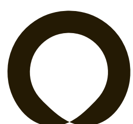
Values Added

The Challenge of Integrating Human Rights into the Financial Sector



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The Danish Institute for Human Rights (DIHR) is an independent national human rights institution, first established as the Danish Centre for Human Rights in 1987, and re-established by law in 2002. DIHR's work encompasses research, education and national and international programs.

DIHR's objective is to promote and develop knowledge about human rights in Denmark and internationally. DIHR cooperates with organisations and public authorities in Denmark and internationally, such as the Council of Europe, the European Union, the Organization for Security and Co-operation in Europe, the United Nations, the World Bank and other international donors.

The Human Rights and Business Project is a department of DIHR devoted to business and its impact on human rights. The Human Rights and Business Project's research, tools, methodologies and initiatives are focused on improving corporate human rights performance. It is directly engaged with 17 Fortune 500 companies. The Human Rights and Business Project also engages in partnerships with multilateral institutions, non-governmental organisations, business associations, and others including the UN Global Compact.

VALUES ADDED:

THE CHALLENGE OF INTEGRATING HUMAN RIGHTS INTO THE FINANCIAL SECTOR

In 2009, the Human Rights and Business Project was funded by the Swiss Federal Department of Foreign Affairs to take the first step toward developing a version of the Human Rights Compliance Assessment tool for the financial sector as a means of providing the practical means of assessing the human rights challenges and risks related to investment decisions and detecting risk areas for non-compliance. This project aimed at assessing the feasibility of collaborative development of tools to support this integration process.

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EXECUTIVE SUMMARY

This report presents the results of research to assess the feasibility of adapting the Danish Institute for Human Rights' Human Rights Compliance Assessment (HRCA) tool to the financial services sector, including the process of identifying the framework and collaborating partners for the development, testing and roll-out of such a tool.

This task would not be possible without developing a granular understanding of the financial services sector and the status of the sustainability debate therein, achieved through research and direct consultation with key actors in the financial field, and by identifying if and how they have integrated human rights into their investment decision-making. A participatory approach enabled the research team to obtain informants' views on the appropriate framework for a Financial Sector Human Rights Compliance Assessment (FS HRCA) tool, and the feasibility of moving into the tool development phase of this initiative.

The key findings of the study include the following:

Increase in Social Awareness

1. Socially responsible investment (SRI) and the use of non-financial factors (also known as ESG, or environmental, social, and governance factors) in financial decision-making has picked up momentum, and the range of actors engaged in the debate has expanded from a few pioneers to main-stream global financial actors.
2. Financial sector actors have mixed understandings of the content of human rights and of their responsibility toward them, including how the financial sector impacts human rights in internal operations and through investments.
3. Nevertheless, many financial institutions have committed to enhancing the integration of human rights into their work, usually by joining sector initiatives. In practical terms, however, there is still a gap in the implementation of these commitments in their financial processes.

Challenges in Identifying Added Value

4. Most social issues are not regarded within the financial sector as material to return on investment and are difficult to reliably quantify. This provides a substantial barrier to their integration into investment analysis and processes.
5. The different languages of financial analysis (quantitative) and human rights (qualitative), presents an obstacle to understanding the relevance of human rights to the sector. This perpetuates the perception of social indicators as not material.
6. Active engagement is the preferred approach for addressing social issues in investment practice. Except in rare cases, current practice does not appear to include benchmarks or address the issue of what to do when engagement does not produce desired results. There is a general lack of awareness about what happens and should happen when active engagement fails to improve the social performance of an asset.
7. The majority of financial sector actors have weak in-house capacity to integrate human rights information into their decision making, and there are strong trends towards the compartmentalisation of social and human rights issues in particular products and the outsourcing of management of these issues to service providers. A few leading institutions have independently developed methods for the integration of social issues in their decision-making.
8. Research providers are the main source of social information for the financial sector, offering self-similar methodologies that draw upon similar sources of information, (particularly companies themselves, industry reports, databases and publicly available data). They are essential actors to include in FS HRCA development.

