases this was the result of organic, geographical expansion.

Compliance and business ethics

Corruption and the employment of illegal workers are widespread in the building sector. Combating such practices is certainly not a primary task of the lender. However, there should be strict checking rules when issuing loans, purely for risk considerations. The Hypo Real Estate Group is a good example of how a bank

should conduct itself here: It has separate compliance rules applying specifically to these areas, which employees have to sign when joining the bank.

There is no evidence of inadequate money laundering controls or unethical business conduct in the covered bond issuers we assessed.

Public-sector financing:  
Most of the cover pool lies  
in the area that qualifies for  
sustainable investment ...

For public covered bonds to qualify for Bank Sarasin's sustainable portfolios, the countries financed by the bonds must satisfy a certain level in their environmental and social profiles. In the Sarasin country rating (see Appendix 1), this is expressed as the position on the Sarasin Sustainability-Matrix<sup>®</sup> for countries. For covered bonds whose asset pool is usually spread over several countries, the assessment is based on the average country rating.

Our analysis of cover pools as of 31 December 2004 shows that the average rating for 20 out of the 21 issuers of public covered bonds lies in the area of the Sarasin Sustainability-Matrix<sup>®</sup> that qualifies for investment. One of the main reasons for the good scores is that 14 of the issuers studied in this report are German institutions.<sup>5</sup> Despite the spectrum of eligible countries being extended in 2002, their cover pool still contains mainly public-sector loans to German public bodies. As a result, the average rating of the cover pool in the Sarasin Sustainability-Matrix<sup>®</sup> is close to Germany's position. German issuers of public-sector loans can be expected to expand their business activities outside Germany, and this will result in a shift of the average position in the Sarasin Sustainability-Matrix<sup>®</sup>.

... but too high a quota of  
excluded countries in some  
cases

Our assessment of countries also takes into account exclusion criteria, such as the enforcement of the death penalty. Public covered bonds are only eligible for Bank Sarasin's sustainable funds if the quota of ineligible countries in their cover pool is less than 10%.<sup>6</sup>

For all 21 issuers of public covered bonds, the average quota of ineligible countries is 12%. The 10% threshold was exceeded in six cases. It's interesting to note that in these six cases, the threshold was exceeded by a significant amount (average: 43%). By contrast, the average quota of ineligible countries is only 5% for those issuers of public covered bonds that lie below the 10% threshold.

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<sup>5</sup> These 14 German issuers account for 88% of the volume outstanding of all the 21 issuers of public-covered bonds examined in this report.

<sup>6</sup> Weighted by volume outstanding of public covered bonds as of 31 December 2004.

No influence on how public-sector loans are put to use

According to the rule of non-assignment of revenue and expenditure, state revenues are not usually tied to specific purposes, but are used as a source of general funding for the state budget. The same principle applies to loans to public-sector bodies. The lender therefore has no influence on how the funds are used. The question of the lender checking the environmental and social sustainability of the project to be financed is therefore redundant.

However, there are cases where the funds can be allocated to a concrete use, such as a special-purpose association set up to construct a sewage treatment plant. Due to the conditions imposed by the law on covered bonds, public-sector loans refinanced through covered bonds are mainly granted to countries with properly developed environmental legislation and efficient enforcement of this. It is therefore safe to assume that environmental impact is properly checked.

Property financing: Only a few banks promote green building methods

Mortgage-backed covered bonds are used to refinance mortgages. The most important aspect for the sustainability rating is the granting of the loan on the basis of environmental and social criteria.

Energy-saving measures for buildings make a big contribution to sustainability because of the high energy consumption of heating and hot water, as well as the long service life of buildings. In industrialised countries, residential properties typically account for around a third of total CO<sub>2</sub> emissions. Financing terms can have a big impact on the profitability of energy-saving measures in buildings. This also applies to the use of solar energy. The imposition of special conditions for loans therefore allows issuers of covered bonds to help reduce the consumption of non-renewable energy sources and to cut CO<sub>2</sub> emissions.

Numerous Swiss banks offer preferential lending terms for houses that conform to the "Minergie" standard<sup>7</sup>. As far as energy consumption is concerned, this standard is stricter than the requirements imposed by the usual building regulations. If the borrower submits the relevant certificate confirming compliance with this standard, the *Raiffeisenbanken*<sup>8</sup>, for example, grant a 0.5 percentage point discount on loan interest for up to four years, up to a maximum loan value of CHF 250,000. The total savings to the owner of the building of CHF 5,000 could encourage people to build houses to the *Minergie* standard, so the effect is likely to be more than just a windfall gain.

Banks are able to exert a certain amount of influence on the construction project in the advisory session before the loan is granted. This includes providing information on public subsidy programmes and arranging development assistance loans to supplement the bank loan. In Germany, for example, it is standard practice for banks to provide information on the incentives offered by the KfW Bankengruppe (the promotional bank of the Federal Republic of Germany) and where appropriate act as brokers for KfW promotional loans.

<sup>7</sup> Minergie is a voluntary Swiss building standard which, among other things, sets down limits for maximum energy consumption of new and refurbished buildings (see [www.minergie.ch](http://www.minergie.ch)).

<sup>8</sup> Swiss *Raiffeisenbanken* are members of the central issuing body, *Pfandbriefbank schweizerischer Hypothekarinstitute*. No details are available on the volume of *Minergie* mortgages refinanced by covered bonds issued by the *Pfandbriefbank*.



