INVESTING IN STABILITY

Conflict Risk, Environmental Challenges and the Bottom-Line

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Research Inputs

This publication draws upon the written contributions of several leading experts in the field of corporate risk consulting, sustainable finance and political risk assessment and management. It was also informed by desk research and interviews, as well as presentation at several fora.

The primary findings emerge from telephone interviews and discussions at a Finance and Conflict workshop hosted at the HSBC Headquarters in London on September 5, 2003, featuring nearly 30 representatives, from finance, civil society, academia and government. A draft paper was presented and further informed by discussion at the symposium ‘Environment for Peace: The Role of the Business Sector’, hosted by the Loccum Academy and InWent in Germany, from October 3–5, 2003, and featuring participants from some 15 countries. It was further revised based on results of and informal discussions at the Roundtable on ‘Terrorism: Common Challenges of an Interdependent Society’ hosted by Swiss Re at the Rüschlikon—Centre for Global Dialogue, Switzerland on October 14–15, 2003.

The authors kindly thank reviewers Aiko Bode (Gerling) and Walter Kahlenborn (European Sustainable Investment Forum), and John Bray (Control Risks Group), Michael Kelly (KPMG) and Daniel Wagner (Asian Development Bank) for their detailed suggestions and written contributions.
This report raises an important issue, and it also poses a challenge. The issue is the role of the international financial sector in alleviating or contributing to sub-state conflict—whether directly or indirectly. The challenge is what to do about it. What are the real, day-to-day responsibilities of fund-managers, bankers and insurers? What practical tools can the financial community develop to ensure that its activities reduce the risk of conflict rather than enhancing it?

The timing of the report reflects wider international developments. Since the end of the Cold War, civil wars have become more rather than less common. The link between the September 11th hijackers and the Taliban in Afghanistan served as a reminder of the interconnectedness of politics, finance and terrorism. Failed states pose problems not only to themselves but also to their neighbours, and potentially, to distant international centres such as New York. Civil wars and terrorist campaigns cost money. International financial networks have helped facilitate the transfer of funds both to Al-Qaida and to Tamil rebels in Sri Lanka and to drug mafias in Colombia.

Meanwhile, the debate on the developmental role of international business has become more nuanced. Developing countries that once nationalised the local subsidiaries of international firms now compete for their investments. Improved access to information via the Internet means that companies are all the more sensitive to their reputations. In some cases, there may be little scope for them to make a constructive, profitable contribution in countries that are vulnerable to conflict. More often, the policy question is not so much whether private companies should operate in conflict-affected regions, but how they should do so properly. How can they help reduce the risks of conflict while protecting their investments? How can they get things right?

This report correctly argues that the international financial sector must be part of the answer. The debate on the role of the private sector in conflict zones has tended to focus on natural resources companies in the petroleum, mining and forestry sectors. However, these companies typically depend on finance raised from banks and stock markets. Their risk management strategies include insurance provided by the private sector, the state-owned Export Credit Agencies (ECAs) and the World Bank's Multilateral Investment Guarantee Agency (MIGA). Moreover, balanced regional development—which itself reduces the risk of conflict—requires the participation of smaller and medium-sized enterprises (SMEs) from within the host country and from neighbouring countries. These SMEs also require access to finance from either local or international sources. So how can the finance industry—in all its different components—make the most positive contribution to reducing conflict? And what exactly are the responsibilities of the various financial players? For example, is there a conflict between asset managers' fiduciary duty to provide the best possible return for their clients and the demands of socially responsible investment?

Part of the answer lies in minimising risk by avoiding ‘negatives’. No one lends money to projects that are likely to fail. In their own self-interest, lenders and insurers will wish to avoid sponsoring projects that are likely to get caught up in conflict, thus imperilling the security of their investments. Similarly, since the September 11th terrorist attacks, the international anti-money laundering campaign has received new impetus. The speed and the scale of contemporary cross-border financial transactions mean that the challenge of developing an effective anti-money-laundering regime remains enormous, but the need is clear.
Avoiding negatives is at best only part of the solution. The more important requirement is to develop a positive business case for investment in conflict-affected regions. Financial managers may have an interest in avoiding bad risks: they also have an interest in seizing opportunities before their competitors. Many of those opportunities may be in conflict zones. Well-managed commercial projects can play a critical role in lifting countries out of conflict.

In many conflict regions, SMEs will provide the main source of private sector growth. Locally-based SME owners often have a personal commitment to the development of their home regions, and their knowledge of the region may mean that they are better-placed to avoid or manage conflict risks than the larger international companies. However, they often find it hard to obtain finance or insurance. Carefully designed collaboration between locally-based and international financial institutions may provide part of the answer.

The task of achieving the right commercial balance between risk, opportunity—and responsibility—will always be a matter of judgement. However, individuals will make better judgements if they have better tools. In the case of lenders and insurers, these will include more sophisticated risk assessment techniques to help them avoid bad choices, and to identify warning signs in otherwise favourable projects. Fund managers are constantly reviewing the criteria that guide their investment decisions. Growing interest in the Socially Responsible Investment (SRI) market has led to the development of new indices such as FTSE4Good and the Dow Jones Sustainability Index. Again, there is scope for further development in these indices to take account both of conflict risks and of the positive benefits that well-designed investment will bring.

No single actor or set of actors has all the answers to the political and social complexities of contemporary conflicts. The financial sector can play a crucial role in resolving conflict, but only in partnership with other public and private sector actors, and this requires dialogue. Dialogue is useless unless it is well-informed. The United Nations Environment Programme is well-placed to convene a tri-sectoral debate between government, companies and NGOs. The analysis in this report will prepare the way for informed debate, and practical solutions—both in the conference room and in the market place.
Investing in Stability and Sustainability—Conflict Risk, Environmental Challenges and the Bottom-Line

Jason Switzer, IISD
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Executive Summary

Conflict prevention is high on the list of global political priorities, but should it be a concern for firms in the financial sector? If conflict deters responsible finance and if finance can contribute to conflict, what concrete actions can firms in the financial sector take to reduce risks and deliver benefits both to peace and to the bottom-line?

The aim of this paper is to stimulate debate on the interactions between finance and conflict, and to begin an exploration of opportunities to improve financial institutions' management of these interactions, thereby contributing to global and human security. It is a preliminary attempt to approach these issues in a comprehensive manner.

Concerning itself principally with the range of voluntary actions that private firms in the financial sector could take to reduce the risks posed by violent conflict, this paper seeks to identify mechanisms whereby firms could strengthen their positive development impact, help to reduce the negative economic impacts of violence and terrorism, and minimise the interactions between financial products, services and violent conflict.

The paper describes the current state of knowledge on the drivers and triggers of violent conflict, focusing on the role of economic factors in modern intra-state wars, rather than international conflicts. It then maps out the finance sector, and sets out the range of risks, conflict-finance interlinkages, and areas where the interests of peace, corporate citizenship and financial return may overlap. The paper concludes with a series of recommendations for financial sector practice, and for supportive public policy.

In spite of many years of research, there remains considerable debate on the causes of violent conflict and the necessary tools for securing peace. A consensus has emerged on the other hand that:

- The majority of modern conflicts are fought within the borders of existing states, rather than between states.
- The outbreak of violent conflict is often a symptom of rapid economic and social change, linked in part to inequity, underdevelopment and environmental stress. Three-quarters of those nations classed by UNDP as Least-Developed Countries experienced violent conflict in the 1990s.
- Violence emerges amid other governance failures such as state weakness, lack of accountability, corruption, proliferation of small arms, historical grievances and structural inequities between groups.
- Civilians make up nearly 90% of casualties in contemporary wars.
Attention has recently focused on the implications of increased ‘self-financing’ by combatants—through licit and illicit natural resource trade, access to international finance networks and diaspora remittances—for the motivation, duration and character of armed conflicts.

How is this relevant to private firms in the financial sector? Given a rising interest in and focus on the **importance of economic factors in many of today's conflicts**, and the tremendous financial impact of recent terrorist attacks, attention has turned to the role of this sector in conflict prevention, management and peace-building.

Access to a well-functioning financial sector is closely linked to positive economic development. The financial sector plays several vital roles in an economy, by facilitating commerce, mobilising savings for investment, managing risk, identifying productive investment projects and monitoring their management. The private financial sector is highly diverse, and includes **banks, insurance and reinsurance companies, and asset managers**. Each group of financial institutions has different products, and as a consequence, faces different conflict risks, uncertainties and openings for positive action.

A survey of academic and advocacy literature suggests that the finance sector can become entangled in conflict scenarios as a consequence of long-standing investments or operations in formerly-peaceful countries, or through investment in projects whose impacts may generate local grievances. Armed groups and conflict entrepreneurs can misuse financial services, and the financial sector can be associated with contributing to or failing to prevent macroeconomic shocks that weaken the state.

On the other hand, **the financial sector can help to secure peace and manage or prevent conflict** through its core business—including through insuring or mobilising finance for key infrastructure, energy and water services, through ensuring that projects are implemented in a conflict sensitive manner, and through spreading the financial impacts of conflict and terrorism over time and space. Finance can also contribute to peace through its social investments in communities and sustainability, through its engagement in knowledge sharing with the public sector, and through participation in policy dialogue to promote reconciliation, more-accountable governance and protection of human rights. Some financial institutions may be able to profit from win-win opportunities: mobilising and managing funds from diaspora communities for post-conflict reconstruction, providing innovative services to companies and governments that help to predict and prevent conflict and terrorism, and identifying investment opportunities that will outperform competitors by managing or avoiding conflict-related risks.

The **key drivers moving violent conflict onto the agenda** of the finance sector are concerns about the uncertainty and rising costs of extreme terrorist acts, threats to reputation, staff and investments, emerging regulatory and litigation threats, and opportunities for competitive advantage. Some of these are material risks; others may become so in the future. Firms that start now to identify the emerging opportunities and risks posed by conflict/business interlinkages will be **better positioned** to respond if and when these do become material.

**Government-led regulation and multilateral action remain the principal tools to prevent and resolve violent conflict.** That said, voluntary private sector activities are worthy of further exploration in areas where private and public interests are clearly aligned. There is a need to better understand the linkages for which a business case exists that creates incentives for voluntary action, and those linkages which result from a market failure, where government intervention may instead be warranted. The proactive responses already being taken by some firms through public-private partnerships, voluntary codes of conduct and contributions to peace processes, suggest particular **areas where the private financial sector can contribute to conflict prevention and to the bottom-line.**
What concrete voluntary measures are these, and how can governments encourage them? The international community has often called for engagement with the private sector in conflict prevention and post-conflict reconstruction, yet currently lacks the appropriate framework for doing so in the case of the financial sector.

Very little useful information has emerged to guide financial firms towards engagement in post-conflict reconstruction, and towards encouraging better management—if not prevention—of conflict issues by those in whom they invest. Moreover, firms are without guidance on appropriate behaviour in instances where the context, in which their investment has taken place, changes from peace to conflict or oppression.

It is critical to recognise the dilemmas that managers must face in tackling these issues, due to uncertainty both of the causes and nature of conflict, and of the means whereby conflict can be prevented or resolved. A nuanced approach to conflict is needed, one which includes a strong element of public communication.

One approach would be to **build upon ‘win-win’ opportunities**, including the following:

- Working together to improve conflict risk assessment
- Introducing new products, services and public-private partnerships that mobilise private finance for post-conflict reconstruction
- Developing guidance on good-practice in the control of financial flows into and out of conflict zones

Firms that adopt these measures may take on additional financial commitments, and may increase their exposure to liability. To offset these risks, **governments can offer regulatory and economic incentives, and help to reduce learning and implementation costs**. With conflict high on the international political agenda, the feasibility of launching a multi-stakeholder platform for more-sophisticated and informed dialogue and learning towards these ends should be assessed, and appropriate convenors and participants identified.