The Need for a Targeted Assessment Tool

9. The actors that are most suited for a FS HRCA are universal banks or asset managers and owners, but other actors and asset classes in the field would also benefit from such an initiative.
10. The wide spectrum of financial actors and instruments will require different methodologies in a tool to measure human rights compliance.
11. A tool targeted at asset managers should emphasize the identification of human rights methodologies by asset class, and focus on best practice recommendations for active engagement.
12. A tool targeted at universal banks should follow the existing methodology for an industry-specific HRCA tool, focusing on internal practice and product/service lines.
13. The Global Reporting Initiative's Financial Services Sector Supplement (GRI FSSS) is the most widely endorsed reporting framework for social issues in the financial services sector, and can be adopted as the overall framework for a tool for universal banks.
14. For a universal bank tool to be effective, methodologies for assessing human rights risk for asset class will still need to be developed and integrated into its modules.
15. Universal banks are still reluctant to apply the 360 degree approach to human rights compliance that a FS HRCA tool would offer, due in part to a lack of awareness of the relevance of human rights issues to their operations. Addressing this gap is a crucial first step toward tool development.

These findings indicate a need to enter into dialogue with key financial sector actors, institutions and initiatives, in order to develop a shared understanding of the relevance of social issues to the sector and build a consensus about the way forward. Substantial work must be done by and with financial sector actors to identify how social risk, particularly human rights risk, can be translated into a format that is digestible to financial analysts. Finally, emphasis must be placed on developing methodologies that are specific to particular asset classes.

The recommendations and annexes in this document contain further details about how these findings can be taken forward.

INTRODUCTION

Why the financial sector?

Turning the human rights lens onto the operations of the financial services sector is much more challenging than it is in the context of traditional providers of goods and services. The financial sector is similar to other sectors in the sense that it provides services and products, but is different in that the sector's main activity is the management of capital, and provision of related goods and services. Yet unlike goods produced in most sectors, which have intrinsic value—such as food, vehicles, or buildings—financial products themselves have little intrinsic value in and of themselves until they are used by third parties in entirely different business processes. Financial actors and their products are to a great extent middlemen in the business world.

At the same time, it is undeniable that capital is the lifeblood of business processes and all material investments. Without provision of capital to actors who lack the cash outlay to fund business ventures, most business ventures and transactions would not take place. Neither the contribution of the business to society, in the form of enhanced welfare, nor the harm to society, through abuse of worker rights or environmental damage, would occur without the availability of financial services. Despite this fundamental enabling function of financial services, provision of capital has traditionally been regarded as a neutral act—'it's just business'— and quite different from directly manufacturing goods that can be used in ways that may involve human rights abuse.

The state of play

Nonetheless, the arm's length distancing of the sector from the impacts of investments is breaking down, eroding the strength of Milton Friedman's famous statement, 'the only business of business is business.'[1] Although it remains companies' responsibility to turn a profit and to bring the highest returns on capital, many stakeholders, including shareholders and the general public, expect that companies conduct their business in a sustainable manner, and even contribute to positive social outcomes.

Increasing stakeholder expectations of sustainability in business operations has been accompanied by the development of methodologies for measuring impact and sustainability. Along with the sustainability topics of environment and governance, social issues including human rights and labour have been propelled to the forefront during the past decade. Accompanying this movement has been the development of the means of measuring the impact and risks of human rights abuse in company operations. This has become an achievable objective for many types of business actors, with the emergence of tools such as the Human Rights Compliance Assessment by the Danish Institute for Human Rights and the Human Rights Matrix by the Business Leaders Initiative for Human Rights (BLIHR).[2]

Despite the availability of these tools, a persistent cluster of challenges form stumbling blocks for the financial sector's ability to recognise and measure their human rights impact, stemming from the nature of their products and role in business activities.

> The provision of capital has traditionally been regarded as a neutral act, and quite different from other services or products that can be used to directly abuse human rights

[1] Friedman expressed this statement in an article for the New York Times Magazine, September 13, 1970, with the title *The Social Responsibility of Business is to Increase its Profits*.

[2] This initiative is now known as the Global Business Initiative.

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First, financial sector actors are often several steps away from violations linked to the provision of financial services or capital. For example, the bank that funds an infrastructure project where workers' rights are systematically abused is unlikely to be directly involved in the management or implementation of the project. Another example could be if a teacher's pension fund purchases shares of a fund managed by an asset management company. That fund might be composed of different types of assets, one of which consists of shares in a global chemical manufacturer that produces an insecticide with a dual-use potential in chemical warfare, which can pose risk to human life. The pension fund might not be aware of the chain of ownership, and may not have the capacity to investigate the company's funds, and funds of funds.