Prior claims have raised awareness of residual pollution

Getting rid of residual pollution, such as removing asbestos from existing buildings, for example, can be a very expensive business. Spectacular (and expensive) clean-up operations in the past should have raised banks' awareness about the problem of residual pollution. Most banks claim to take residual pollution into consideration during risk assessment. This mainly consists of gathering more detailed information if there are grounds for suspicion, such as a property being built on a site that had prior industrial use. There is a lingering impression that the issue of residual pollution is ultimately left to the discretion of the risk assessor who follows up (or alternatively disregards) his suspicions. The question of whether such an approach is adequate for screening the risks of residual pollution cannot be answered within the scope of this report. In any case it makes sense for the bank to identify residual pollution in building plots or existing buildings, as cleaning up this pollution can jeopardise the borrower's solvency.

Financing of social housing through covered bonds

Social housing is a specialist segment of the commercial housing development market. Its importance is evident in the UK, where social housing accounts for around 20% of all households. About a third of the social housing stock belongs to special, non-profit-making housing developers known as registered social landlords (RSL). RSLs finance themselves partly through asset-backed bonds on the capital market. In 2004 HBOS, one of the UK's largest banks, issued covered bonds for the first time, intended solely to refinance loans for building social housing (social housing covered bonds).

Another interesting development in this area is the initiative taken by a Spanish savings bank, la Caixa. la Caixa owns properties in Spain, which it rents out. By 2006 it wants to build 1,000 homes which will be leased to low-income groups (such as pensioners) at rents below the going market rate. It plans to build another 2,000 of these homes in the period 2007 to 2009. This is not social housing subsidised by the state, but purely a housing programme funded by la Caixa itself.

Special assistance for families is less common

Some banks offer special loan terms for families with children. For example, the Hypothekbank in Essen has set aside a number of special quotas for this purpose in the past, waiving its margin in the process. Some Swiss banks also offer family mortgages.<sup>9</sup> The incentive offered by Luzerner Kantonalbank, for example, grants a 0.5 percentage point reduction on the interest payable for up to five years, up to a maximum loan value of CHF 200,000. The total saving is CHF 5,000. Although this is certainly a substantial sum, it is probably not the crucial factor in persuading people to acquire their own home.

Borrowers are far more likely to be influenced by the government assistance scheme for home buyers, which is usually based on the level of income and number of children. In this respect it is important for banks to provide information on the assistance available and to arrange the public funds where appropriate.

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<sup>9</sup> Cantonal banks in particular offer family mortgages. No details are available on the extent to which they refinance these with covered bonds (issued by their central issuing body *Pfandbriefzentrale der schweizerischen Kantonalbanken*, a collective undertaking of the cantonal banks).

Property as a retirement provision

Home ownership is often put forward as an important component of private retirement provision. If the mortgage is repaid on reaching retirement age, the maintenance costs are usually less than the rent and incidental costs for a comparable property.

Owners of property with no encumbrance can also raise funds through lending against the property. While such reverse mortgages (lifetime mortgages, equity release mortgages) are common in the US – partly because they are federally insured –, banks in Europe have so far tended to be very reluctant to offer such products. Reverse mortgages have been available in the UK for decades. When the property crisis hit Britain in the eighties, many lenders got into difficulties as their accrued debt exceeded the value of their properties.

Since reverse mortgages are targeted at older people, it is especially important with this type of financial product that borrowers receive proper advice and that loan agreements are suitably formulated.

Among the issuers of covered bonds assessed for this report, only HBOS (under the Halifax brand) and Northern Rock offer lifetime mortgages.

Product transparency improved

Recently information on mortgages for private clients has been improved. The European Code of Conduct for home loans<sup>10</sup> specifies what information should be provided to the consumer before the mortgage agreement is signed. Standardised details make it easier to compare different products. The Code is already widely used in Germany, France and the UK, but some European countries are dragging their feet.

Another aspect of transparency is the amount of commission paid to mortgage brokers. In 2004 HBOS, for example, decided to disclose to the borrower all commissions paid. It is unclear, however, how useful this information actually is (or could be) for the consumer.

Germany: Transparency improved for investors

Germany's new law on covered bonds requires German issuers to publish extensive information on the composition of their cover pool. This is meant to put investors in covered bonds in a better position to judge the quality of the underlying collateral. As far as sustainable asset management is concerned, this new rule is welcome, as Bank Sarasin also takes into consideration the composition of the cover pool in its assessment.

Overall picture: Public covered bonds ...

21 of the 29 institutions studied in this report issue public covered bonds. Twelve of these 21 are rated as being eligible for Bank Sarasin's sustainable portfolios. Measured by volume outstanding, eligible bonds constitute roughly 58% of all the public covered bonds examined in this report.

Of those public covered bonds which do not qualify, the sustainability rating of the issuer or parent company is the sole exclusion criterion for elimination in just three cases. In three other cases, the quota of countries in the cover pool which

<sup>10</sup> The "European agreement on a Voluntary Code of Conduct on pre-contractual information for home loans", which came into effect in 2001, is a voluntary code of conduct adopted by mortgage providers.

do not qualify for investment (on the basis of Sarasin's country rating) is higher than 10%, as well. With two issuers, the excessively high quota of ineligible countries is the sole criterion for exclusion. Only with one issuer did the bulk of the cover pool for public covered bonds lie outside the area of the Sarasin Sustainability-Matrix<sup>®</sup> that qualifies for investment.

... and mortgage-backed  
covered bonds

Seventeen of the 21 issuers of mortgage-backed covered bonds were rated as eligible for Bank Sarasin's sustainable portfolios. Ten of them also issue public covered bonds that qualify for investment. Measured by volume outstanding, eligible bonds constitute roughly 71% of all the mortgage-backed covered bonds examined in this report.

The four issuers whose sustainability ratings make them ineligible lie outside the area of the Sarasin Sustainability-Matrix<sup>®</sup> that qualifies for investment.