**1. Conflict is a Global Concern and Finance has a Role to Play**

Conflict is again at the top of the international policy agenda. Whereas traditionally conflict was mostly associated with ideological and ethnic differences, attention has recently turned more strongly to the economic agendas driving many wars. Exemplified by the so-called ‘conflict diamond’ trade, the linkages between today's conflicts with global narcotic trade, illicit diamond traffic and the proliferation of small arms have drawn attention to the interaction between conflict and the private sector.

This scrutiny of the private sector and conflict has focused initially on the interaction between the industries of resource extraction—oil, gas and mining and forestry—and social stability in diverse contexts. Attention is turning progressively; however, towards the interplay between the private financial sector and key actors in contemporary wars.
and terrorist acts.

The financial sector plays a vital role in facilitating economic development and international trade, fundamental to social coherence and sustainable development. Since 11 September 2001, however, the financial sector has been put under unprecedented pressure by governments to monitor clients and control the flows of money for terrorism and organised crime. Efforts to understand and enhance the contribution of the financial sector to the broader issues of conflict prevention and peacebuilding remain underdeveloped.

Government-led regulation and multilateral action remain the principal tools to prevent and resolve violent conflict. That said, opportunities for voluntary action are worthy of exploration in areas where private and public interests are clearly aligned. There is a need to better understand the linkages for which a business case exists that creates incentives for voluntary action by the financial sector, and those linkages which result from a market failure, where government intervention may instead be warranted.

The weak engagement on the part of international actors and donor governments with financial institutions on the issues of conflict prevention and peacebuilding may be the consequence of a failure to identify the most appropriate options for productive engagement with these firms, based on the areas where action would be of benefit both to peace and to the firms' bottom-line and reputation.

The aim of this paper is to stimulate debate on the interactions between finance and conflict, and to begin an exploration of opportunities to improve financial institutions' management of these interactions. A broad yet shallow survey, it is only a preliminary effort to approach these complex issues in a comprehensive manner.

This paper concerns itself principally with the range of voluntary actions firms in the financial sector could take to promote peace and reduce the risk involved in interactions between their products, services and violent conflict. It focuses principally on intra-state conflict rather than on multi-state wars. It focuses on the prevention of the outbreak of violence, the management and mitigation of its impacts, and on financing for reconstruction following violent conflict.

The paper describes the current state of knowledge on the drivers and triggers of violent conflict, concentrating on the role of economic factors in modern wars. It then maps out the finance sector, and sets out the range of risks, conflict-finance interlinkages, and areas where the interests of peace, corporate citizenship and financial return may overlap. The paper concludes with a series of recommendations for financial sector practice, and for supportive public policy.

2. Violent Conflict is Driven by Greed, Grievance and Malgovernance

‘Careful and fair management of environmental resources is an important part of our peace policy for the future.’

Klaus Töpfer
Executive Director, UNEP

The outbreak of violent conflict is symptomatic of a failure to pursue development that is both sustainable and equitable. Most of today's violent conflicts are civil wars¹. Some are fought by groups competing in part over access to or control over valuable natural resources within national borders—the ‘greed’ hypothesis; some are the consequence of development failures, where projects or policies exacerbate and entrench

existing divisions in society, often by undermining natural resource-based livelihoods—the ‘grievance’ hypothesis. In both instances, violence emerges primarily amid other governance failures, and may exploit natural resource endowments for financing. Valuable natural resources appear to provide the opportunity, and in some instances, the motivation, for civil war².

Yet it would be a mistake to simplify war to economics alone. At their root, conflicts are the result of insecure or inequitable access to vital resources, of competition between social groups for political power (governance), and of incompatibilities between groups with distinct value systems (identity and ideology) (see Box 2.1, below).

**Box 2.1: Root Causes and Triggers of Conflict**

Our principal concern here is **violent conflict**, though with its roots in human insecurity, including war, civil war, terrorism, sabotage, widespread social unrest and armed oppression. Conflict can be envisaged as moving through a series of interconnected stages that can be usefully be classified as ‘pre-conflict’, ‘during conflict’ and ‘post-conflict’. It should be recognised though that the pre-conflict and post-conflict stages can be synonymous, and that some conflicts can be ending even as others rage on simultaneously in the same geographic locality.

Today's violent conflicts emerge primarily in underdeveloped regions, and are often motivated or sustained by trade in commodities, narcotics or people. Critically, it can be argued that ‘natural resources have provided the bulk of revenues financing wars in developing countries since the end of the Cold War’³. Civilians—women and children, predominantly—now represent 90% of conflict fatalities, a dramatic growth in civilian deaths⁴.

The types of conflict of principal concern to firms in the financial sector are the following:

- Intra-community and community-community conflict
- Community-company conflict

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- Government-community conflict
- Government-company conflicts
- Government-government conflicts

Violence can emerge out of conflict through any of a number of social, economic or environmental triggers, such as an influx of refugees or a change in resource access rights, the collapse of a major industry or the onset of a severe drought. A development project can likewise cause conflict by changing the allocation of resources in a society (see Box 2.2, below).

**Box 2.2: Public Utility Project Triggered Violence in Bolivia**

In Cochabamba, Bolivia, more than 40% of the city’s inhabitants lack direct access to treated water sources. In 1999, Bolivia granted a 40 year privatisation lease to London based International Waters Ltd., giving it control over the water utility for the town. The company increased water charges as a prelude to infrastructure investment. In mid-January 2000, residents called a general strike, allegedly in protest against higher water prices and lack of measurable access and service improvements. Cochabamba was placed under martial law. More than 175 protesters were injured and several more killed in street battles over four days. In concession to the public uprisings, the Bolivian government broke the contract that had privatised the region’s water system. International Waters Ltd. in Bolivia withdrew, claiming some US$40 million in damages. The resolution of the urban water crisis in Cochabamba will require, therefore, not only compensation for the failed privatisation, but new investment sources, which may be even harder to attract in the wake of past violence.

Poverty is fertile ground for violent conflict. Three-quarters of the 20 least developed countries have experienced civil conflict in the last decade. Yet, poverty alone is not a sufficient trigger for violence. More precisely, the problem is rapid change. A sudden decrease in standards of living or a rise in inequity due to macroeconomic shock, coupled with a failure by governments to adequately respond, is believed to be behind many recent violent conflicts (see Box 2.3, below).

**Box 2.3: Environmental and Macroeconomic Triggers for Ethnic Violence in Rwanda**

The social and political implications of different types of environmental scarcities, coupled with macroeconomic crisis, were important contributors to the violent conflict in Rwanda during the 1990s. Resource scarcities, which became acute in the 1980s, were the result of complex interactions between demographic pressure, inequitable access to and shortage of land resources, and resource depletion or degradation. The resulting degradation of ecological capital forced rural inhabitants into a vicious cycle of poverty, thereby compounding their dissatisfaction with the State. This, coupled with the collapse of the price for coffee, the country’s principal export, gravely diminished the state’s capacity for social investment as well as for defending itself. The government’s weaknesses presented opposition leaders with an opportunity to challenge the regime, and for Tutsi exiles to invade from Uganda. When the country became deeply entangled in the subsequent war, radical politicians were able to re-centre the dialectic from rich versus poor to Hutu against Tutsi.

The erosion or inequitable distribution of scarce natural resources is likewise a key ingredient in conflict. Environmental stress brought on by deforestation, soil erosion, desertification, flooding and

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pollution can, in combination with rising demand and unresolved inequity, result in a series of severe social outcomes, including impoverishment, outmigration, dynamic political power shifts, loss of state legitimacy and in extremis, state failure or collapse.9

Many believe that ‘scarcity conflicts’ will become increasingly pervasive as the vital resources that people depend upon for their livelihoods—freshwater, fuel wood, agricultural land and fisheries—become scarce owing to the continued growth in population and in per capita consumption, and to persistent structural inequities in resource access and benefit-sharing.10

This link is particularly relevant at the community level in the developing world, where such environmental degradation means ‘loss of environmental quality that forces hungry people to go farther for fuelwood and water, to graze their cattle over a wider area, to grow their crops on more impoverished soils, and to face chronic ill health and poor nutrition’.11 The poor are most dependent on natural resources for their livelihoods, and thus most vulnerable to environmental degradation. These conditions contribute to the outbreak of intra- and inter-community violence, as well as conflicts between communities and companies.

At the macro level, on the other hand, scarcity of critical resources—land and water in particular—is likely to constrain many countries' efforts to increase economic productivity. Competing emergencies such as global commodity price shocks and widespread HIV-AIDS infection coupled with environmental scarcities may well outstrip the capacity of governments to cope, reducing their ability to prevent violence from emerging.12

Violent conflict for its part clearly entrenches poverty. In civil war, a country's per capita output falls an average of more than 2% a year relative to what it would have been without conflict. The GNP of Sierra Leone, for example, fell by almost 10% between 1998 and 1999.13 Conversely, ‘peace is most commonly found where economic growth and opportunities to share in that growth are broadly distributed.’14

Recent studies indicate that many of today's violent conflicts are civil wars, fought at least in part over access to or control over natural resources within national borders, particularly where these have value on international markets.15 World Bank studies indicate that countries heavily dependent for their income on the export of primary commodities are at dramatically higher risk of conflict than other poor countries, particularly during periods of economic decline.16 Moreover, ‘in some cases, average per capita growth rates actually have been lower [in resource rich] than in resource poor developing countries, and some resource-rich developing countries remain among the world's poorest’.17

12 Homer-Dixon, T.F. Environment, Scarcity and Violence, 1999
Commodities of particular concern in regards to insurgent violence are readily ‘lootable’: timber, diamonds, cash crops including narcotics, and exotic wildlife\textsuperscript{18}. Those most tightly linked to secession and state oppression are resources that require greater effort and technology to extract from the ground: oil, gas and valuable minerals\textsuperscript{19}.

Perhaps the largest international market for illegal goods is the drug trade. Traffic in narcotics generates between US$150–500 billion in revenues per year, making it one of the largest components of international trade (\textasciitilde 8\%), larger even than even the oil & gas or automobile trade. If so, the drug trade may have reached proportions ‘capable of tainting or destabilising global financial markets’\textsuperscript{20}. Opium production, for example, is believed to have generated some US$2.3 billion in income for Afghan farmers and traffickers in 2003, approximately double that of Overseas Development Aid\textsuperscript{21}.

Whatever the underlying sources of conflict, the transition to violence takes place amid other governance failures. These include the following:

- Corruption and patronage
- Failure to monopolise violence resulting in widespread presence of small arms
- Failure to generate employment resulting in large numbers of unemployed urban youth
- Absence of clearly defined property rights
- Absence of legitimate and broadly-accessible mechanisms for non-violent dispute resolution
- Absence of social safety nets
- Oppression of minority groups by dominant majority

3. Conflict-Related Risks to the Private Financial Sector

Access to a well-functioning financial sector is closely linked to positive economic development\textsuperscript{22}. The financial sector plays several vital roles in an economy, by facilitating commerce, mobilising savings and future income for present-day investment, spreading and managing risk, identifying productive investment projects and monitoring their management.