Second, financial sector actors are varied and provide a wide range of services related to an equally wide range of assets. For example, private banks manage the wealth of individuals; investment banks raise capital, trade securities and manage corporate mergers and acquisitions; and retail banks serve individuals, investing their funds and providing them with loans. Some actors provide insurance to companies operating in conflict-plagued countries. Research providers may provide research or engagement services to banks. Some institutions perform some, or all, of these functions.

Financial companies find that each time they answer one question about human rights, another set of challenges arise, for which there is no easy solution.

Third, assets and the means of investing are likewise diverse, calling for an equally differentiated approach to human rights integration. Asset types include stocks, bonds, real estate and commodities. It is possible to invest in a much wider range of instruments, such as exchange, loans and derivatives, and additional possibilities for investment products are continuously being developed. Some activities, such as project finance and private equity investment, can be directly enriched by human rights impact assessment methodologies. Others, such as insurance, derivatives and bonds, do not include direct, undiluted links between investor and recipient, and must be approached in a different way to incorporate human rights principles and standards.

Financial companies that have made a human rights commitment find that each time they answer one question about human rights, another set of challenges arise, for which there is no easy solution. Take the example of a bank that purchases shares in a food company or provides insurance or other forms of financing that enable the company to conduct its operations. Onsite in a developing country, the food company may impoverish the local community by consuming most of the available water resources. In this scenario, the relationship of the financial institution to the human rights abuse could be described as one of complicity, and most observers would recommend that the financial institution take measures to ensure that abuses do not continue. Yet, how would a financial institution learn about this risk? Once risk is identified, should the finance company divest, or should it engage in dialogue with the food company? What principles, criteria, benchmarks and processes should the company apply in detecting and managing these risks?

In other investment scenarios, the relationship between the investment and the human rights abuse may be even more complex. Take the example of investment in state bonds in a country with weak human rights protections. Does investment strengthen the state's ability to violate human rights, calling for divestment? Or does it strengthen the state's ability to improve its performance, calling for investment to support that objective? Or, if an investor is considering purchasing shares of a forest, how would the investor assess the impact of its investment on the human rights of the local community that resides there? Consider a state pension fund, with ownership in a wide variety of assets. If the pension fund invests in a fund that is composed of mixed types of assets, such as bonds, stocks, infrastructure projects, and real estate, what is the pension fund's human right responsibility and how would it assess its human rights impact?

There is clearly a relationship between provision of capital and potential human rights abuses and violations. It is equally evident that human rights expertise and human rights methodologies must be brought to bear on the debate in the financial sector, as a means of developing a shared language and understanding of what it means to integrate human rights into the financial sector.

DIHR's research and analysis on human rights and the financial sector represents a first step in assessing the sector through a human rights lens. DIHR's human rights and business tool-building and application experience serve as a unique platform for driving the field forward.

This report is structured as follows:

- Section I describes the objective and methodology.
- Section II reviews the relationship and basic concepts in human rights and finance and presents an overview of the main initiatives in this debate
- Section III contains the findings and recommendations as emerged from the stakeholder consultation.
- Section IV contains the references and the annexes, including detailed mappings of ESG tools in the sector and descriptions of the HRCA.

SECTION 1
Objective and Methodology

Objective

The objective of this study was to identify the primary target group of users of a proposed tool intended to assess human rights compliance and risks in the financial sector - initially called the Financial Sector Human Rights Compliance Assessment tool (FS HRCA), develop a framework and methodology for such a tool, and identify a core group of committed industry stakeholders that would be able to take the project forward into tool development, testing and rollout in Phase 2.

To fulfil this objective, this study examined the social dimension of ESG (environmental, social, and governance factors) as is commonly applied in the sector, comprising human rights, labour, equality and diversity, health and safety in the workplace, human capital and community relations. At the outset of the team's work, the following questions were posed and have guided the analysis:

How are social issues identified and quantified by financial sector analysts and researchers?

How do financial actors incorporate extra-financial human rights information into their valuation processes, investment decision-making and post-investment actions related to investments?

What do analysts and investors need to further integrate social issues and human rights into analysis and decision-making?