## Results for selected issuers

In this section we look at four case studies of issuers of covered bonds. The selection is intended to illustrate the spectrum of the cover pool and how issuers deal with sustainability themes.

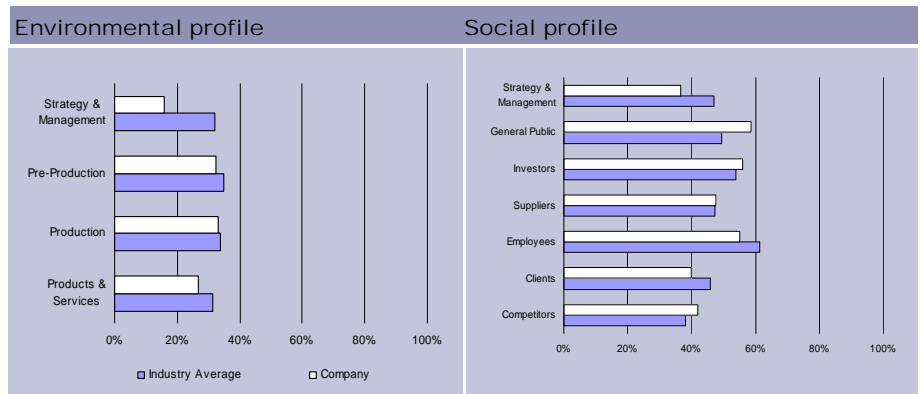
- ◆ Deutsche Genossenschafts-Hypothekenbank (DG HYP) is a private German mortgage bank and is a large and regular issuer of covered bonds. The distribution of covered bonds issued by DG HYP is typical for private German mortgage banks: two-thirds public-sector and one-third mortgage-backed covered bonds.
- ◆ Germany's other leading issuers of covered bonds are the state-owned Landesbanken. This report takes Landesbank Baden-Württemberg (LBBW) as a case study. LBBW's main business is public covered bonds, which account for 92% of the volume outstanding. However, mortgage-backed covered bonds will become a more important source of refinancing for the *Landesbanken* in future.
- ◆ One of the prominent features of the Spanish savings bank, la Caixa, is its focus on social aspects, as reflected in its product range and charitable activities. la Caixa mainly issues *Cédulas hipotecarias*, refinancing mortgages for owner-occupied housing in Spain.
- ◆ The UK has no specific legislation in place for covered bonds. British issuers of covered bonds therefore employ special vehicles, in the form of special-purpose entities, to model securitisation structures that are typical of covered bonds. HBOS is Britain's fourth largest bank, and market leader for UK mortgages. Recently HBOS launched covered bonds intended purely to finance social housing.

### Deutsche Genossenschafts-Hypothekenbank (DG HYP)

#### Issuer's profile

DG HYP is mortgage bank that belongs to the *FinanzVerbund*, a German cooperative financial system. It is part of DZ Bank AG, one of the two central banks of the *Volksbanken* and *Raiffeisenbanken*. DG HYP is active in real estate and public-sector financing. Most of its refinancing is through covered bonds. DG HYP is one of the biggest players in Germany's covered bond market, with volume outstanding of EUR 54bn (as of 31 December 2004). Around two-thirds of the covered bonds issued are public covered bonds, a quota that is typical for private German mortgage banks.

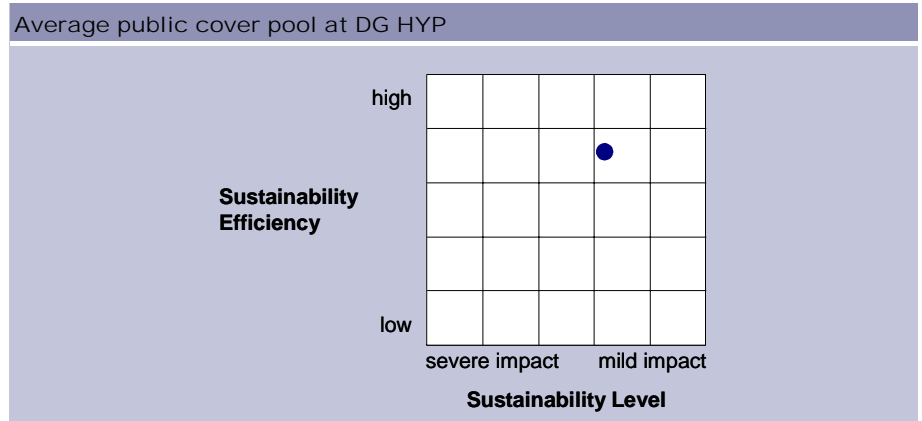
The current restructuring programme at DG HYP has entailed some job losses, but created new jobs in other areas. Those affected have been offered internal transfers in some cases. To minimise layoffs, the company has made use of natural wastage and offered early retirement packages, as well as part-time working for older staff. The bank has set up a social plan to accompany job cuts already initiated. Despite job cuts, the number of apprentices was higher in 2004 than in the previous year.