The financial sector is highly diverse. Firms may be wholly-private, or be operated for-profit yet at arms’ length from their public sector owner. They may be managed with both public interest and profit objectives, and backed against failure by government guarantee. This paper focuses on the private financial sector, and in particular on Banking, Insurance and Asset Management. We recognise, however, that in order to broadly understand the financial sector, the group of actors in the analysis ought to more broadly include the following:

- Corporations making use of financial services
- Private financial service providers
- Public and private pension funds

\textsuperscript{18} De Billion, P. War Commodities and the Settlement of Civil Conflicts—DRAFT. University of British Colombia, 2003.
• Export Credit Agencies
• Credit and Sovereign Risk Ratings Agencies
• Financial markets
• National governments, who set the rules for these institutions and who guarantee them in the event of shock or collapse

The private financial sector interacts with public and intergovernmental sources of finance, including public export credit agencies and multilateral organisations like the International Finance Corporation. There is a two-way flow of capital, information, standards of practice, and personnel, between these institutions. Public and private sources of finance are also complementary—locking in public export credit guarantees and political risk insurance may be a pre-condition for access to private finance.

Each group of private financial institutions has different products, and as a consequence, faces different conflict risks, uncertainties, and openings for positive action. In some instances, a win-win business case can be made for voluntary action today on the part of individual firms or groups of firms. In others, it may well be that a market failure creates perverse incentives, and these can only be overcome through government and intergovernmental action and incentives.

Definitions23:

**Banking** is the business of holding money owned by public, commercial or private customers, and then lending this money for profit. Retail and commercial services include holding money in accounts for future use; providing loans for the purchase of goods and services; and providing cash management services such as checking and foreign currency exchange. Commercial and Investment Banks provide financial support to projects, businesses and governments in the form of loans, securities and advice. Trade finance is the provision of short-term finance to an exporter delivering goods to a developing country. Commodity finance is the finance of commodity imports to the developed world, using the underlying commodity as collateral. Banks also provide various advisory services, from advising public service privatisation processes, through to carrying out business valuations for merger or purchase processes, and assist clients in raising capital on private equity markets.

**Insurance** is a legal contract—a conditional promise to pay—that protects people or organisations from financial exposure to risks such as loss of life or health, lawsuits, property damage, political risk or business interruption. Insurance companies share risk across many policyholders, thereby reducing individual exposure. Reinsurers by contrast pool risk across many insurance companies. Because of the delay between collecting and paying out their funds, insurance and reinsurance companies have substantial assets, which they use to generate additional revenues by investing in stocks, bonds and other assets.

**Asset management** is the administration of funds by expert third parties in order to maximise returns. An asset management company is a firm that invests the funds provided by clients in a wide variety of securities, in exchange for management fees. By aggregating the funds of a large number of small investors into specific investments, an asset management company gives individual investors access to a wider range of securities than the investors themselves would have been able to research and hold. The manager holds funds in accordance with specified aims, e.g. high income, maximum growth, ethical objectives, etc. Services include private portfolios for large investors, management of pensions, mutual funds, and venture capital trusts.

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As investors and insurers who hold a stake in a wide range of businesses and industries, financial institutions are exposed to a particularly broad set of risks and uncertainties. To understand and manage this exposure is becoming an increasingly complex and important task for firms.

<table>
<thead>
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<th>Corporate Risk Profile circa 1997</th>
<th>Today's Organisational Risk Profile has expanded to include:</th>
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<tr>
<td>• Health and Safety risks</td>
<td>• Brand and reputation protection</td>
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<tr>
<td>• Protection of physical assets</td>
<td>• Asset vulnerability due to greater emphasis on intangibles</td>
</tr>
<tr>
<td>(fire and flood)</td>
<td>• Changing markets</td>
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<tr>
<td>• Regulatory compliance,</td>
<td>• Political, social and economic instability,</td>
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<tr>
<td>covering financial and</td>
<td>• Terrorism, sabotage and vulnerability of infrastructure</td>
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<td>reporting obligations</td>
<td>• Human capital</td>
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<tr>
<td>• The Y2K bug</td>
<td>• IT and communication risks</td>
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<td>• Product liability</td>
<td>• Development and application of new technology</td>
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<td>including market and societal acceptability</td>
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Conflict risk may be defined as the positive or negative impacts that violent conflict (or linkages to it) can have on the financial performance and reputation, as well as on the safety and security, of staff, clients and property. Managers in the financial sector that identify the opportunities and threats posed by conflict/business interlinkages will be better positioned to respond to emerging threats and opportunities. These include the following:

- **Ignorance of conflict-finance interlinkages can be expensive.** ‘Insurers have always found it costly to ignore new exposures’, wrote Warren Buffet in his 2001 letter to shareholders. ‘Doing that in the case of terrorism, however, could literally bankrupt the industry’ 24. Facing uncertainty over both the probability of major terrorist acts and of their likely damages, financiers may choose to exclude investment or insurance cover for ventures in conflict-prone or high-visibility regions. A better understanding, however, can reduce the risk of defaults or of unforeseen costs. Under standard political risk insurance cover, for example, firms unable to complete a project on time as a consequence of rising violence may claim ‘force majeure’, a significant change in external conditions that renders the contract impossible to fulfil. Yet evidence is surfacing that some projects may themselves result in the emergence of violence, invalidating the claim of a change in external conditions25. This may not be adequately reflected in insurer-client contractual relationships.

- **Investments affect the conflict dynamic.** Every investment decision allocates resources and potentially creates winners and losers. Companies thus become part of the context in conflict-prone regions, as do the consortia of institutions financing them. Their decisions may influence that conflict either positively or negatively26. It is likely, for example, that access to financial

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services and foreign capital can be a decisive factor in determining the winner and the duration of a conflict, a possibility gaining increasing attention in NGO campaigns\textsuperscript{27}.

- **Far-away conflicts can create local threats.** Unresolved local conflicts can spill over borders onto the main streets of the world's capitals, threatening staff and capital investments\textsuperscript{28}. The threat of terrorist acts targeting the financial sector remains a key concern for public officials\textsuperscript{29}. Moreover, in today's interconnected world, pressure is steadily rising on companies to justify their activities in countries and regions that previously were far from view, and confidentiality is becoming far more difficult to maintain\textsuperscript{30}.

- **Conflict capacity could be a new source of competitive advantage.** Conflict poses not only risks but also opportunities for proactive firms able to develop unique expertise, to position themselves in post-conflict markets, and to develop new products and services with both bottom-line potential and a peace-building dividend. Such **win-win opportunities** well-understood now in the field of environmental management\textsuperscript{31}, remain underexploited in the field of social issues.

- **Conflict is high on the regulatory agenda.** Regulation related to conflict and oppression is a rising concern. For example in 2001, the US House of Representatives passed a bill that would prevent firms investing in Sudanese oil development from raising money in US capital markets or trading on the New York Stock Exchange or NASDAQ, in order to prevent further fuelling of the civil war in Sudan through oil money\textsuperscript{32}. In the wake of September 11, over 160 countries put blocking orders on hundreds of bank accounts, estimated at more then US$70 million in frozen assets\textsuperscript{33}. In the US, it is estimated that the implementation of the Patriot Act dealing with terrorist financing could cost some banks as much as 20% of annual profits\textsuperscript{34}. Separately, the call for transparency in the payments between extractive sector companies and host governments in the developing world has gone from a few lone voices to a loud chorus, led by Prime Minister Tony Blair of the UK and billionaire trader George Soros. Each of these regulatory trends—against global terrorism and corruption, towards enhanced transparency and good governance—is creating new costs and challenges for firms in the financial sector.

- **Conflict complicity is an emerging litigation risk.** Several legal actions have been filed seeking to hold parent companies liable in ‘home country’ courts for acts of violence alleged to be associated with their operations abroad. Examples include US litigation under the Alien Tort Claims Act against Canadian company Talisman Energy over its oil investment in the Sudan, against Shell over its operations in the Niger Delta, against Rio Tinto over the Bougainville Mine in Papua-New Guinea, and against Total over its investment in Myanmar\textsuperscript{35}. To date, no

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\textsuperscript{34} ‘Homeland Insecurities’ in The Economist.23 August, 2003: 45–46.

claims have been filed yet against leading shareholders or insurance providers in this regard. On the other hand, some participants at a recent meeting at the OECD on ‘Foreign Direct Investment in the Minerals Sector’ stressed that because mining projects have significant environmental impacts that often outstrip a government’s oversight capacity, liability for damages ought to be extended to the commercial financial institutions who provide the bulk of mining project finance, as this would stimulate more-rigorous compliance monitoring36.

- **Conflict is an opportunity cost.** A recent IMF study of economic growth in 53 developing countries found that political terrorism was one of the most important security factors preventing investment in the short to medium term37. Moreover, conflict and instability in one country can spur financial flight and crisis across an entire region, and even unsettle the world economy.

### 4. Avoiding Conflict Risk Exposure is Neither Possible Nor Profitable

The decision on whether to enter into an investment or offer a product or service is ultimately a question of the risk-return trade-off. Developing economy stock markets are highly volatile, both in terms of growth rate and rate-of-return. Yet returns can far exceed those of developed markets, which are increasingly saturated by goods and services that emerging markets still desire.

A conflict-linked investment, product or service increases a firm’s exposure to risk. The higher the risk, the higher the potential reward, yet the faster the exit from the investment desired by those putting up the capital. Particularly given the tendency in times of recession for investors to avoid high-risk ventures, could a strategy of avoiding investments or financial service operations linked to conflict-prone regions eliminate exposure to these risks?

Risk and reward are intimately linked. The average return from investment in sub-Saharan Africa, for example, is four times that in G-7 countries and twice that in Asia, a reflection of its perceived volatility38. If an opportunity is good in terms of its potential return and the capabilities of its management team, investors will enter. Firms with the tools and capabilities to successfully navigate potential pitfalls will have an advantage over their less-skilful competitors. Indeed, some firms need to demonstrate that they are taking on additional risk in order to meet investors’ desire for future growth.

Moreover, because social stability is dynamic, particularly over many decades (e.g. Indonesia, Cote d’Ivoire), finance companies need the tools to better identify and manage unforeseen and unforeseeable situations where peace turns into conflict.

This need varies according to the sector of the industry. Banks with retail operations in risky regions, for example, are not ‘carpetbaggers’—they are arguably in for the long haul when they set up retail operations in a country, in many instances for centuries39.

Asset managers, for their part, are concerned about reputation, yet are interested in seeing that the firms they invest in take on appropriate levels of risk to ensure productive returns on investment. Thus, even if a major oil company suffers significant losses due to conflicts at a particular project site, this is unlikely to depress its share price substantially over the long term. Whereas a failure to invest in

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39 Personal communication, Barclays Bank, 12 September 2003.
operations with potentially large payoffs—untapped oil reserves located in formerly-unstable regions, for example—would indicate a failure to adequately plan for the future. On the other hand, poor management of conflict issues by a firm may signal to an asset manager a broader problem of poor management across a company, and depress share values.

In some instances, public campaigns have resulted in significant drops in share prices. Talisman Energy's operations in Sudan, long mired in civil war, drew protest from several church and human rights organisations. It was estimated that in late 1999, Talisman had suffered a loss of about US$1.8 billion in market value, a consequence of the loss of institutional investors, and of a regulatory action to curtail financial flows fuelling the conflict. On the other hand, those firms with early positions will reap first-mover rewards should the peace prove enduring. It is important, therefore, to integrate reputational risk considerations and corporate conflict management capabilities within the broader assessment of investments in conflict-prone regions.

The above discussion indicates that being affected by conflict is hard to avoid, and is in some instances financially undesirable as well as counterproductive to global development. What do managers need to know about the links between financial investments, products and services, and conflict? And what should they do to minimise the negative linkages while maximising the positive impacts?

5. Reducing Exposure to the Negative Links Between Finance and Conflict

There are several means whereby firms in the finance sector can become entangled in conflict scenarios. This entanglement can be a consequence of investment in projects that undermine social stability, or that are located in areas where conflict is emerging. It can result from the misuse of financial services by insurgent or criminal groups, arms traders and corrupt officials, and from the association with macroeconomic shocks. By taking preventative action to reduce their exposure to these links, firms in the financial sector can help to stop violence and end destructive conflict.