What are the attitudes and level of interest among financial sector actors regarding the possibility and usefulness of integrating human rights issues into investment analysis and decision-making?

Methodology

The research was divided into two phases: a desk study and key informant interviews.

Desktop study

The team reviewed a wide range of financial sector documents to identify relevant issues and actors for inclusion in this study. This included a review of the work already performed related to the financial sector and human rights, and a systematic mapping of the sector, existing ESG initiatives in the sector and available tools.

Key informant interviews

The second step of the research was aimed at generating qualitative data through semi-structured interviews with key stakeholders in financial sector institutions. This method provided a forum for frank discussion with assurances of confidentiality to the informants, who included the employees of research institutions specialising in corporate social responsibility, socially responsible investment departments of international and Danish banks, and international organisations that are active in the coordination and promotion of ESG reporting and awareness. Key informants were chosen according to their relevance to the financial sector, their presence in international ESG-related sector forums and their willingness to participate in interviews.

Sixteen respondents agreed to share their experiences and insight through interviews and teleconferences. A basic model interview format was tailored to the profile of each informant (see Annex 2). Most of the institutions were located in Denmark and Switzerland, with the exception of a few located in the United Kingdom, and they represented a range of financial actors, including:

- *Five universal banks, composed of various divisions including private banking, asset management, and investment banking*
- *Two investment banks*
- *One pension fund*
- *One ethical bank*
- *Five research and consultancy providers*
- *One non-governmental organisation*
- *Two United Nations (UN) agencies*

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Limitations to the methodology are those typically associated with qualitative research. The sample was strategically selected and small, and the findings cannot necessarily be generalised to the entire financial sector.

Consulted stakeholders were provided with the opportunity to review the draft report, and they raised questions and provided detailed feedback, prompting the following additional observations:

- *This study involved the application of a human rights lens to the financial sector by human rights experts, and is not intended to substitute financial expertise.*
- *The report conclusions are mainly applicable to asset managers and owners and universal banks.*
- *This report reflects a deliberate decision to focus on the types of actors and assets that were determined to have a greater interest in enhancing their capacity to integrate human rights criteria.*

SECTION II
Overview of Social Initiatives and Criteria in the Finance Sector

This section summarizes current efforts to integrate social criteria into financial sector processes and analysis. Though efforts to integrate ESG issues into the financial sector are not new, the fundamental challenges have not yet been met. Even so, dialogue in the sector has mushroomed during the past decade, and it is useful to scan how the debate arose, and its actors, initiatives and tools, in order to identify potential steps forward.

Social responsibility initiatives in the financial sector

Public acceptance of the financial sector's denial of responsibility for the human rights impacts of their investments eroded during the 1970's, with the emergence of the socially responsible investment (SRI) movement as a part of European and North American investment strategies against social irresponsibility. Spearheading this movement were anti-apartheid activists who lobbied for companies and investors to withdraw their investments from companies with operations in South Africa. The Global Sullivan Principles (1977) consisted of 6 simple principles[3] comprising a code of conduct for companies with operations in South Africa. Activists sought to extend the reach of the divestment movement to institutional investors, advocating for such actors—including pension funds—to disinvest from direct investments in South African-based companies, and even further, from companies that owned assets in South-African based companies that had not adopted the principles. The divestment movement continued through the 1980's, and the experience developed during this period may be regarded as the springboard for the contemporary SRI movement.

SRI distinguishes itself from mainstream investment by the importance it places on linking capital provision and finance to long-term sustainable social and environmental goals. Also known as responsible investment,[4] SRI takes into account extra-financial considerations for the benefit of the shareholders and communities that may be impacted by the investment. An important assumption sustaining SRI is that financial instruments are intrinsically—albeit indirectly—connected to society and the environment, and that they have the potential to positively or negatively impact sustainable development outcomes. As the field has developed beyond the South African case and other specific contexts, SRI has incorporated a number of social issues as they have become widespread concerns, including the environment and corporate governance.[5]

Early SRI pioneers were ideologically motivated by social and environmental factors, and for many years were alone at the forefront,[6] but these groundbreakers have been joined by more mainstream financial sector proponents of SRI during recent years. Now mainstream financial actors are making greater efforts to push the field in the direction of identifying the positive impact of social and environmental factors on positive long-term financial performance[7], and some have taken steps to develop SRI products[8] or processes in some parts of their operations. Multilateral organisations in the United Nations, consultancy firms, human rights institutions and financial sector research providers have also become heavily engaged in the movement, joining financial institutions and social and political activists.