Source: Bank Sarasin

Public covered bonds

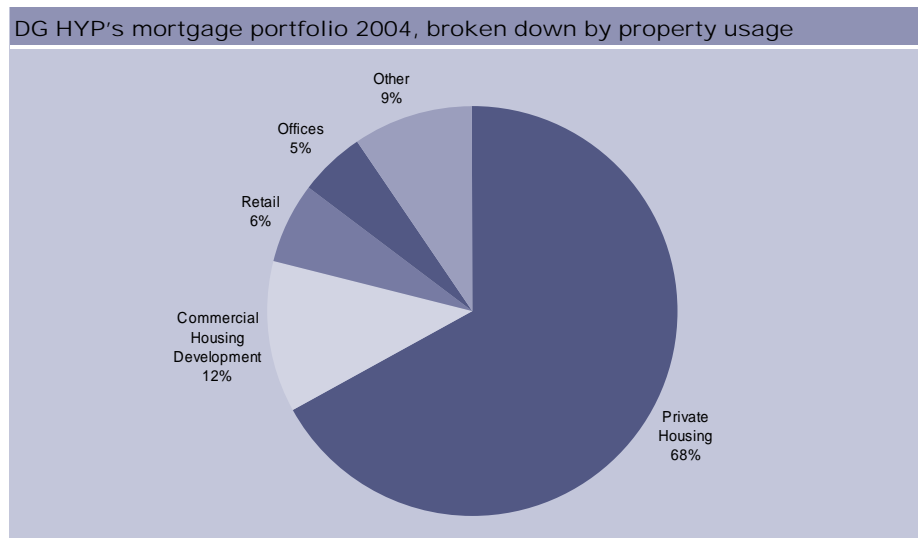
Public-sector financing, which accounts for 59% of the loan portfolio, mainly comprises the lending business with German local authorities, with the *Volksbanken* and *Raiffeisenbanken* acting as intermediaries. Germany therefore accounts for 83% of the cover pool, followed by Spain, Italy and Austria.



Source: DG HYP, Sarasin calculations

Mortgage-backed covered bonds

Most of DG HYP's mortgage cover pool is in housing. Apart from mortgages, the cover pool also contains bonds of international debt issuers which are covered by mortgages.



Source: DG HYP

Around 85% of the volume of mortgages granted by DG HYP goes to private borrowers. These loans are brokered through Bausparkasse Schwäbisch Hall (a building and loan association within the German cooperative financial system) and more than 1,300 *Genossenschaftsbanken* (cooperative banks).

The subsidiary VR WERT produces valuations on the lending value of the property. On suspicion of residual pollution (soil contamination on building plots or asbestos found in existing buildings) more detailed investigations, such as checking registers of residual pollution, are carried out as part of the mortgage lending process.

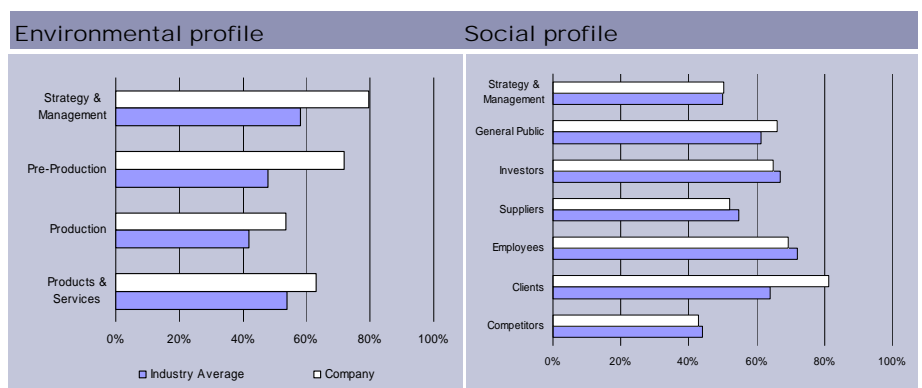
DG HYP does not offer special conditions for green construction methods or social components.

### Landesbank Baden-Württemberg (LBBW)

Issuer's profile

LBBW is the regional bank (*Landesbank*) of the federal state of Baden-Wuerttemberg. It is a full-service bank and an international commercial bank. LBBW also acts as the central bank for the savings banks in Baden-Wuerttemberg and Rhineland-Palatinate. Its owners include the federal state of Baden-Wuerttemberg and the Savings Bank Association of Baden-Wuerttemberg (around 36% each), the City of Stuttgart (19%), the L-Bank and the Savings Bank and Giro Association of Rhineland-Palatinate (5% each). Landesbank Rheinland-Pfalz (LRP) which was taken over at the start of 2005, is viewed separately when rating sustainability because it still operates under its own name as an autonomous issuer.

Continuing its staff reduction programme in a socially sustainable way (about 500-600 of the 12,000 jobs are due to be axed in 2005) is still a major challenge for LBBW. The company has a very well structured system of internal environmental management.



Source: Bank Sarasin

Public covered bonds

LBBW is one of the big issuers of public covered bonds, with a volume outstanding of approximately EUR 84bn. Around 95% of the cover pool of the LBBW's public covered bonds is based in Germany. The savings banks are the biggest borrowers, accounting for 58% of loans. Direct loans to public corporations account for 23%, and to other *Landesbanken* 19%.



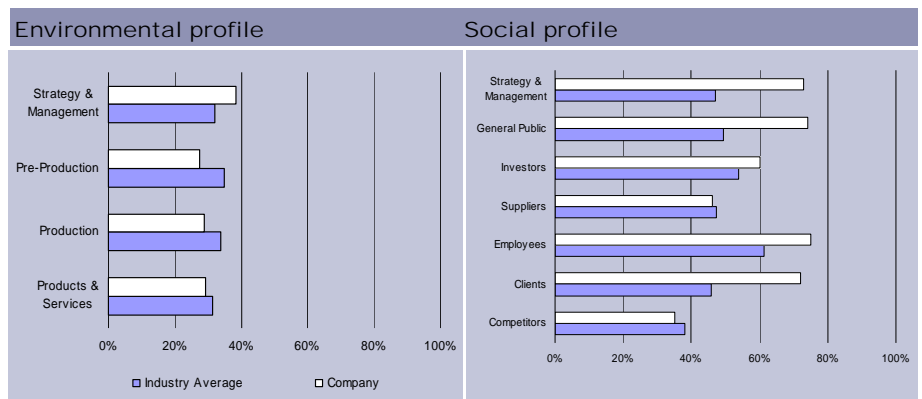
### Caja de Ahorros y Pensiones de Barcelona (la Caixa)

Issuer's profile

la Caixa is Europe's biggest savings bank and Spain's third biggest financial institution. It has the biggest network of bank branches in Spain (4,655), 58% of them outside the traditional home regions of Catalonia and the Balearics, and offers all the products of a full-service bank for private customers and companies (mostly small and medium-sized enterprises). Mortgages account for almost 70% of its lending volume. It also owns, through CaixaHolding, extensive stakes in big Spanish corporations (including almost 13% Repsol, 35% Gas Natural and 5% Endesa).