- **Project finance, loans and insurance** can contribute to conflict through development projects whose local impacts are borne by communities while the benefits are enjoyed by a privileged few. A 1998 IFC/World Bank assessment of mining and oil extraction projects in Colombia, Papua New Guinea and Venezuela noted that ‘frequently…national governments reap the most benefit from these projects, while social and environmental costs tend to be borne by local communities’. This mismatch between national benefits and local costs has been associated with grievances that can lead to violence, if not appropriately mediated.

- **Investments or retail operations** can fall into conflict scenarios in countries that were previously stable but which over time have evolved into conflict or authoritarianism. These investments or operations can inadvertently sustain malgovernance by participating in corruption, lending legitimacy to the regime, strengthening its repressive capacity through tax revenues, and thereby reducing the leverage of international actors and local populations in support of peace and human rights. At the same time, complete withdrawal may only

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exacerbate the situation, removing an important external actor from the conflict context while undermining the livelihoods of those who depended on it.

- Conflict-related governance failures (e.g. corruption) and war economies may in turn be facilitated by private financial institutions. The fugitive funds of corrupt public officials, the gains of illicit timber and diamond commerce, the reserves of terrorist groups and of international arms traders may be held by intermediaries in banks and other financial institutions. In the early 1990s, for example, it is estimated by the World Bank that the Angolan rebel group UNITA held some US$4 billion in New York-based financial markets. One contested estimate holds that nearly US$1 trillion in ‘fugitive funds’ is currently in global circulation. Commercial borrowing by combatants to enable arms purchases on the basis of natural resource wealth has been reported in the context of Angola, Somalia and the Democratic Republic of the Congo. Likewise, it is estimated that some US$1 billion a year in expatriate remittances is transferred formally and informally to conflict zones, a key source of funding for violence in Eritrea and Kosovo. Tamil diaspora organisations are estimated by the World Bank to have raised some US$450 million per year in the 1990s to buy arms for insurgents. Emerging financial sector products like ‘kidnapping insurance’, moreover, can increase the supply of ransom payments, thereby contributing to war economies.

- At a broader level, macroeconomic swings and commodity price collapses are widely believed to have triggered or intensified violence in Rwanda, Central America and Indonesia, among other cases. The G-8 leaders recognised in 2000 that ‘economic downturn and its social fallout can have explosive consequences for welfare and stability’.

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44 Manifesto for a Switzerland without fugitive capital, Bern Declaration, Action Financial Centre Switzerland, 1991.
6. Accentuating the Positive - the Finance Sector and Peace

In contrast to the negative links described above, access to a well-functioning financial sector plays an important role in economic growth and in preventing, managing and recovering from conflict. Finance firms can contribute to peace through core business operations; through social investments in communities and sustainability; and through engagement in policy dialogue and knowledge sharing to promote protection of the environment, human rights and other public goods. Through these levers, firms can address political, economic and social grievances that may be driving conflict, pressure combatants towards negotiations, and finance reconstruction, laying the foundations for sustainable peace.54

Critical to any attempt to better manage conflict, however, are tools to derive better information, and examples of effective practice. The financial sector can both enhance its own capacity to monitor and assess conflict risks, and develop products and services to share this expertise with others. It can also benefit from the experiences of other firms and sectors in dealing with conflict-related issues. The table below presents some potential information needs for the financial sector in developing new and more-integrated approaches to the management of conflict risk. The sections that follow describe a few of these areas in greater detail.

Box 6.1: Specific Information Needs at Different Stages of the Conflict Cycle

<table>
<thead>
<tr>
<th>Conflict-Prone</th>
<th>During Conflict</th>
<th>Post-Conflict</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Conflict indicators</td>
<td>• Conflict indicators</td>
<td>• Conflict indicators</td>
</tr>
<tr>
<td>• Guidance on maximising the positive impacts of financial products and services for social stability</td>
<td>• Standards of ‘appropriate’ behaviour (applicable norms, tools, laws and best practice)</td>
<td>• Mechanisms to mobilise private finance for reconstruction (e.g. public incentives, new products and services, public-private partnerships)</td>
</tr>
<tr>
<td>• Guidance on conditions to place on access to finance</td>
<td>• Good practice in monitoring and controlling flows of finance into and out of conflict zones</td>
<td>• Guidance on conditions to place on access to finance</td>
</tr>
<tr>
<td>• Standards of ‘appropriate’ behaviour (applicable norms, tools, laws and best practice)</td>
<td>• Guidance on conditions to place on access to finance</td>
<td>• Maximising the use of conflict risk-spreading through insurance and other mechanisms</td>
</tr>
</tbody>
</table>

6.1 Strengthening Conflict Indicators and Assessment

Conflict related information is of high value in instances where that conflict may become a material risk to an investment. A recent set of guidelines for business participation in Iraqi reconstruction calls on firms to carry out a ‘conflict impact assessment’ before investing. While techniques for carrying out an

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assessment of this type are in early stages of development, there are several models under development that can be drawn upon.55

**Box 6.1a: Project-Level Human Rights Risk Assessment**

Export Development Canada (EDC) has for many years conducted political risk assessments in its due diligence for project finance and political risk insurance transactions in developing countries. Its Human Rights Risk Assessment is an additional filter for screening projects, on the basis of ethics, reputational concerns and of project-context interactions. Criteria used by EDC include the following:

- Socio-economic inequality, ethnic or religious tension, terrorism and criminality
- Government coercion, corruption, capacity, legitimacy
- Existence of effective dispute resolution processes and press freedom
- Past record of security forces
- Relocation and community compensation
- Canadian governmental reviews, and policies regarding human rights abuses

The Conflict Risk and Impact Assessment process, led by International Alert and IISD with the support of the British, Canadian and Swiss governments, seeks to develop broadly-accepted guidelines for conflict-sensitive environmental and social impact assessment (ESIA) and management planning for large extractive projects, building on the foundations of the Global Compact’s earlier conflict dialogue, and existing good practice in project environmental assessment. Guided by a steering committee of ESIA practitioners from the extractive and finance industries, consulting firms, civil society and the development sector, this initiative will publish draft guidelines in June 2004, and then move into a phase of field testing with industry partners.

Taking the reverse approach, the Collaborative for Development Action has carried out a series of field assessments of company-conflict interactions in Myanmar, Nigeria and other sensitive locations. The assessments are funded by CDA and public sector donors, though they depend on the full participation of the companies involved. Through these field assessments, CDA aims to identify the aspects of project operation that have direct and indirect impacts on the social environment, to develop alternative management approaches that promote social and political stability, and based on this process to distill conflict prevention and peacebuilding tools for companies. Many of the resulting guidance notes are already available on the CDA website, and are being shared with a broader business community.

Increasingly, financial institutions are incorporating human rights considerations into the conditions they place on access to capital for investment and project finance. The Vice-President of the International Finance Corporation (IFC), for example, has recently initiated the development of a human rights safeguard policy for the IFC's lending practices. As a leading source of industry standards on environmental and social policies, the IFC’s human rights safeguard will set an important benchmark for private sector practice.

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56 Information drawn from speeches available at: http://www.edc.ca
58 http://www.cdainc.com/cep/
Box 6.1b: FTSE4Good Index Introduces Human Rights Criteria

In April 2003, investment index provider FTSE introduced criteria to screen resource extraction companies on the basis of their commitment to human rights in their policy statements, management systems and external reporting. Additional requirements are raised for firms operating in countries of higher risk, identified on the basis of Freedom House rankings and other relevant reports. Commitments include: to respect core labour standards and other human rights norms, to monitor and address non-compliance, to consult with stakeholders, and to integrate human rights concerns into impact assessment processes.

Likewise, financial institutions, while scrupulously respecting rights of privacy, can sell or share information and expertise with companies, and with the public or humanitarian sectors, that can enhance early warning and rapid response to crisis, and facilitate the monitoring of conflict actors. The Investor Responsibility Research Centre and Conflict Securities Advisory Group introduced the Global Security Risk Monitor, in April 2002. ‘The GSRM assesses reputational and financial risks posed to publicly-held corporations operating in the six countries designated by the US Department of State as sponsors of terrorism or involved in proliferation of weapons of mass destruction’.

Box 6.1c: A Futures Market for Predicting Terrorism and Civil Violence?

A controversial Pentagon proposal to establish a futures trading market for significant political events raises interesting questions about how else risk managers in the financial sector might be able to share expertise with the public sector. In the now moribund Policy Analysis Market (PAM), traders would buy or sell futures contracts based on a listing of general events in economics, civil and military affairs, or specific events, such as terrorist attacks. In theory, the higher the price for the wager, the more likely the incident. Recent studies suggest that speculative markets similar to PAM, in which participants bet on election results and Academy Award winners, can outperform traditional predictive tools like polls and expert opinion.

Firms that develop products or services which respond to conflict-related imperatives may secure competitive advantage, yielding above-market returns to the insightful investor. The Kimberley Process to eliminate trade in ‘conflict diamonds’ has created just such an opportunity for investors in Canadian diamond mines, in spite of their higher production cost. By investing in such firms, the financial sector can reward and create incentives for further conflict-sensitive activities.

Box 6.1d: ‘Conflict-Free’ Products—a Competitive Advantage

The Canadian Polar Bear Diamond was introduced in 1999 to capture some of the market in diamonds from customers concerned about ensuring that their purchases were not connected with conflict. Each diamond is identifiable by the image of a polar bear inscribed by laser on its girdle. While more expensive than diamonds from other origins, the Polar Bear Diamond are reportedly able to command this premium price, with the Canadian industry ‘taking off more quickly than any but the brashest optimists expected’. As a consequence of continued discoveries and a growing shift away from diamonds sourced in Africa, experts predict that 10–12 per cent of the world’s diamonds may soon come from the Canadian Arctic.

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6.2 Conflict Prevention, Mitigation and Resolution

The finance sector’s keystone role in the economy opens a range of opportunities for contributing to stability and peace. The core businesses of banking and insurance diversifies the economy through the provision of loans to entrepreneurs, finances and insures critical infrastructure (e.g. buildings, water, sanitation, energy and transport), generates employment both directly and indirectly, and catalyses foreign investment. The financial sector provides vital services that enable people to plan for the future, and contributes to the public purse and to strengthening the rule of law. The conditions placed on project-related loans and insurance, moreover, can be important levers for ensuring that these initiatives are undertaken in a conflict-sensitive manner. Financial actors can also facilitate crisis response and recovery operations by non-governmental actors like the Red Cross, through appropriate insurance cover.

Box 6.2a: The Equator Principles for Project Finance

The Equator Principles, a voluntary set of guidelines for managing social and environmental issues in project finance, were launched in June 2003 by ten leading project finance banks. To date, an additional twelve banks have adopted the Principles, which now cover the largest part of the global project finance market.

The guidelines relate to the financing of development projects in all sectors, based on World Bank and IFC environmental and social policies and guidelines. Under the principles, the banks commit to screening all projects over US$50 million which they propose to fund, on the basis of their environmental or social risk. For those projects posing the greatest risk, banks will require detailed Environmental Assessments, and Management Plans where needed, to identify and mitigate environmental and social risks. The banks further agree to ‘not provide loans directly to projects where the borrower will not or is unable to comply with our environmental and social policies and practices’. If management plans are not followed and problems not remedied by borrowers, the banks can declare the loans in default.

Banks adopting these principles will thus have leverage in both project design and execution to encourage borrower compliance with basic environmental and social standards. Critics point to a number of potential loopholes, including the implicit need for a mechanism to verify project compliance.