Financial instruments are intrinsically —albeit indirectly—connected to society and the environment, and they have the potential to positively or negatively impact sustainable development outcomes.

[3] Global Sullivan Principles. Accessed at http://muweb.marshall.edu/revleonsullivan/indexf.htm, 4 January 2010.

[4] Responsible Investment (RI) seems to be the term increasingly used to refer to SRI, as well as just ESG. We will use the acronyms SRI and ESG interchangeably throughout the report.

[5] Elias Bengtsson, *A history of Scandinavian Socially Responsible Investment*, Journal of Business Ethics (2008) Springer 2007, p. 970.

[6] Mercur Bank in Denmark was one of these pioneers in Denmark, establishing operations in 1982.

[7] Not all stakeholders in the sector agree that long-term social and environmental factors have been proven to improve financial performance. A significant deal of recent CSR research has focused on demonstrating the positive link between responsible investment and performance, but positive consensus has not been established, particularly among researchers whose focus is more financial rather than social. However, it appears to be generally accepted that SRI funds neither outperform nor underperform ordinary funds.

[8] The field is growing both in terms of total funds, at more than US2 trillion in SRI investments worldwide Eurosif, *European SRI Study 2008*. The report estimates the total volume of assets under SRI options as 4963 billions, distributed mainly between Europe (53%), the USA (39%) and the rest of the world (8%).

ESG integration: Two fundamental challenges

SRI has moved forward in the range of issues addressed and the strategies for addressing them since the anti-apartheid movement. Financial actors no longer constrain themselves to the options of investment or disinvestment, and many have adopted systems and processes for identifying human rights risk and following up with investments that pose risks to the human rights of workers and local communities. The financial sector has also seized the initiative to identify where human rights can be integrated into the fundamental processes in investment analysis and decision making. In this area, the sector has defined its own challenges.

The financial sector has seized the initiative to identify where human rights can be integrated into the fundamental processes in investment analysis and decision making.

According to the stakeholders interviewed, SRI faces two major challenges. The first is how social issues should be integrated into asset valuation, if at all. Key questions are: which social issues should be deemed material, can they be quantified, and what bearing should the social issues have on asset valuation?

The second challenge is how social criteria can be integrated into the investment processes of a wide range of financial actors. Efforts to meet this challenge explore how social issues should be addressed in the investment process from start to finish, from the point of identifying an asset that might be an attractive investment, through to how an investor or asset manager communicates, monitors, and follows up with the asset related to its impact and performance *vis à vis* social issues.

Financial institutions have been actively tackling these challenges. The ongoing efforts to address the first challenge, one of financial valuation challenge, pose the question of how to integrate material extra-financial information into financial valuation calculations, or 'fundamental research'.

Some of these terms are the bread and butter of financial analysts, but require some explanation to other audiences. *Fundamental research* is the process by which the value of a prospective asset is determined. Data enters into the fundamental research equation if it is considered to be material, i.e. if it can affect the financial returns of an asset beyond a minimum threshold. Data is broken down into categories including financial and *extra-financial* distinctions. A great deal of extra-financial data consists of 'intangible' issues, which are unquantifiable costs related to identifiable sources. When these are expected to positively impact value, they have also been defined as *'non-physical factors that contribute to or are used in producing goods or providing services, or that are expected to generate future productive benefits for the individuals or firms that control the use of those factors'*.[9] Many social issues are little understood, and are hard to quantify, and thus suffer the fate of being labelled as not only intangible, but also as not -material, and thus marginally relevant or irrelevant to the valuation process.

A coordinated effort to enhance research and analytical interest in extra-financial data was spearheaded by the Enhanced Analytics Initiative (EAI), established in 2004, and is described in more detail below. The EAI was the first project explicitly aimed at rewarding financial professionals for doing 'enhanced' financial research that took extra-financial issues into account.[10] This network of institutional investors and asset managers built up a system of incentives to stimulate and promote fundamental research by research providers and brokerage houses, and significantly contributed to the birth of specialized service providers focusing only on extra-financial research. Progress has been made related to a range of extra-financial information such as corporate governance and environment, but identifying how social issues can be integrated into the valuation process remains elusive.