The company is a foundation. Its most senior control body is the general assembly, with the following representation: customers (36% of 160 seats), local authority bodies (30%), the autonomous regional government of Catalonia (21%) and the employees (13%). Under the articles of association, the company must allocate at least half of its profits to the reserves. The rest is used for charitable purposes (social projects, culture, education, science). In 2005 this was a quarter of profits (EUR 255m).

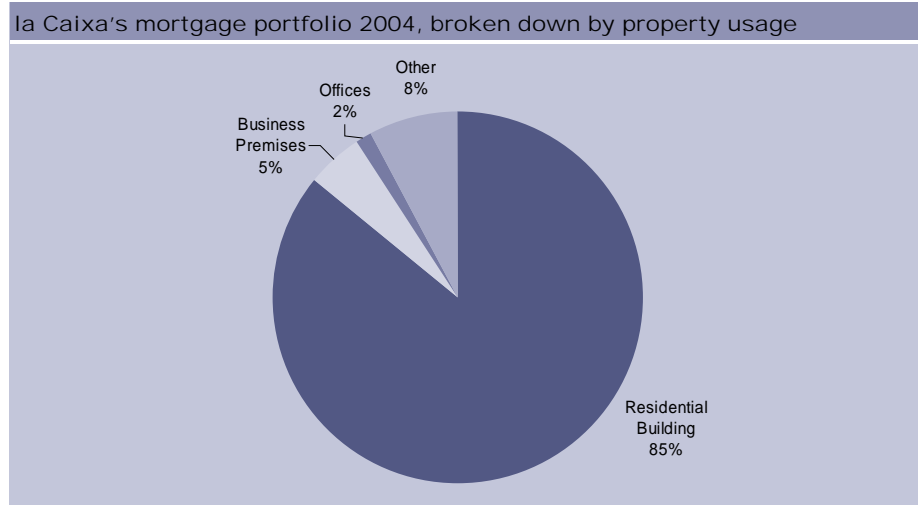
la Caixa offers a series of products for groups of people that find it difficult to obtain access to banking services due to a low income or poor credit rating. These include free basic bank accounts and microcredit for smaller entrepreneurs. la Caixa also acts as a contractor for house building projects. The bank has a programme of building affordable housing for people on low incomes.



Source: Bank Sarasin

Mortgage-backed covered bonds

Since 2001, la Caixa has issued *Cédulas hipotecarias*, which are covered by mortgages for real estate in Spain. The volume of *Cédulas* outstanding on 31 December 2004 was EUR 9.85bn. In February 2005 *Cédulas* worth another EUR 2.5bn were issued. The underlying loan portfolio mainly comprises mortgages for housing. Property loans are only granted on real estate in Spain.



Source: la Caixa

Public covered bonds

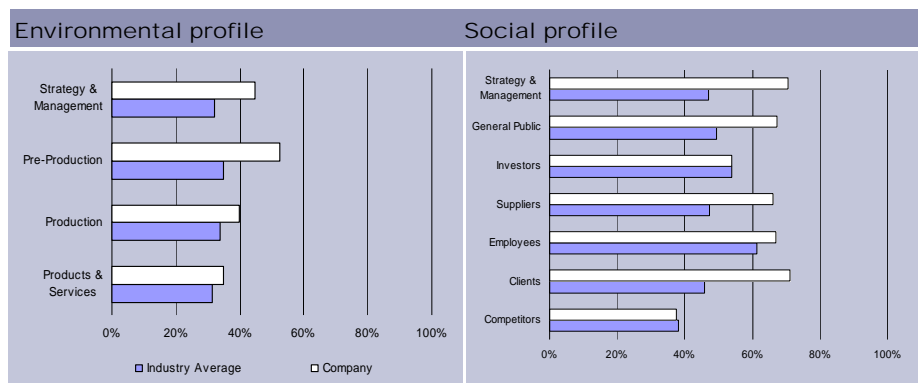
Loans to the public sector account for 2.4% of the total loan portfolio. la Caixa does not issue *Cédulas territoriales* (public covered bonds).

Issuer's profile

## HBOS

HBOS was created in 2001 from the merger of the Halifax Group and the Bank of Scotland (BoS). HBOS is one of Europe's ten biggest banks, both in terms of market capitalisation and balance sheet total. Most of its activities are based in the UK, where it is the leading mortgage provider for private housing, with a 23% market share.

HBOS has a comprehensive sustainability strategy that caters for all its stakeholders. Its product policy is tailored to private individuals and small & medium enterprises. It offers very favourable conditions to clients. The merger between the Halifax and Bank of Scotland was completed without any redundancies. Employee surveys indicate a high level of job satisfaction. HBOS is currently working with WWF to develop strategies for promoting sustainable building methods through loans (green mortgages, sustainable home loans) for energy-saving measures in new buildings and renovated properties.