In order to reduce linkages between economic activities and armed conflict, transparency within the global financial system is believed ‘indispensable’ 64. The financial sector has access to more information than any other actor in society, and can therefore be a powerful force in this regard. 65 ‘Identifying and cutting the financial flows that fuel wars can …increase incentives to negotiate peace accords …Greater financial transparency can help deter and limit corrupt behaviour by state officials and corporations whose actions feed into the escalation of conflict…More broadly, …when combined with other forms of voluntary or binding measures designed to regulate the economic activities that fuel wars, for example, by complementing certification systems used to regulate the flow of weapons,…[financial transparency] would help differentiate licit from illicit transactions, and identify the actors associated with illicit arms trade’ 66.

63 http://www.equator-principles.com/
65 Kahlenborn, W. Director of German Sustainable Investment Forum, Comments on Draft Study, 4 October 2003.
Multilateral efforts by governments to rein in money laundering and terrorist financing have had an important positive impact on the reduction of conflict financing. The UN, the European Union, the Council of Europe, the Organisation for American States, the Organisations for Economic Cooperation and Development (OECD), as well as technical bodies such as the Basel Committee on Banking Supervision, have drawn up general standards to support financial transparency. Nevertheless, enforcement of financial controls by states has been only a partial success, leading some to argue for self-regulation by financial firms. Reasons include:

- High cost to firms. Anti-money laundering rules established by the US Treasury Department in the wake of September 11 cover every ‘brokerage house, insurance company, casino and corner store cheque-cashing business’ in America. The Treasury is considering requiring US banks to perform similar background checks on customers of foreign banks with whom they do business. A survey by the American Bankers Association found that these rules were ‘the single costliest regulation facing banks’.

- Many countries lack the resources and technical capacity to implement regulations and monitor financial transactions. These rules can also make it more difficult to broaden access to financial services among the poor and Small-to-Medium Sized Enterprises, a policy objective believed key to social stability in many countries, including South Africa.

- Differences in legal regimes between states pose challenges for detection of non-compliance and enforcement of sanctions.

**Box 6.2b: Wolfsberg Principles—A Voluntary Code of Conduct to Reduce Money Laundering**

‘The proceeds from illicit trafficking in arms, narcotics, humans, natural resources, and other commodities; kidnapping; corruption and other forms of “white-collar crime”; and diversion of humanitarian aid and siphoning of diaspora remittances play a critical, if sometimes indirect, role in sustaining armed conflict and undermining post-conflict economic recovery. By providing a means to launder and transfer the billions of dollars these enterprises generate for combatants and criminal organisations, the ...international financial system facilitates these transactions’.

‘In 2000, eleven international private banks, representing one-third of the world’s private banking funds, agreed, with the participation of Transparency International, to the Wolfsberg Principles. These voluntary principles, initiated in response to reputational damage over accusations of money laundering, commit the banks to a common global standard for their private banking operations, including customer “due diligence”, identifying the source of funds, monitoring, and voluntary reporting of potentially illegitimate transactions to responsible authorities. Banks are also required to establish an “adequately staffed and independent department responsible for the prevention of money laundering”. Assets may be blocked subject to local laws and regulations. Critics of the principles argue that they do not adequately address existing questionable accounts. Other banks have expressed an interest in committing to the principles’.

Through its **social investment** programs, the financial sector can contribute to the reduction of and recovery from conflict, by investing in community needs (e.g. reconstruction, education, humanitarian

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70 Sustainability Banking in Africa: Executive Summary. AICC Centre for Sustainability Investing, 2003: 3.
relief) and by ensuring that this is done in a way that does not favour one socio-economic group over another, but rather contributes to social capital and mutual interdependence. Examples include loans to small and medium enterprises, and provision of microcredit. The US Community Reinvestment Act, for example, encourages federally-insured banks to extend credit to low-and-moderate income areas. Banks are publicly rated on their community investment performance and those with good ratings receive benefits such as tax credits, government contracts and public praise. Those banks with poor ratings are precluded from certain types of corporate expansion, and may be subject to regulatory enforcement action. At the global level, the Rabobank Foundation seeks to alleviate poverty and to promote development through the provision of microcredit to groups of social entrepreneurs. ‘Rather than just handing out funds, we encourage self-help at grass roots level...[through] joint responsibility ... The initiative must be taken by the people involved and then, with our aid, credit cooperatives can be formed.’

Finally, firms can engage in policy dialogue, advocacy and civic institution building with host governments and other institutions at the local and national levels. Through partnerships with intergovernmental agencies, international financial institutions, governments, NGOs and other firms or sectors, the financial sector can, without overstepping the boundaries of undue political influence on sovereign governments, support efforts to tackle ‘the difficult structural issues that often underpin conflict such as corruption and cronyism, human rights abuses, inequitable distribution of revenues and patronage, lack of democratic process, inequitable or inadequate access to economic opportunities, education, health services, lack of indigenous business development and job creation, and the need for security sector and judicial reform’.

It is alleged for example that in Sri Lanka, when businesses mobilised collectively in support of peace in the wake of an airport bombing, their voice was decisive in bringing combatants to the table to negotiate a cessation of open violence.

Box 6.2c: Policy Dialogue and Social Investment to Promote Peaceful Transition

The Consultative Business Movement (CBM) was established by members of the South African business community in the 1980s to promote a peaceful transition from apartheid. Through consultations with exiles and leaders from banned or restricted organisations such as the African National Congress (ANC), it established relationships between key business people, politicians and activists. This permitted CBM to mediate at a critical juncture between the government and ANC in the negotiations that led to the 1991 National Peace Accord, and in convincing the ANC of relaunching economic growth through a market economy. The CBM has spawned follow-up initiatives, including Business Against Crime (BAC), which works in partnership with relevant government agencies to enhance justice and security inter alia through projects to minimise trial waiting times, reduce corruption and commercial crime, and establish crime victim support services.

6.3 Post-Conflict Reconstruction

The private financial sector has an important role to play in catalysing investment in post-conflict settings. It is well understood that in a post-conflict setting, the wave of donor support for
reconstruction will fade, after which an influx of private capital is needed to relaunch and consolidate efforts towards development. But where are the win-win opportunities for finance?

**New Products**

The dramatic return of exiles after the end of a conflict is a signal of a wider interest by the diaspora community in securing peace and generating economic opportunity in their former homelands. Professionally managed investment funds for diaspora communities seeking to contribute to post-conflict reconstruction may offer expatriates an opportunity both to maximise the impact of their funds in restoring and diversifying their homeland’s economy while potentially reaping high returns. Is there an untapped market for such funds directed towards specific post-conflict zones? Would it be possible to target the nearly $1 billion in annual expatriate remittances to conflict zones and wealthy diaspora investors from these regions?

**New Markets**

There is a potential first mover advantage for firms who make a bold early entry into a post-conflict economy. Standard Chartered Bank in 2003 applied to establish commercial banking services in Afghanistan, offering US Dollar and Afghani deposit services and international transfers. Notes Project Director John Janes, ‘we are a business, we seek to make a profit in time…As we learn the market we will selectively start to be involved in trade finance to help the commerce of Afghanistan and its neighbouring trading partners’.

**Reviving the Financial System**

National priorities for financial reconstruction depend ‘on the scale and character of the destruction as well as the country’s institutional resources and human capital’. The restoration of the financial system is impeded by damage to the banks, the loss of trained staff, the destruction of records, and the pillage of bank assets. Complete or partial privatisation of state banks may be necessary in order to recapitalise them, and revive the commercial banking system. But this process needs careful supervision to ensure it does not further concentrate assets among a narrow elite.

The return of material volumes of capital into a post-conflict economy or an economy that is very insecure, requires certain basic conditions to be met; among them, inalienability of property rights, ability to convert and transfer currency, prevention of seizure of goods or cancellation of licences, limited prospect of war or civil disturbance—in short, the elements of good governance and stability that will most likely be in short supply following the cessation of violence.

That said, as a first step, it may be possible to entice funds to return on a small scale, relying both on the potentially high return to (high risk) investments, and the patriotism of the wealthy diaspora investor.

In these jurisdictions, where governance is non-existent or fragmented, the implementation of proxy governance structures may be helpful. These can take the form of bonds and other financial guarantee instruments to reduce risk, coordinated with the broader reconstruction process (e.g. financial sector policy reforms and institutional capacity support). This would require considerable coordination between the financial sector, the donor community, and the national government or post-conflict interim authority. One of the main issues is to make such financial instruments accessible for the SMEs.

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operations that are typical in post-conflict investment environments. An integrated approach of the kind described would provide an enabling environment for investment attractive not only to diaspora communities but to larger inward capital flows.

7. Responding to Gaps in Knowledge and Normative Guidance

Very little useful information has seemingly emerged to guide financial firms towards engagement in post-conflict reconstruction, and towards encouraging better management—if not prevention—of conflict issues by those in whom they invest. Moreover, firms are without guidance on appropriate behaviour in instances where the context in which their investment has taken place changes from peace to conflict or oppression.

Guidelines by the International Financial Institutions (IFIs) on Environmental Assessment are the leading international benchmark for practice. These guidelines were not, however, prepared with conflict prevention as an explicit goal, and were developed largely through an expert process. As a consequence, they lack specificity with respect to conflict issues. They also lack the procedural legitimacy necessary to address many of the lingering perceptions of 'profit before people' that polarise attempts at multistakeholder dialogue to clarify broadly-acceptable practice in relation to business-conflict linkages.

One attempt to address these procedural and conflict-specific shortcomings was the 2001-02 UN Global Compact Policy Dialogue on Business and Conflict (see Box 7.1, below), though participation by the financial sector was modest.

Box 7.1: Global Compact Policy Dialogue on the Role of the Private Sector in Zones of Conflict

The UN Global Compact was launched by UN Secretary-General Kofi Annan in 1999 in order to promote good corporate citizenship globally. It calls on business leaders, trade unions and NGOs to join forces behind a set of nine core principles in the areas of human rights, labour standards and the environment. Signatory firms must express support for the principles in their mission statements and annual reports, and demonstrate concrete progress or lessons learnt in implementing them annually.

The Global Compact facilitates thematic dialogues, focusing in 2001-02 on the role of companies in conflict zones. Representatives from leading companies and NGOs, as well as from the development policy world, were brought together to identify key issues and challenges, and practical recommendations for companies operating in conflict zones. Guidance was developed in four areas, though at a preliminary level and with only modest participation by the finance sector:

- Ensuring transparency of extractive sector revenue flows
- Alternative models for revenue sharing from extractive sector investments in a country
- Case studies of multistakeholder partnerships to reduce conflict
- Conflict impact assessment and stakeholder identification

Many corporate codes of conduct developed with corporate social responsibility aims in mind only indirectly address conflict drivers through provisions on environment, human rights and community and labour welfare.
The Global Reporting Initiative (GRI) guidelines are an example of the indirect inclusion of conflict-related issues, while they stand out through the unique multi-stakeholder consensus-building process in which they were developed (see Box 7.2, below).

**Box 7.2: Global Reporting Initiative Guidelines**

The GRI was born in 1997 to respond to the gap in internationally-recognised standards for consistent, comparable and independently verifiable external reporting on environmental and social performance by organisations. It has since convened over 5,000 individuals from some 80 countries, representing business, government, accountancy organisations, rating agencies and research institutes, to contribute to the development of the Guidelines and related materials. The GRI Guidelines contain a detailed process for company disclosure on environmental, economic and social issues, as well as for reporting on governance structures, management systems and stakeholder engagement activities. While not expressly designed to address business and conflict links, a number of indicators are nevertheless directly relevant. These include the following:

- Taxes of all types paid
- Human rights strategy and management
- Non-discrimination
- Core labour rights
- Policies and procedures for managing community impacts
- Bribery and corruption

The OECD Guidelines for Multinational Enterprises, endorsed by 36 governments, are a potentially valuable source of guidance. Though they lack direct reference to conflict and peace-building, the OECD Guidelines cover a wide range of management challenges at the interface between business and conflict, including corruption, environmental assessment, and public reporting.