[9] Business for Social Responsibility, *Business brief: Intangibles and CSR*, Allen White, February 2006.

[10] Ivo Knoepfel, Gordon Hagart, *Research centre stage: Four years of the Enhanced Analytics Initiative*, Zurich, December 2008.

The second challenge, the question of how social criteria can be incorporated into investment decision-making and risk management processes, flowed naturally from the disinvestment movement in the 1970's and 1980's, and has progressed a great deal since that time. Screening and active engagement practices comprise the main two types of strategies used by financial institutions, which apply screening filters to build SRI portfolios. Through *negative screening*, certain types of stocks are screened out of the potential investment pool (for example the so-called 'sin stocks' of tobacco, gambling or weapons), and *positive screening* seeks to include the best-in-class companies rated for positive social or environmental practices. *Active engagement* practices are the second type of strategy, in which an investor or a group of investors use their influence to improve or maintain the ESG performance of an investment.

The question of how to incorporate ESG criteria into the full range of investment processes was addressed in the early 2000's by the Who Cares Wins initiative, and these efforts have maintained a good deal of momentum, even through the recent financial crisis.[11] The Who Cares Wins initiative was established in order to develop guidelines and recommendations for improving the integration of ESG issues into asset management, securities brokerage services and associated research functions. A wide range of financial actors participated in this forum for analysts, investment and asset managers, regulators and governments, NGOs, consultants, companies and institutional agencies, and the scope of work pursued by participants included the integration of ESG into both fundamental research and the full range of investment processes. Participants in the Who Cares Wins Initiative focused on asset screening methods and also the practice of active engagement. After the Who Cares Wins Initiative ended in 2008[12], the hosting of this discussion and research forum was continued by the United Nations Principles for Responsible Investment (UN-PRI)[13] Initiative, a partnership between the UN Global Compact[14] and the UN Environmental Programme Financial Initiative (UNEP FI).

Major SRI Initiatives

A great number of visible financial sector actors increasingly acknowledge the significance of ESG factors. A survey conducted under the direction of the UN Special Representative of the Secretary-General on Human Rights and Transnational Corporations and other Business Enterprises Professor John Ruggie and the Corporate Social Responsibility Centre at Harvard University, which was aimed at researching the recognition of human rights by multinational companies, including financial actors, revealed positive attitudes by financial institutions toward the issue.[15] Although SRI funds are still the front-runners in supporting integration of human rights into the financial sector, other financial institutions increasingly commit to respect labour rights, community engagement and indigenous peoples' rights in their capital flows. The main means of engaging is by joining multistakeholder initiatives. The most active actors have been researchers, consultancies[16] and international organisations, all of which have generated reports, new valuation and assessment frameworks and further evidence for the impact of non-financials on value and price.[17] The main forums and frameworks for advancing the field include:

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[11] *Investing for Long-Term Value. Integrating environmental, social and governance value drivers in asset management and financial research—A state of the art assessment*, Conference Report, onValues, Zurich October 2005, p.2.

[12] The initiative started in 2004 and was completed in 2008. See UNGC Financial Markets, accessed on 5 January 2010.

[13] See: www.unpri.org

[14] The United Nations Global Compact is a voluntary initiative launched by the then Secretary-General Kofi Annan, to promote business action and responsibility in the fields of human rights, labour, environment and anti-corruption. See: www.unglobalcompact.org

[15] Wright M., Lehr A., *Business recognition of human rights: global patterns, regional and sectoral variations*, a study conducted under the direction of John G. Ruggie, Harvard University, 2006.

[16] See for instance: KPGM, *International Survey of Corporate Responsibility Reporting 2008*, Wim Bartels, Amstelveen 2008; KDL Research and Analytics, *Environmental, Social and Governance Ratings Criteria 2007*.
SOCRATES The social ratings monitor, 2007; and UNEP FI Asset Management Working Group and Mercer Investment Consulting, *Demystifying Responsible Investment Performance. A review of key academic and broker research on ESG factors*, October 2007. It is interesting to notice the absence of major social issues or topic reported and re searched, besides very few exceptions.