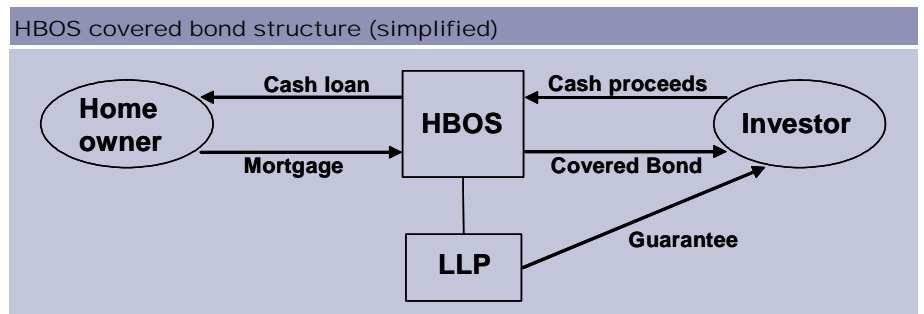
Source: Bank Sarasin

Mortgage-backed covered bonds

In 2003 HBOS broke new ground with its issue of the first British covered bond. By the end of 2004, HBOS had issued covered bonds worth almost EUR 11bn. The cover pool consists almost entirely of mortgages for residential property in

the UK. HBOS continues to issue conventional residential mortgage-backed securities (RMBS) to refinance mortgages.

The UK has no specific legislation in place for covered bonds. In particular, it does not keep a cover register and there is no system of preference in the case of bankruptcy. British issuers therefore transfer the eligible assets to special purpose entities known as Limited Liability Partnerships (LLP), which ensure the covered loans are serviced even if the issuer becomes insolvent. Thanks to this structure, the covered bonds issued by HBOS enjoy the best possible ratings from credit agencies.



Source: HBOS

In December 2004 HBOS launched a new Social Housing Covered Bond Programme, initially set to run for five years. Since then, HBOS has issued social housing covered bonds with a volume of GBP 1bn in the UK. Total refinancing of loans for social housing comes to GBP 4bn in the UK, which gives HBOS an effective share of 25% of the British market.

Public covered bonds

So far British issuers have not launched any covered bonds for public-sector financing, nor have any plans to this effect been announced. Public-sector loans are virtually negligible at HBOS.

Appendix 1:

# Environmental and social rating method

Sustainability assessment criteria expanded

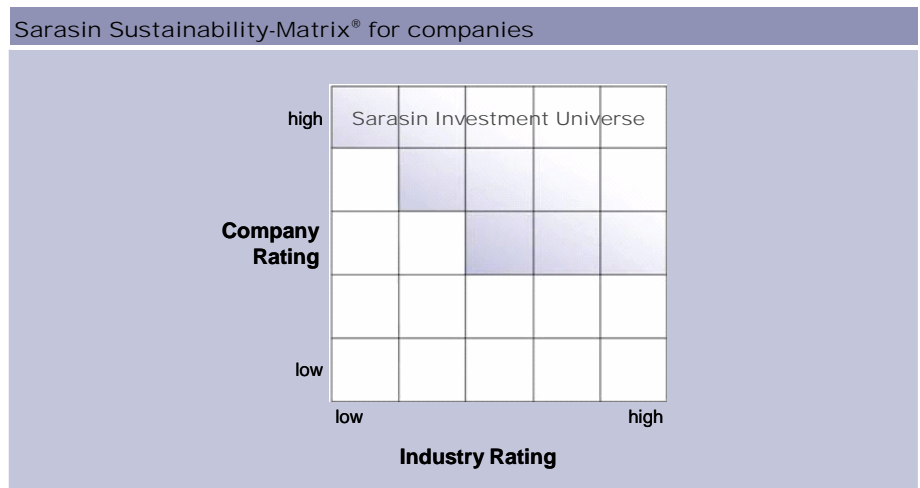
Our method of assessing sustainability has to be customised to cater for the special characteristics of bonds described earlier in the introduction to this report. In the past, issuers of covered bonds were assessed using the same benchmarks as for all other banks. The following elements are now incorporated as well:

- ◆ **Sustainability of the countries financed:** Bank Sarasin has a comprehensive sustainability rating method for countries that was originally developed for assessing the eligibility of sovereign bonds for the Sarasin investment universe. Bank Sarasin's country rating method is now used to assess the public cover pool as well.
- ◆ **Environmental and social aspects in property financing:** Positive criteria here include in particular social and environmental initiatives within the framework of the mortgage business. These include the promotion of green building methods and access to home ownership for families.
- ◆ **Affiliation to a parent group:** Where issuers are refinancing vehicles for the parent company, the sustainability ratings of parent companies are taken into account as well. This ensures that full consideration is given not only to the refinancing side, but to the lending business as well.

Sustainability rating of issuers

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® for companies:

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



Source: Bank Sarasin

Only those securities that lie in the blue shaded area of the Sarasin Sustainability-Matrix® for companies qualify as suitable investments for Bank Sarasin's retail sustainability funds.

Industry rating

The concept of industry ratings is based on the idea that lower risks imply a higher level of sustainability. The criteria for measuring environmental risks are resource consumption and emissions along the entire life cycle of the products and services in question (pre-production, production, use). In the area of social sustainability, the criteria include degree of centralisation, undermining of social stability and impairment of individual values and rights. The industry rating is calculated using a points system for all stakeholders (clients, employees, investors, etc.).

The industry rating of banks compared with other sectors is "average". The industry scored a total of 18 "risk points", with the highest score 45 and the lowest three. The key factors for this risk assessment are unethical business practices, redundancies, and concentration of power though board of directors' mandates and shareholdings. In the environmental profile the biggest risks come from indirect effects (leverage effect by financing environmentally damaging activities).

