



## **The scope of banks' sustainable investment policies – the issue of direct and indirect financing**

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May 2010

In recent years more financial institutions (FIs) have become aware of the social responsibility linked to their financing and investment behaviour. Sustainable investment policies have been or are drawn up and implemented on several topics, e.g. environmental issues, human rights, dams, mining, arms industry, indigenous people rights.

One of the most confusing factors for analysis, interpretation or understanding of such an investment policy is the scope of the policy within the whole spectrum of financial services a financial institution offers. This scope is becoming more important as a lot of financial institutions are integrated financial corporations offering a wide range of financial services.

Whether a policy contains exclusion criteria, engagement goals, or other social and environmental risk systems, the question often remains: «to which financial services of this financial institution are these policy measures applicable?»

Although any type of financing or investing implies a social responsibility to a financial institution, more often financial institutions refer to terms like direct and indirect financing or investing. Many financial institutions limit their responsibility towards heavily contested or controversial issues merely to their direct financing services.

*Example: A financial institution has an exclusion policy for investments in producers of cluster munitions, but the policy is limited to direct financing services. This means the financial institution will be able to keep on investing in cluster munition producers through its indirect investment products.*

Regardless all possible critical notes to this limitation of the scope of an investment policy, a clarification on the term «direct financing» is rather useful. Unfortunately within the investment world, there is no clear and universal definition of 'direct financing'. Financial institutions use this term for different contents.

### **What's direct financing?**

Broadly speaking there are three different ways of seeing the difference between direct and indirect financing. The two first approaches are most common in the financial sector.

- **Financing versus asset management? (direct financing = ■)**

This is a very restrictive approach of direct financing. In this approach the concept direct financing only covers loans and specific banking services.<sup>1</sup> That means that e.g. asset management, even when it is for the financial institution's own account, is considered as indirect financing.

- **Financing for own account versus financing for third parties? (direct financing =  + )**

A more common approach is that all investments made for own account are considered as direct investments. This definition includes certain types of asset management.

- **Financing with a direct impact versus financing with an indirect impact? (direct financing =  +  + )**

This is the distinction we think would be appropriate, but it is not very common to see it this way in the financial sector.<sup>2</sup> This approach sees every kind of financing where a banker can possibly have a direct impact (meaning that the banker can choose whether or not to invest in a certain company or product) as direct financing. Indirect financing in this view means that a banker only has an indirect impact on the choice of the companies invested in.

## Types of financing

### Credits

- **project finance credits** : loans granted for a specific project
- **corporate finance credits** : loans granted to a specific company, but not for a specific project of the company. These loans can be used by the company for specified or general corporate purposes.

### Several sorts of banking services

- **offering bank accounts**
- **offering bank guarantees**
- **investment banking services** : assisting companies to raise capital on the market by issuing company stocks and bonds (including underwriting bond and share issues)

### Asset Management

- **Trading and managing assets, bonds, or other securities** for own account of the bank
- **Trading and managing derivatives** : options, futures, etc, for own account of the bank
- **Investment funds**:
  - **Asset Management or Investment Management part of the bank is managing the fund**  
The bank can choose which investments can or can't be done by the fund manager.  
The fund manager is free to decide in its investment policy in which kind of companies it can or can't invest in.
  - **Funds in open offer**

<sup>1</sup> Some FI's even have still more restricted policies merely applicable to their project financing. FI's claiming to no longer be involved in for example "open pit mining", are sometimes merely excluding project finance for an "open pit mining project", but nonetheless can keep on offering corporate finance credits to a mining company that a.o. manages "open pit mines".

<sup>2</sup> Actually this approach is implicitly used by the Belgian lawmaker in the law banning investments in controversial weapons.

The bank offers funds that are developed or managed by third parties. A bank can have a policy that demands of the fund manager to exclude companies producing cluster munitions from its investment universe. Moreover, the bank can choose not to offer products that invest in producers of cluster munitions.

Both above mentioned types of investments funds are also widely used by insurance companies and pension funds to reinvest insurance and pension money.

- Private banking: investments sold to individual clients through private banking activities.

### The index fund question

Many FIs claim they cannot exclude certain companies from their investments through index funds. Index funds or an index tracker is a collective investment scheme (usually a mutual fund) that aims to replicate the movements of an index of a specific financial market. Indexes measure the section of a financial market by means of a basket of relevant values offered on that market.

Legislation on these kind of funds differs widely between different countries. This means for example that due to legal constraints it's harder to change the investment universe of an index fund in some countries. Legal measures in one country can oblige time consuming procedures to allow these changes in the investment universe. As this situation is totally different in many countries, general conclusions cannot be drawn on these issues.

Experience tells that even in countries where the financial sector generally claims not to be able to change the contents of index funds, some FIs managed to prove the opposite by successfully cleaning up their index funds from e.g. anti personnel mine producers. Exclusion of certain companies is technically possible, the main blocking factors for FIs are extra time and extra costs due to extra fund management and small IT adaptations. Sometimes FIs run into unwilling big institutional investors against re-modelled index funds.

But a banker can choose to develop index funds that track an index as closely as possible and in the meantime exclude certain companies

### Recommendations for campaigners

1. The distinction between direct and indirect financing should be irrelevant, as FIs should act responsible in all their activities regardless their direct or indirect nature.
2. When a financial institution refers to direct financing in an investment policy, further clarification should be given by the FI on the content of this concept.
3. In discussions with FIs on the direct/indirect nature of investments campaigners should use the broadest definition of direct financing. Any investment which leaves the choice of investment to the FI itself can be considered as a direct investment. In this background paper it has been documented that even regarding to index funds the FI has a possibility to avoid certain investments.

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