[17] Among others, Ivo Knoepfel, Gordon Hagart, *cares Wins, Future Proof? Embedding environmental, social and governance issues in investment markets* onValues Ltd, Zurich January 2009Who; UNEP FI, *Show me the money. Linking environmental, social and governance issues to company value*, UNEP FI Asset Management Working Group, Geneva 2006.

Integration of social issues has advanced furthest in project finance and corporate investment, but making inroads into other types of finance continues to be challenging.

1. *The UN Principles of Responsible Investment (UNPRI)*. These are a set of voluntary principles, endorsed by signatories in the financial sector, which commit their institutions to integrating ESG issues into all aspects of their operations. Institutional investors are the primary target group, and the initiative provides both a framework and a forum (the UNPRI Clearinghouse) for investors to guide their efforts toward integration of ESG in their decision-making and share experiences in the field. The initiative also includes knowledge sharing and learning portals, including the Enhanced Research Portal, a special database of cutting-edge financial and non-financial research which is available to signatories only.
2. *The United Nations Environmental Programme Financial Initiative (UNEP FI)*. This is a leading provider of reports, information and guidance tools for investment actors. UNEP FI has focused on sector research and thematic working groups (e.g. the Human Rights Working Group, the Asset Management Working Group), and leads the debate on environmental and governance reporting. It has also stressed the importance of human rights in the banking sector. An additional notable contribution by UNEP FI has been the Human Rights Toolkit, an online tool intended for use by lenders in assessing the human rights risks in lending practices.[18]
3. *The Equator Principles*. These are a set of principles promoted by the International Finance Corporation and the World Bank, which target one financial instrument, project finance, and set minimum standards for human rights, transparency and environmental compliance of investment ventures in developing countries.
4. *The Global Reporting Initiative (GRI)*. This initiative has been the frontrunner in setting the standard for corporate reporting and transparency, by providing businesses with a model of full disclosure, which also represents a great contribution to enhanced investment analytics. The GRI recently established the Financial Services Sector Supplement (GRI FSSS), a set of sustainability reporting guidelines adapted to the financial sector.
5. Regional initiatives that have been particularly relevant in the debate include the European Social Investment Forum), the European Federation of Financial Analysts, the UK Social Investment Forum and the recently launched Danish Social Investment Forum. Other institutional initiatives include the Investors Group on Climate Change, the International Corporate Governance Network, the Coalition for Environmentally Responsible Economies, and the Nordic Engagement Cooperation.

Additionally, a number of investor, fund and manager networks, including extra-financial research providers, gather support and raise awareness on general or specific ESG issues.

To an observer with little knowledge of the financial sector, the initiatives above may appear adequate, but they only cover small sections of the sector, and efforts are still nascent in most areas. The asset classes and financial instruments that are least understandable to the layman, such as insurance, derivatives, and bonds, are not visible, while those that are most understandable, such as project finance, are best covered by tools and initiatives. There has been a tendency to focus on large project finance and corporate investment. For example, the needs of project finance are addressed by the Equator Principles and the UNEP FI Human Rights Work Stream tool for project planning for environmental and human rights compliance. Making inroads into other types of finance, such as investment banking and structured products however, has not been well addressed. Moreover, recent research has revealed that some of the critical players within financial institutions such as managers and analysts are slower to be convinced as to the potential and value for integrating ESG into their work.

[18] See: http://www.unepfi.org/humanrightstoolkit/, accessed on 5 January 2010.

[19] The human rights community has contested the extent to which the Equator Principles adequately cover the sector's needs in human rights, but for the purpose of this discussion—the broader financial sector - the Equa tor Principles can be regarded as a frontronner in the field.

[20] See for example: ECCE, *Use of Extra-Financial Information by Research Analysts and Investment Managers*, William Jawor ski, March 2007; and Hummels Harry, Woodv David, *Knowing the Price but also the Value?* Financial Analysts on social, ethical and environmental information, with PriceWaterhouseCoopers. Boston College, September 2005.