Company rating

When evaluating individual banks in the company ratings, we assess how they deal with industry-specific environmental and social risks and how they exploit the associated opportunities. They are compared with the industry average in the company's environmental and social profile and then aggregated into an overall rating. The next table contains an overview of the criteria and their weightings, as well as the most important indicators that underlie the criteria.

Criteria and weightings used in the assessment of banks			
	Criterion	Weighting	Important indicators
<b>Environmental assessment</b> <b>40%</b>	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 in 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%	Promotion of green building methods and other environmentally friendly projects, quality of the examination of environmental sustainability as part of risk management, financing of environmentally harmful projects

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Criteria and weightings used in the assessment of banks			
	Criterion	Weighting	Important indicators
<b>Social assessment</b> <b>60%</b>	Strategy and management	20%	Commitment to socially responsible business, integration of sustainability criteria into the business, quality of reporting
	State and public	20%	Prevention of money laundering, controversial business activities
	Investors	10%	Corporate Governance, transparency of financial reporting
	Suppliers	5%	Transparency of the selection process
	Employees	25%	Job cuts, measures to avoid redundancies as a result of operational efficiencies, opportunities of achieving a balance between professional and private life, training & professional development opportunities
	Clients	15%	Meeting client requirements, encouraging home ownership, range of complementary services (especially advice)
	Competitors	5%	Market position, behaviour towards competitors, hostile bids

Source: Bank Sarasin

With issuers of mortgage-backed covered bonds, special attention is paid to the social and environmental aspects of the mortgage lending business.

- ◆ **Social aspects of property financing:** Promoting home ownership and financing affordable housing for certain social groups (families with children, the disabled, pensioners, and low-income groups). These aspects are part of the social criterion "Clients".
- ◆ **Environmental aspects of property financing:** Promoting green construction methods in new buildings and renovated properties by providing information on energy-saving design (e.g. as part of a principal evening or brochures), favourable lending terms, information and where appropriate arrangement of suitable public financial assistance. These aspects are part of the environmental criterion "Products & Services".

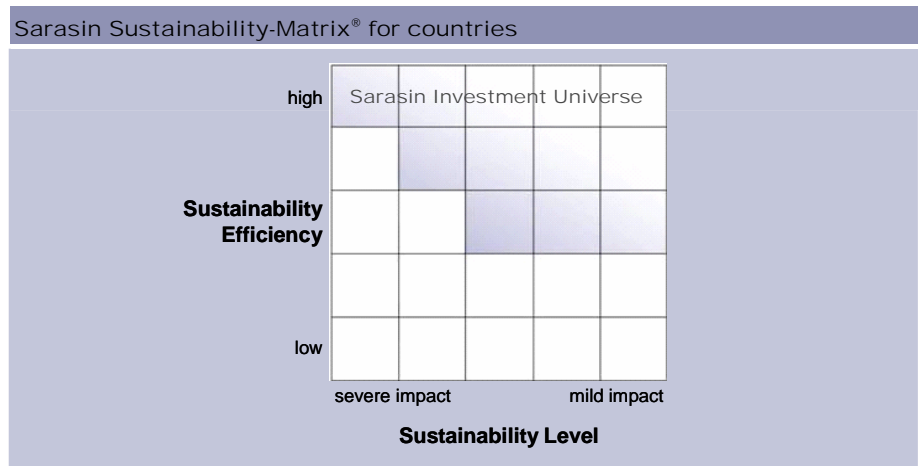
Certain business activities that are not considered to be compatible with sustainable development (e.g. financing of armaments or nuclear energy) may result in companies being excluded from Sarasin's sustainable investment universe. The fund advisory board has defined the exclusion criteria for our retail funds Sarasin ValueSar Equity and Sarasin OekoSar Portfolio.

Sustainability rating for countries

Our environmental and social analysis of countries is based on a proprietary two-dimensional assessment method developed by Bank Sarasin.

- ◆ **Sustainability level:** The level of actual impact on the natural environment and society (people and nature).
- ◆ **Sustainability efficiency:** Assessment of the impacts in translating economic performance into quality of life (social and economic efficiency).

The two dimensions of the country rating are positioned on the Sarasin Sustainability-Matrix<sup>®</sup> for countries.



Source: Bank Sarasin

Only those sovereign bonds that lie in the blue shaded area of the Sarasin Sustainability-Matrix<sup>®</sup> qualify as suitable investments for Bank Sarasin's retail sustainability funds.

As with the company rating, our assessment of countries also takes into account exclusion criteria, such as the enforcement of the death penalty. The fund advisory board has defined the exclusion criteria for the retail funds Sarasin OekoSar Portfolio and Sarasin Sustainable Bond Euro.

The methods and results of the country assessments are described in detail in the following reports:

- ◆ Sustainability of sovereign bonds? - Approach and results of the Sarasin country evaluation, January 2004
- ◆ Emerging country sovereign bonds: A sustainable investment?, June 2005

To order copies of these reports, please see the contact details in the Publications section below.

Assessment of the cover pool for public covered bonds

The distribution of countries for the assets contained in the public cover pool is used to calculate the average rating of the cover pool in the Sarasin Sustainability-Matrix<sup>®</sup>. Here the countries' ratings are weighted by their financing volumes. For public covered bonds to qualify as suitable investments for Bank Sarasin's retail sustainability funds, the average of the cover pool must lie in the appropriate area of the Sarasin Sustainability-Matrix<sup>®</sup>.

The exclusion criteria for a given country apply as well.

The cover pool must not contain more than 10% of countries rated as ineligible on the basis of their position on the grid or negative exclusion criteria.

Overall rating of covered bonds

The overall assessment is based on the rating of the issuers ("issuer rating") and the rating of the covered bonds themselves ("issuance rating").