These voluntary norms call for companies to ‘develop and apply effective self-regulatory practices and management systems that foster a relationship of confidence and mutual trust between enterprises and the societies in which they operate’. Importantly, signatory nations are required to provide an independent recourse mechanism to host state communities negatively affected by the activities of foreign firms, through the establishment of ‘national contact points’ to respond to complaints. Signatory states are also subject to annual reviews of implementation.

The UN Sub-Commission on the Promotion and Protection of Human Rights recently adopted a set of (2003) ‘Norms on Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights’. These Norms, drafted by a small group of international human rights experts with industry and stakeholder input, seek to offer a concise restatement of existing government-to-government agreements international law - on issues ranging from bribery, human and labour rights to environmental and consumer protection. The Norms were presented to the Commission of Human Rights in April 2004, which in reaction requested the Office of the High Commissioner for Human Rights to compile a further report on the responsibility of transnational corporations with regard to human rights. Barclay’s Bank has been the first financial institution to ‘give serious consideration to

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the role these norms will play in [its] work’, by joining a Business Leaders’ Initiative on Human Rights chaired by former UN High Commissioner for Human Rights, Mary Robinson\textsuperscript{87}.

The UN Norms stress that ‘...business enterprises shall refrain from any activity which supports, solicits, or encourages States or any other entities to abuse human rights. They shall further seek to ensure that the goods and services they provide will not be used to abuse human rights’. Firms will be required to implement internal rules of operation that comply with the Norms, monitor and report on their implementation to external stakeholders, and refrain from doing business with firms who have not done likewise. They are to be subject furthermore to a range of compliance monitoring, complaint recourse and reparations mechanisms.

Though faced with considerable opposition by business lobby groups, the Norms establish important benchmarks for managers on many of the issues of concern. Regardless of whether they will ultimately adopted by the UN Commission on Human Rights, they will likely influence practice by many firms.

It is critical to recognise the dilemmas that managers must face in tackling these issues, due to uncertainty both of the causes and nature of conflict, and of the means whereby conflict can be prevented or resolved. A nuanced approach to conflict is needed, one which includes a strong element of public dialogue and communication. The box below presents some potential elements of proactive conflict management for firms in the financial sector.

**Box 7.3: Potential Elements of a Proactive Approach to Conflict in:**

<table>
<thead>
<tr>
<th>Banking</th>
<th>Asset Management</th>
<th>Insurance</th>
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<tbody>
<tr>
<td>• Conflict impact assessment</td>
<td>• Disclosure and Know Your Customer Rules</td>
<td>• Conflict impact assessment</td>
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<tr>
<td>• Conflict indicators</td>
<td>• Including conflict factors in investment screens</td>
<td>• Conflict indicators</td>
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<td>• Conditions on access to finance</td>
<td>• Shareholder engagement</td>
<td>• Public-private collaboration to enhance risk-reward ratio</td>
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<tr>
<td>• Disclosure and Know Your Customer Rules</td>
<td>• Revenue transparency</td>
<td>• Conditions on access to insurance</td>
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<tr>
<td>• Providing banking services to enhance social stability</td>
<td>• Options for mobilising diaspora wealth for post-conflict reconstruction</td>
<td>• Communications/outreach strategy</td>
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<td>• Guidelines for operation in risky places</td>
<td>• Communications/outreach strategy</td>
<td>• Options for mobilising diaspora wealth for post-conflict reconstruction</td>
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\textsuperscript{87} ‘Companies Set to Work with UN Ethics Code’. Financial Times, 9 December 2003. (Lexis/Nexis)
8. What Can Governments Do to Encourage Voluntary Conflict Sensitivity?

Governments from the home states of firms in the financial sector can do a great deal to help bring the financial sector into conflict prevention and peacebuilding. Efforts can focus on creating incentives for positive action, forging partnerships around shared objectives, and convening multistakeholder learning dialogues to resolve normative gaps through codes of conduct and case studies of good practice.

Box 8.1: Helping Prevent Violent Conflict: OECD Orientations for External Partners

The OECD Development Assistance Committee suggests that ‘like public and aid supported investments, the private sector needs to be guided by an informed commitment to guard against side effects of its investments which may have negative impacts on “structural stability” of the local and national host society, and plan for ways it can ensure the maximum positive benefits’ 88. It recommends inter alia that donors:

1. Promote the use of peace and conflict impact assessment by businesses.
2. Support processes to resolve project-related claims by indigenous communities.
3. Improve codes of conduct on specific issues and risk-insurance mechanisms.
4. Explore tri-sectoral development partnerships, and create fora for multistakeholder dialogue.
5. Identify mechanisms and create space to involve the private sector in the peace building process.

Incentives for positive action. Firms that adopt voluntary commitments often take on additional costs and financial commitments, and may increase their exposure to liability. To offset these risks, regulators can offer incentives and reduce learning and implementation costs. The Dutch government, for example, has recently passed a measure linking compliance with the OECD Guidelines to the availability of government trade-promotion subsidies. Public incentive mechanisms include the following:

- Positive public recognition for participation in voluntary challenge programs
- Enhanced access to investment incentives, export credit, financial subsidies, tax credits and reduced fees linked to compliance with safeguard policies for sustainable development and conflict prevention 89
- Reduced future liability through enhanced audit confidentiality protection and through recognition of adoption of voluntary commitments as a signal of ‘due care’
- Establishment of public-private learning platforms and financing for academic research on issues of concern
- Establishing a ‘white-list’ to identify and reward financial institutions complying with transparency measures 90. The system would need to be designed to avoid unfair competition detrimental to smaller financial institutions in the developing world.

90 Guaqueta, A. Economic Agendas in Armed Conflict: Defining and Developing the Role of the UN—A Symposium Report. IPA/Fafo, March 2002: 8
**Partnering** between governments, civil society actors and private firms to implement development goals is of growing interest, premised on mobilising private sector funds and on allowing partners to focus on their respective core competencies. However, international efforts to engage the financial sector in the peace agenda lag, behind the ‘partnering’ rhetoric. The failure of engagement may in part be the result of governments and NGOs lacking the appropriate vocabulary or options for productive engagement with these firms. Likewise, too, it may be due to reticence on the part of a conservative industry sector to engage in activities that are perceived as ‘political’.

There are some significant examples of efforts to partner with the financial sector in the promotion of development. Moving from policy statements towards implementation of effective public private partnerships remains a major challenge, but some lessons could likely be drawn from partnership initiatives in post-conflict or conflict-prone settings.

**Box 8.2: Emerging Africa Infrastructure Fund and African Trade Insurance Agency**

Perception of high investment risks in Africa drives up the costs of insurance and financial services, resulting in low levels of infrastructure investment and trade, thus making essential imports unaffordable or unavailable.

Launched in January 2002, the Emerging Africa Infrastructure Fund is a public-private partnership aiming to finance commercially viable infrastructure projects in Sub-Saharan Africa with a positive development effect. The consortium’s main donor is the UK Department for International Development, with Standard Bank and Barclays Bank contributing senior debt. Overall, US$305 million have been committed to the fund.

Created in 2001, the African Trade Insurance Agency seeks through the provision of political and commercial risk cover to improve the terms of trade finance for imports into and exports from participating countries. Owned by its seven African member-nations, ATI is supported by the World Bank, Lloyd’s of London, and Gerling NCM Credit & Finance Ag. It is estimated that risks underwritten under A.T.I.’s initial mandate could generate as much as US$5 billion over ten years in additional trade for the seven member countries of the agency91.

**Box 8.3: Tackling Water Supply in Montenegro—Public Private Partnership (PPP) with Difficulties**

AquaMundo, a joint venture between three large infrastructure companies, has developed an innovative public private investment model in collaboration with partners in the German development sector (including KfW, DEG and GTZ) in which the level of risk taken on by the private sector actors rises progressively over time. This concept was applied in the Republic of Montenegro to provide water and sanitation for 150,000 inhabitants and 250,000 tourists in seven municipalities, and to resolve problems including high levels of leakage (est. 40%), summer water shortages, and unsustainably high costs to the public authority. According to sources, after running into delays in establishing the local administrative and governance structures, due in part to latent or open conflict between communities, the original project was closed. KfW revised the collaboration model and Aquamundo no longer holds any stake in the project. It was restructured and since early 2004 has become a 100% subsidiary of the Austria-based company Inframan GesmbH, which belongs to the Amiantit Group registered in the Kingdom of Saudi Arabia92.

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91 http://www.africaplc.com/docs/Gerling_proposal.doc

92 http://www.aquamundo.de/indexie.html and specific information from Aquamundo
Multistakeholder Dialogue and Learning Platforms could be established by governments in order to share knowledge and fill in gaps in normative guidance and good practice, focusing on some the issues identified below:

- Conflict assessment tools and conflict indicators
- Case studies on good and bad practice in the finance sector on conflict management/post-conflict investment, including linking of international finance to local Small-to-Medium-sized Enterprises
- Inventory of applicable norms, tools and laws (international and national) for finance in conflict-prone regions
- Public sector actions to enhance incentives for investment and service provision in risky places (e.g. tax credits, export credit, Bilateral Investment Treaties, conditionalities in contracts, use of technology to provide financial services at a distance, etc.)
- Framework for decision-making with regards to the legitimacy of investments, and private or commercial service provision in zones of potential or open conflict
- Working with other actors in conflict prevention and post-conflict reconstruction
- Good practice in controlling resource flows into and out of conflict-prone regions
- Innovative financing mechanisms for post-conflict reconstruction

9. Conclusions

Our concern here has been to identify areas open to voluntary action by firms in the financial sector, and gaps in existing tools. We have strongly asserted the key role of the public sector, export credit agencies, and international institutions such as the United Nations and World Bank, in establishing international standards of good practice, and creating space for multistakeholder dialogue and learning. We have also identified some actions whereby home state governments can establish an enabling environment for positive action by firms.

We believe it is warranted to suggest the convening of a tri-sectoral dialogue between the financial industry, civil society and UN agencies, to review the conclusions of this report and define appropriate next steps.

Key recommendations for this next phase include:

1. Developing a stronger business case for investment in conflict-affected regions.
2. Providing a more-sophisticated review of the full range of actors in the finance industry including ratings agencies, pension funds and socially responsible investors, as well as a review of public, semi-private and private financial institutions.
3. Providing a more systematic and exhaustive list of risks and negative linkages between the different sectors of finance and conflict, possibly carried out as separate sector-specific studies, with the inclusion of detailed case examples and corporate responsibility tools to illustrate both challenges and practical responses.
4. Placing greater emphasis on describing the links between finance and terrorism.
5. Seeking to prioritise and cluster recommendations and responsibilities for follow-up action.
6. Linking up with Global Compact, UN and World Bank efforts, as well as other relevant initiatives.

