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The Financial Crisis

a failure of risk management on a massive scale

The crisis has exposed shortcomings and omissions in some ESG research, but will increase demand for non-financial information on company performance in the longer term, says Mike Scott

The financial crisis that has been going on for more than a year has its roots in unsustainable and irresponsible lending to 'sub-prime' customers in the US.

This lending was flagged up as a danger area by a number of SRI analysts, such as Greg Larkin at Innovest Strategic Investors, well in advance of the crisis – and the warning signs were there, with HSBC one of the earliest to flag problems in the market. 'There has been irresponsible lending that was fairly obvious if you looked for it and it was not questioned,' says Stephen Hine, head of international relations at London-based Ethical Investment Research Services.

The entire crisis underlines the requirement for transparency, accountability, stewardship and responsibility, says Hine. Other key SRI considerations have also been highlighted during the current turmoil, such as executive pay and the need for a long term focus.

Michael Jantzi, president and founder of Toronto-based Jantzi Research, says: 'In some ways the current situation reminds me of the governance crisis earlier this decade, when we faced the bankruptcy of Enron in 2001 and WorldCom in 2002. Only after the bankruptcies did mainstream investors begin to see the link between governance and long-term shareholder value.'

This should play to the strengths of the SRI market, where investments are analysed on a range of non-financial factors. The sector thrived in the bull market, with figures from the European Social Investment Forum showing that the amount of money in SRI funds had more than doubled from December 31, 2005 to 22665billion \$3578bn, £2066bn) at the end of 2007, or 17.5 per cent of the market. Eurosif's executive director Matt Christensen says: 'In spite, and because of, the ongoing financial market turmoil, environmental, social and governance issues are becoming more relevant as important criteria for investors.'

In the last 12 months the value of SRI funds has fallen in the general bear market, but SRI fund performance in key markets has held up. Indeed, in key markets SRI funds outperformed the benchmark over this period, according to Morningstar figures (see graph far left, facing page). Penny Shepherd, chief executive of the UK Social Investment Forum, says that the current 'back to basics, know what you own, invest in the real economy themes we are seeing will mean responsible investment will be more central to the financial community'.

The other concerns of SRI also remain relevant, she said. 'We need to mobilize vast amounts of money to make the transition to a sustainable, low-carbon economy. If we don't make that transition, you may think the credit crunch is bad, but wait until you see the carbon crunch.'

This feeds in to demand remaining strong in certain areas. Emma Howard-Boyd, head of SRI and corporate governance at Jupiter Asset Management, says: 'We have been encouraged by trends [in SRI funds] that have shown particular resilience in the face of the broader economic downturn. The compelling need to deal with issues such as climate change remains just as strong, despite the current market pressures, and will continue to offer investors interesting opportunities.'

But Rory Sullivan, head of investor responsibility at HBOS-owned Insight Investment, wonders whether analysts covering environmental, social and governance issues have been looking at the wrong things. 'A lot of analysis was looking at issues such as climate change, but we did not really look at what could cause huge economic and social dislocation, a huge rise in unemployment and instability. A bank failure is obviously one of those things.'

Perhaps good performance on CSR is not a good proxy for performance, he says. Northern Rock had a good record on CSR and its business model, though now revealed to have been flawed, was perfectly transparent. 'Everyone knew the business model. It was fine as long as the price went up.' The current situation also suggests that the assessment of extra-financial risks should be much more central to the whole process, he adds. 'Investors need to look beyond the traditional SRI agenda and look at how businesses are run. We need to rethink the scope of risk management', he says, suggesting that there is also a need to rethink the entire purpose of investment. 'Investment should be about ensuring the health, productivity and sustainability of the economy, not just about returns.'

One sector whose qualities are being highlighted by what is going on in the rest of the financial sector is building societies, which have been almost untouched by the crisis. The building societies that converted to listed banks prior to 2000 have all either failed or had to be rescued. Another is credit unions, which are financial co-operatives owned by their members. Mark Lyonette, chief executive of ABCUL, the Association of British Credit Unions, said: 'The members of credit unions have been sheltered from financial turbulence because credit unions don't speculate with their members' money on global markets.' The money they raise locally through savings is ploughed back into the community in the form of affordable loans, making them live within their means, by definition.

Jantzi adds: 'The current debacle has shone the spotlight on short-term thinking. My expectation is that as financial markets begin to focus on the longer term, the value of evaluating environmental, social and governance factors as part of due diligence will become better understood. There is sometimes a silver lining hidden in the darkest of clouds.'

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