Issuer rating: For an issuer's public covered bonds to qualify as suitable investments for Bank Sarasin's retail sustainability funds, the issuer (and where appropriate the parent company as well) must be classed as eligible both on the basis of their position on the Sarasin Sustainability-Matrix<sup>®</sup> and the exclusion criteria for banks.

The following criteria must be satisfied as well (issuance rating):

- ◆ **Public covered bonds:** The cover pool must be eligible for investment both in terms of the position on the Sarasin Sustainability-Matrix<sup>®</sup> and the exclusion criteria for countries.
- ◆ **Mortgage-backed covered bonds:** Where appropriate the parent company may also have to be assessed to check whether it qualifies for Bank Sarasin's universe of sustainable investments. Social and environmental aspects relating to property mortgages are also taken into consideration, as positive criteria.

Information sources

The environmental and social analysis is based on information provided by the issuers (financial, environmental and social reporting, company presentations, product information, details on the cover pool, website). Independent sources are evaluated as well, especially press reports and financial research of rating agencies and banks. We contact the issuers to fill any information gaps.

## Appendix 2:

## Overview of the issuers assessed

As well as switching to the new valuation method, Sarasin has expanded the circle of issuers analysed to 29, spread over nine European countries. The selection of names added to our existing portfolio of issuers was usually based on the volume outstanding of the covered bonds. Geographical considerations were taken into account as well.

Some banking groups have several subsidiaries that operate as autonomous issuers of covered bonds. In such cases the subsidiaries are assessed individually, as the different cover pools can vary significantly.

Overview of the issuers assessed and their covered bonds			
Issuer	Legal domicile	Volume outstanding of covered bonds on 31.12.2004 (EUR m)	
		Public covered bonds	Mortgage-backed covered bonds
Allgemeine Hypothekbank Rheinboden	DE	35,448	14,515
Bayerische Landesbank	DE	47,038	7,192
BBVA	ES	3,920	19,200
CIF Euromortgage	FR	-	10,306
Depfa ACS Bank	IE	21,907	-
Depfa Deutsche Pfandbriefbank	DE	49,472	880
Deutsche Genossenschafts-Hypothekbank	DE	35,562	18,656
Dexia Hypothekbank Berlin	DE	22,704	30
Dexia Municipal Agency	FR	36,048	-
Erste Europäische Pfandbrief- und Kommunalkreditbank	LU	4,314	-
Eurohypo AG	DE	77,738	45,106
Europäische Hypothekbank	LU	11,318	-
HBOS	UK	-	10,957
HypoVereinsbank	DE	15,530	49,418
Hypo Pfandbrief Bank International	LU	4,838	-
Hypo Real Estate Bank	DE	36,648	23,813
Hypothekbank in Essen	DE	51,340	4,128
la Caixa	ES	-	9,850
Kommunalkredit Austria	AT	2,648	-
Landesbank Baden-Württemberg (without LRP)	DE	84,281	7,181
Landesbank Hessen-Thüringen	DE	19,894	5,095
Landesbank Rheinland-Pfalz (LRP)	DE	14,951	1,735
Münchener Hypothekbank	DE	16,229	8,852
Northern Rock	UK	-	2,000
NRW.BANK	DE	62,554	389
Pfandbriefbank schweizerischer Hypothekarinstitute	CH:	-	13,360
Pfandbriefzentrale der schweizerischen Kantonalbanken	CH:	-	22,863
Realkredit Danmark	DK	-	88,250
Württembergische Hypothekbank	DE	14,311	5,196

Source: Companies



In total these issuers account for 63% of the European covered bond market, with a volume outstanding of EUR 1,033 billion at y/e 2004. The German issuers assessed account for 77% of Germany's covered bond market, with a volume of EUR 776 billion.

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## Publications

Country Sovereign Bonds	Emerging Country Sovereign Bonds: A Sustainable Investment? Michaela Collins, June 2005
Financial Institutions	The Sustainability of Public Financial Institutions. Klaus Kämpf, March 2005
Solar Energy 2004	Solar energy – sunny days ahead? Current status and outlook for photovoltaics and solar thermal energy. Matthias Fawer, November 2004
China	“Made in China” - Is this a Sustainable Label? Makiko Ashida/Eckhard Plinke, September 2004
Media	Corporate Social Responsibility Issues of the Media Industry. Gabriella Ries, June 2004 (only available in German)
Biotechnology	Will Medicinal Biotechnology sustain its promise? Delivering on potential – to patients, investors and society. Andrew DeBoo, March 2004
Government Bonds	Sustainability of Sovereign Bonds? Approach and results of the Sarasin country evaluation. Michaela Collins/Astrid Frey, January 2004
Photovoltaics 2003	Solar energy – is the outlook cloudy or bright? Current status and future prospect for photovoltaics and solar thermal energy. Matthias Fawer/Eckhard Plinke, November 2003
Social responsibility	Measuring corporate social responsibility – Bank Sarasin’s social criteria for sustainable investments. Eckhard Plinke, September 2003
Telecom	On course for sustainability – How is the Telecommunications industry faring? Themes, Trends and Leaders. Gabriella Ries/Christoph Ladner, July 2003
Water	Solutions to the water crisis – Can an investor focused on sustainability make a contribution? Andreas Knörzer/Eckhard Plinke, März 2003 (only available in German)
Performance	Share Performance and Sustainability – Does environmental and social performance have any influence on share performance? Eckhard Plinke et al., September 2002
Food	How sustainable is the food industry? A study of environmental and social performance in the food and beverage industry. Matthias Fawer/Christoph Butz/ Catrina Vaterlaus-Rieder, August 2001
Forestry	Are the founders of sustainability true to their roots? An overview of the forestry and paper industry. Christoph Butz/Catrina Vaterlaus-Rieder, July 2000



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