Potential entry points for the results of the above research and dialogue might include the following:

- IFC, MIGA & World Bank Guidelines and Operational Directives
- Export Credit Agency guidelines for conflict-sensitive project finance
- Corporate Disclosure and Governance rules
- Global Reporting Initiative guidelines
- The Equator Principles on Project Finance
- The UNEP Finance Initiative Policy Statements
- Multilateral efforts to scale up home state legal recourse/liability mechanisms (e.g. US Alien Torts Claim Act) and social investment promotion programs (e.g. the US Community Reinvestment Act)

The potential for the financial sector to play a positive role in conflict prevention and peacebuilding remains unclear, and yet compelling. From positive financial sector engagement can emerge the dynamic layer of entrepreneurs and small businesses that create opportunities for sustained economic growth and more-lucrative returns. This can generate benefits for poor communities, for the environment and for investors. Does the intersection between finance and conflict call out for further research, engagement and effort? Our research, preliminary as it may be, suggests that it does.
Promoting Conflict Responsibility in the Developing World—The Role of Project Finance and Insurance

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The views expressed herein are those of the author and do not represent the views of the Asian Development Bank

Project Finance Defined

The importance of project finance in promoting infrastructure development in the developing world is well known. Without the billions of dollars of support generated for infrastructure projects through the use of project finance, hundreds of millions of poor people in the developing world would not have access to basic needs such as electricity, clean water, and sewage treatment.

Typical project financing involves the issuance of a non-recourse loan, wherein the sponsor has no obligation to make payments on the project loan if revenues generated by the project are insufficient to cover the principal and interest payments. Lenders seek to minimise the risks associated with making non-recourse loans by requiring indirect credit supports in the form of guarantees, warranties, and other covenants from the sponsor, its affiliates, or other third parties involved with the project. Political Risk Insurance (PRI), which protects a sponsor or lender against non-commercial risks (such as Expropriation, Currency Inconvertibility/Non-Transfer, Political Violence, or Breach of Contract) is often utilised to remove country risk from the equation. Project sponsors and lenders thereby assume the commercial risks associated with a given project.

The Project Finance Challenge

Project financiers have had to balance their desire to participate in sound, profitable business ventures, with the needs and capabilities of the people and governments of developing countries, as well as the interests of non-governmental organisations (NGOs). This has been a slippery slope for many in the project finance business. Project sponsors, financiers and insurers alike have had to find a balance between the many competing forces that impact the construction and operation of infrastructure projects in the developing world. Their need and desire to adhere to strict credit, accounting, design, construction and operational standards has often conflicted with equally important objectives such as strict environmental compliance, greater socio-economic benefits for workers, and the rights of indigenous peoples.

Until approximately 10 years ago, project sponsors, lenders and insurers did not pay sufficient attention to the latter issues. Since non-recourse project finance is a relatively new phenomenon, having come about in the early 1990s, the emphasis tended to be on how to get an important project in a difficult country funded, rather than how to do so in a manner consistent with the objectives of all parties involved. What project financiers often did not appreciate was that it was in their interest to create a win/win environment with the governments and people of the developing world.
Now that project finance has become a standardised means of promoting infrastructure development, the project finance industry as a whole (which includes the sponsors and PRI providers) has come to realise that it is very much in its interest that:

- The people who work at each project, as well as local inhabitants, have a sense of participation in and belonging to each project;
- The long-term interests of projects are served by meeting the long-term interests of the governments and people of the countries where these projects are located;
- A fair and competitive long-term price should be charged for services provided;
- A uniform, conservative environmental standard should be used (World Bank standards are now commonly used); and
- It contributes to the long-term peace and stability of the country and region where a project is located.

Businesses are increasingly recognising that only in stable operating environments are projects most likely to earn an acceptable rate of return. What is perhaps most important is that a project does not contribute to or accentuate perceived imbalances between ethnic groups, social classes or geographical sub-regions. Particularly in areas where conflict exists, extra attention needs to be paid to ensuring transparency in all aspects of project implementation.

The Importance of Corporate Social Responsibility

‘Social responsibility’ has become an integral part of the planning and implementation of infrastructure projects since the 1980s. Project sponsors, financiers and insurers have learned some tough lessons about the dangers of not paying sufficient attention to these issues. A good example of the possible consequences of not paying enough attention to the social and environmental issues associated with owning and operating a mine is Bougainville in Papua New Guinea (PNG). In 1988 a small group of villagers blew up some of the mine's installations, coming in the wake of demands for compensation for loss of land and resources to the project, and alleged pollution of the local river system. Refusal by the mine owner and the PNG government to address the demands prompted escalating guerrilla action against the mine and its employees. The company closed the mine down the following year and it has remained closed. Thousands of people died in an ensuing civil war, and litigation against the mine and its owners continues to this day.

NGOs have also learned some lessons. One of the best examples is the Freeport mine in West Papua (formerly, Irian Jaya), Indonesia. An NGO sought to have Freeport's PRI cancelled for alleged violations of the environmental conditions set out in the insurance provided by the Overseas Private Investment Corporation (OPIC, a US Government agency) and the Multilateral Investment Guarantee Agency (MIGA, a member of the World Bank Group). Because covenants of the insurance appeared to have been breached by the company, OPIC cancelled the coverage. Freeport took OPIC to court, had the insurance reinstated, and then itself cancelled OPIC's and MIGA's insurance. The NGO's objective of stricter environmental compliance backfired. When the insurance was cancelled, Freeport was no longer obligated to adhere to strict, internationally accepted environmental regulations.

Many mining companies have subsequently made great strides in taking the initiative to avoid conflict with NGOs and indigenous peoples by taking care to be inclusive in the planning, construction, and operation of mines. Before the mining company RTZ built the Lihir gold mine in PNG, it spent a great deal of time establishing strong relationships with tribal leaders, understanding the concerns of local
inhabitants, and negotiating a sensible agreement with the Government. They went so far as to remunerate islanders for every coconut tree that was cut down and they studied 100 years of islander family histories in order to establish property rights based on written history. The banks that financed the mine, and the PRI providers who insured it, recognised the benefits of a carefully thought out approach to making an investment in a country as culturally complex as PNG.

These examples demonstrate that it is in all parties' interest to collaborate in achieving mutually satisfactory guidelines for the construction and operation of infrastructure projects in the developing world. It is only through cooperation and collaboration that the objectives of all parties can be reached.

**Public/Private Sector Collaboration**

Multilateral Development Banks (MDBs), such as the Asian Development Bank and the World Bank, have a unique role to play in this regard. Since their work is by nature oriented toward promotion of development and the alleviation of poverty, the concept of social responsibility strikes a familiar chord. MDBs have strict covenants governing all aspects of their participation in project finance. From a ‘no child labour’ policy to a requirement for total transparency to no tolerance for bribery and corruption, MDBs have played a pivotal role in ensuring that social responsibility is a common theme in the projects they become engaged in.

Many private sector banks and insurers have attained a surprising degree of convergence with the MDBs in the general area of social responsibility. In addition to the commonality that has been achieved in applying World Bank environmental standards to projects that are financed and insured in the private sector, the type of due diligence that is now applied by most private sector institutions has achieved a remarkable degree of similarity with those of the MDBs. While public sector insurers have, for example, addressed a host of developmental and social responsibility issues in the natural course of conducting their project risk analyses, many private banks and insurance companies now routinely address the same issues during their due diligence process. In determining whether a project is worth supporting, for example, it is now common to assess the degree to which substantial tax revenues are generated, local workers are hired, and technology transfer is present.

Banks and insurance companies face a host of performance, reputation and ethics issues when engaging in project finance, particularly now that there is such emphasis on the whole concept of ‘corporate governance’. PRI providers, in particular, have moved from making ‘traditional’ assessments of country risk based largely on the social context in which a project operates to better understanding the degree to which infrastructure projects impact the wider geographical area and contribute to indigenous and cross-border conflict. This is particularly important because so much foreign direct investment in the developing world exists in areas that are inherently politically unstable. Promoting corporate social responsibility is therefore an underlying, albeit indirect, objective of PRI providers.

**Information Sharing**

Despite the great progress made in the convergence of public and private PRI providers' interests, there remains a need for even greater collaboration with respect to information gathering and sharing. MDBs and export credit agencies (ECAs) have a distinct advantage in collecting project-related information because they have access to sources private sector entities do not have. For example, MIGA has access to IMF and World Bank Group data, and OPIC can access any number of information sources from within the U.S. Government. Similarly, information gathered from local sources by private sector institutions could prove to be extremely valuable to MDBs. All such institutions could benefit from
greater adherence to widely acknowledged guiding principles, such as the OECD's Guidelines for Multinational Enterprises, or those of the UN's Global Compact Conflict Dialogue. Enhanced information sharing, and the establishment of greater commonalities in project assessment and operational safeguards, will contribute to a higher degree of conflict avoidance in the project finance process.

The Path Forward

Private sector sponsors, financiers, and insurers of project finance-related infrastructure projects should be given credit for having moved solidly in the direction of corporate social responsibility. It is clearly in the interests of all parties involved in the development process that the maximum amount of attention be paid to promoting social responsibility, and to minimising the potential for conflict. Much remains to be done.

Greater information sharing is one important aspect to enhancing the risk assessment, which is key to being able to better predict where problems are likely to arise. Generating accurate risk assessments is critical to increasing the flow of foreign direct investment to the most difficult conflict ridden areas of the globe. The problem is that as the realities of the post-9/11 world become clearer, the utter unpredictability of political events makes the creation of more accurate risk analyses even more difficult to produce. Where and when will the next terrorist attack occur? What will its impact be on the foreign investment climate? Will a host government's response to terrorist attacks create an investment climate that is less conducive to attracting foreign investment? These are the types of questions political risk analysts now face.

MDBs can play a better, more effective role in supporting access to project finance during periods of crisis by improving the finance methodologies they use so that they can be quickly and economically introduced into new markets, even before a crisis starts. They can focus on filling market gaps that might appear, so that capital flows from private banks may remain open longer. MDB's can also consider using the least amount of intervention possible in times of crisis, giving priority to financing tools that help private-to-private flows first, leaving the public-to-public foreign exchange loans as a last resort. MDB intervention can and should occur in times of crisis, but only when the ordinary functioning of capital markets fails, so as to avoid creating a future financial burden in crisis-ridden countries. The loans provided by MDBs must eventually be repaid.

Finally, increased adherence to principles of corporate social responsibility among all stakeholders in the project finance business will certainly minimise the extent to which such business aggravates conflict-prone locations. Increasingly, project financiers are insisting that adherence to such guidelines be a condition precedent to issuing loans to projects. As the example of RTZ in PNG above illustrates, future conflict between project and local stakeholders can be anticipated and even neutralised by thoughtful planning. In the future, the hope is that projects that are managed by socially responsible sponsors, financiers and insurers will prove to be the most profitable. Yes, it can be done.
Investing in Stability—Conflict Risk, Trade Finance and the Bottom-Line

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The views expressed herein are those of the author and do not represent the views of KPMG LLP UK.

More than 47,000 soldiers, military observers and civilian police served in 15 peacekeeping missions active at the end of 2001, up 24 per cent from about 38,000 a year earlier 93. 12,126 local and international civilian personnel supported the missions.

In addition to U.N. peacekeeping operations, some three-dozen additional missions are being carried out by regional or military organisations such as NATO, the Organisation for Security and Co-operation in Europe, and the Economic Community of West African States. The total cost of such operations is subject to varying estimates, but is considered to be not less than US$3 billion dollars for the UN activities with an additional US$9 billion for the NATO and OSCE missions.

The costs of conflict are on the rise—in both human and economic terms. A recent World Bank study calls civil war ‘development in reverse’. Conflict and terrorism are indirectly linked to the recent fall in the rate of growth of gross world product—which in 2001 was at 2.1 per cent, close to its lowest growth rate since 1950 94. It is in this context that the role of the financial services sector is being challenged as to how it might best support social stability and peace and lower the potential for conflict to start.

The financial sector has a considerable history of engagement with different stakeholders to mitigate significant global concerns. For example the insurance sector first led in inter-governmental lobbying at the COP in Buenos Aires in 1998 95 with a call for governments to limit greenhouse gas emissions, and the German speaking banks collectively published guidelines on the ecological footprint of their business and operations in the mid 90's. In later years this dialogue on environmental concerns has broadened to encompass more explicitly social concerns and to consider the role of finance in a more holistic fashion. At the same time in a response to the changing dynamics of the industry such dialogue has become more targeted to match the industry make up. So, rather than attempting to engage the industry as a whole, stakeholders have started to converse directly with far smaller number of players who participate in specific activities. There are common themes, though, which are clearly relevant within all different sub-sectors:

- Time horizons
- Risk reward ratio
- Customer profile
- Geographic scope

It is helpful to think about these when addressing each group. Other factors will come into play in each specific context, but on a global basis the above are critical issues.

95 UNEP III press release of November 5, 1997 by Insurance Company signatories to the UNEP Statement on Finance and Sustainable Development
Finally, much has been written about the role of the financial sector as influencers of their client base. It is true that a financial institution has the ability to influence the actions of its clients and it uses the cost of capital as one of the more direct tools to effect change. However, it is important to understand that the potential of this influence can vary and is related (although not in a linear fashion) to the underlying product or service being bought and sold. Calling on the financial sector at large to be more influential in their dealings with their clients is too simplistic a step to result in a reduction in conflict potential or to foster social stability. The industry is more complex and the mechanisms to effect change more sophisticated. The next sections briefly describe specific sub-sectors that make up the financial sector as a whole and give some initial thoughts on the mechanisms that might be engaged to achieve change.

**Commercial Banking**

Commercial banking includes the provision of trade finance, principally debt based and short term, to corporate entities ranging from the largest of transnational corporations (TNCs) through to small and medium sized enterprises.

It does not generally include the provision of equity finance, advisory work on the launch of new issues, or capital raising, nor does it include sovereign states amongst its client base. These are all provisions of an investment bank although some of the major financial institutions will include an investment bank, for example HSBC Holdings plc or Barclays Bank Group, as part of their overall organisation.

In addressing the themes identified earlier, the outline below describes the parameters that generally define the operations of a commercial bank:

**Time Horizons**

A commercial banking organisation will predominantly finance short term funding needs, most likely for less than 12 months. This will normally apply for more than 50% of its balance sheet and the majority of the capital extended will be ‘repayable on demand’. This means that the risk focus is near term. Whilst for example climate change is a significant current risk to some industries, it is too long term to influence the majority of commercial banks’ products and services.

**Risk Reward Ratio**

The risk reward ratio is low risk–low reward and relies on volume and predictability to generate an acceptable return to the financial institutions' shareholders. A large TNC would not expect to pay much more than 1 or 2 per cent per annum above the cost of capital and an SME will pay around 3 to 6 per cent, dependent on the region and type of product. This means that the focus is on low risk clients and low risk products. In the venture capital sector, where higher risks are underwritten, a return of 25 per cent compounded annually would not be unusual. Both types of products may be provided by the same organisation, but in order to introduce change it is vital to understand which aspect of the financial sector is being addressed.

**Customer Profile**

The customer profile will range from the largest to the smallest corporates. In risk management terms this means that a more tailored approach will be adopted to the larger risks and a commoditised process adopted for smaller amounts of risk. In terms of supporting social stability, a differentiation by client size only is too simplistic, as this factor is not known to have a direct relationship on the ability to influence social stability. It is, however, helpful to consider users of specific commercial banking products, such as trade finance and commodity finance as a way of segmenting the client base.

**Geographic Scope**
Finally, the geographic scope of the commercial banking organisation has to be considered. Some entities will only operate within their national borders, others on a regional, and fewer still on a global basis.

**Linkages between Commercial Banking and Conflict**

All commercial banking institutions run the risk of becoming embroiled in conflict situations and can unwittingly help or hinder their resolution.

The most obvious type of engagement will be in the form of non-recourse project finance in a disputed territory where the conflict, or risk of conflict, will impact on the time taken to complete the infrastructure project or impair the potential revenue raising and hence ability to repay the finance. These are long term projects. By incorporating the concerns of stakeholders, including the potential for conflict, the financing institution can produce a more holistic risk assessment.

Stakeholders are defined generally as those who have an influence on a business or are influenced by it. When assessing risk, it must be considered that the definition does not incorporate the concept of legitimacy.

Once an institution factors such concerns into larger and longer term projects, it is a much smaller step to factor such consideration into short term financing. In this way, lower risk financing, such as export credit agency guaranteed or trade finance of varying descriptions, can be reviewed for their risk/return premium in light of conflict risks.

In order for this to happen, incidents of assessments will need to be widely communicated within the industry.

**Defining a Target Group**

In addressing how commercial banking, as a sub-sector of the financial services sector, might contribute to social stability, the first step might be to identify a relevant target group. The following is a profile of the institutions that should be addressed:

Global commercial banking organisations, together with regional organisations operating in developing countries, who

- provide trade finance and commodity financing, and who
- have significant exposure (risk) in developing countries with levels of ongoing conflict.

In order to identify other relevant actors, it is necessary to consider the financial flows for the two products outlined in the profile above.

In trade finance, the commercial bank will provide short-term finance to an exporter who is delivering goods to a developing country. The sovereign risk will generally be guaranteed by the export credit agency of the country exporting the goods. The bank collateralises the underlying assets. Subject to satisfactory delivery of the goods, payment is secure.

In commodity finance, the predominant role of the commercial banking organisation will be to finance the import of commodities to the developed world, using the underlying commodity as collateral. Depending on the financial strength of the corporate, additional security may be required. It is quite common for large corporates and large commercial organisations to be active in both trade and commodity finance. Accordingly, the minimum group of actors that need to be brought on board in order to effect change must include the following:
• Corporates using commodity/trade finance
• Export credit agencies
• Commercial banking organisations providing such products
• National governments who set the rules for their ECAs

Without change by all of these, there will not be any change at all.

**Identifying a Process for Change**

Having described the commercial banking sector and specific dimensions that might be used to catalyse change, how is such change to be achieved?

Past approaches, which have changed the way the sector works have started with a small group, addressed a sub-set of the key issues (e.g. German speaking banks addressing energy efficiency as a pre-cursor to resource efficiency and then developing benchmarks for the industry as a whole), engaged with a broad group of stakeholders (Green Alliance review of UNEP FII in 1996, or Equator Principles development 2003) and used a convention or soft law style approach to initiate change, rather than negotiating onerous legalistic requirements.

In each of the cases cited, the participants understood that their goal was to change understanding rather than to achieve a steep change in the industry's immediate way of working. However, it was also understood that if they were successful in changing understanding; hence, the appreciation of risk reward, changes in how the industry is working would necessarily follow.

Engaging commercial banks in conflict prevention and resolution might start with a simple device, such as the group of stakeholders above describing the value chain of commodity/trade finance and identifying all of the influencers of price (value) in its creation and distribution. From this, a statement of principles could be developed for each stage that sets out how the various participants, including governments, might mitigate conflict risks. It would also address existing tools and mechanisms that are used elsewhere, including the Global Compact or the Ethical Trading Initiative, to understand how they might support such aims. Finally an agreed draft statement covering a specific activity in a specific region might be tested for its effectiveness and practicality.

The process also describes how the UNEP Statement by Financial Institutions was developed more than ten years ago. Our understanding has improved enormously since then, and building in specific implementation and surveillance aspects at the outset would allow a speedy increase in the volume of actors participating in such a standard. Moreover, such a standard could potentially also be applied to other products and services in the commercial banking organisation, if they were considered to have an influence on conflict prevention and resolution.

**Asset Management**

**Industry Profile**

Using the same thought process as above, one would describe asset management as predominantly low risk with far fewer players and a much longer term time horizon—asset managers have to generate returns to cover pension commitments in forty years time and yet are measured on their performance over a few months. It is one of the dichotomies of the industry that it is judged on its immediate performance and yet has to build value over a much longer time frame.
This situation has given rise to a niche market in ‘sustainability’ funds that are marketed with the attribute of using specific metrics to measure their return. For some, this is an environmental dividend; for others, avoidance of social ‘bads’ such as tobacco or alcohol or gambling.

The asset manager investing on behalf of trustees or marketing a fund to individuals will act within a mandate described by its Statement of Investment Principles (SIP), which sets out the risk appetite. Given that the largest funds are custodians of wealth for the next generation, the risks taken are generally low. The low risk profile taken by these funds generally generates lower returns, unless it is an exotic fund set up to undertake high risk investment.

The customer base varies from individuals to major pension funds operating on a global basis. Each of these will look for their asset manager to act as a steward for their funds and deliver against the objectives set out in the SIP.

**Target Group**

Key actors in the asset management industry include fund managers, analysts and trustees. Each of these, together with regulators, who specify the amount of risk a fund will experience, would be needed for any initiative in the area of conflict prevention and resolution.

**Identifying a Process for Change**

In order to effect change in the way an asset manager invests funds, one has to describe the SIP so that it meets the investment objective. This must also be done in a way that allows the asset manager to interpret the direction in a practical fashion, and one which can be measured by the trustees who are acting on behalf of the whole ownership.

Within the socially responsible investment (SRI) community asset managers exist who have considered broader dimensions of risk than are traditionally measured. These individuals will need to be approached to assess whether it is feasible to develop such SIPs as previously described.

In the same way, some of the major pension funds have demonstrated, through their voting instructions as well as the SIP for their fund managers, a propensity to consider longer term sustainability views. As pension funds will be the principal buyers of such a product, representatives from this constituency will be needed as well.

Finally, it is necessary to involve representatives of the investment analysis and regulator groups. The role of the investment analyst will be to develop a metric that allows the identification of a sector's or industry's contribution towards conflict resolution or prevention. This would allow for a ranking of a series of businesses in the same industry and a preference for those who contribute to peace could be established.

It is a much more indirect approach than simply reorienting particular businesses or industries to change their risk assessment processes, but provides the more strategic benefit of using the capital markets to drive change—if the benefit can be clearly articulated, measured and reported.

On a macro economic scale, the positive dividend would be the avoidance of the negative impact that conflict has had on the gross world product, and of the direct cost of conflict—more than US$12 billion from the latter in 2003 alone. So we know that the return is worth the investment of time and the next step must be to marshal the relevant resources.

This is clearly a role for the United Nations as the custodians of the world’s conscience and one for which they are uniquely equipped.
**UNEP Finance Initiative**

The United Nations Environment Programme Finance Initiative (UNEP FI) is a unique global partnership between UNEP, and the private financial sector. UNEP FI works closely with some 235 financial institutions including banks, insurance and re-insurance companies, fund managers, and venture capital funds to develop and promote linkages between the environment and financial performance. Through forums, taskforces, working groups, training programmes and research, UNEP FI aims to address the opportunities and needs that sustainable development can provide to the financial and subsequently the larger stakeholder community.

For more information: www.unepfi.net or contact Mareike Hussels (mareike.hussels@unep.ch)

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**International Institute for Sustainable Development (IISD)**

IISD is one of the world's leading sustainable development policy research institutes. IISD's principal axes of work include: business and sustainable development, international trade and investment, economic policy, climate change, measurement and indicators, reporting on international sustainable development negotiations, and facilitating collaborative policy research and advocacy networks with partner institutions spanning the North-South divide. In 2000 IISD and the IUCN, the World Conservation Union, established a Environment and Security Initiative with the aim of mapping out the links between natural resources and human security, and deriving practical tools for peacebuilding and natural resource management.

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**German Federal Ministry for the Environment, Nature Conservation and Nuclear Safety (BMU)**

The responsibilities of the BMU include the environmental policy of the Federation, interdisciplinary issues pertaining to environmental law, health and the environment, nature conservation and the safety of chemicals and nuclear facilities. The BMU has provided the funding for the project ‘Investing in Stability’.

For more information: www.bmu.de or E-mail: service@bmu.bund.de

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