HUMAN RIGHTS AFFECTED BY BUSINESS

The Special Representative to the Secretary-General on Human Rights and Transnational Corporations and other Business Enterprises John Ruggie has highlighted how businesses can impact the whole range of human rights, through their operations and presence. These include:

- Labour rights (the rights to non-discrimination, safe work environment, freedom of association, minimum wage, rest, leisure, family life, and freedom from forced labour and child labour)
- Civil and political rights (the rights to life and security of person, fair trial, freedom from torture and other degrading treatment, privacy, freedom of expression, self-determination and the rights of indigenous peoples)
- Economic, cultural and social rights (rights to social security, education, physical and mental health, participation in cultural life and benefits of scientific progress, food, clothing, housing and the right to development)

The full spectrum of human rights is relevant in the business context.

Human rights concepts and financial actors

Before taking the next step forward into the world of social issues and the financial sector, we will take a closer look at field of human rights. A clear grasp on human rights concepts is essential for understanding why it is more difficult to identify a means of integrating human rights into the financial sector than it has been in other sectors such as the extractive sector or food and agriculture.

Key human rights concepts

Human rights, including labour rights,[21] are based on an extensive body of international legal instruments, institutions and multistakeholder initiatives. Human rights are universal. All people have human rights, irrespective of their location, ethnic or religious origin or any other distinguishing characteristic. In the business context some rights and issues typically receive more attention than others, particularly freedom from forced labour, freedom from child labour and the rights of indigenous peoples. Despite the popular focus on particular issues, the full spectrum of human rights is relevant in the context of business.

Human rights law is traditionally divided into *civil and political rights*, which refer to civil liberties, participation in governance, the right to a remedy and bodily security, and *economic, social and cultural rights*, which are understood to encompass basic needs, labour rights and cultural practices. These rights overlap in a number of ways, and are both indivisible and interdependent, meaning that no one human right can be fully enjoyed in the absence of the enjoyment of others. Numerous areas of human rights law have been elaborated further in specialized international conventions and declarations, such as the Convention on the Rights of the Child and the Convention on Migrant Workers and Members of Their Families.[22]

All persons should live free from acts and omissions of other societal actors that interfere with the enjoyment of their human rights. Such acts or omissions are called *violations* or *abuses*, with violations being breaches of human rights by the state, and abuses being breaches of human rights by all non-state actors such as companies and individuals. The state is the primary bearer of the duty to protect the human rights of individuals. The most important or foundational of the state's duties is arguably the integration of human rights conventions into national law and regulation, policy and practice. It is also incumbent upon the state to take active measures to develop policy, reform laws, establish institutions and services and intervene to protect persons from abuses or violations by third parties.

The Company Duty to Respect

The human rights framework identifies all actors as 'rights-holders' and 'duty-bearers', and endows all humans with both rights and duties. Under national law or regulation, companies may have legal personality and some legal entitlements, but they do not possess human rights as such. On the other hand, the individuals who work for companies do.

Although only people have human rights, each person, group, organisation and institution, including companies, has the duty to respect human rights. Respecting human rights means *not interfering* with the human rights of others, who may include employees, local community members or any other people who are affected by company activities. In short, businesses must 'do no harm'. The duty to respect rights has traditionally been conceptualized negatively—all actors must not interfere with the human rights of others. However, respecting human rights does not just mean avoiding harm to human rights—companies must take active steps to identify, prevent, and address human rights abuses by implementing adequate *due diligence* processes in company operations.

[21] For the purpose of this report, the term 'human rights' shall be understood to include labour rights.

[22] International conventions are also known as treaties, or agreements between states at the international level. Declarations are non-binding international instruments that contain statements of principles and intentions, which in human rights law are usually a step preceding the negotiation of a binding convention.

Due diligence processes consist of the range of positive measures required to identify, prevent, and mitigate human rights abuses in business operations.[23] The precise content of due diligence, or the exact steps the company manager must take, depends on the company and the challenges that the company faces. At a minimum, due diligence should include actions such as adopting policies, carrying out impact assessments, integrating policies into work processes, and monitoring and auditing performance.

Respecting human rights does not just mean doing no harm. Companies must take active steps to identify, prevent, and address human rights abuses by implementing adequate due diligence processes in their operations.

Respecting the labour rights of employees, for example, requires taking a number of positive steps, including monitoring working hours and management practices to ensure that labour is not compelled. Companies are obligated to create and implement systems to check the age of job applicants to prevent child labour, and must provide workers with protective gear and avoid using certain types of poisonous chemicals that could impact workers' right to health. These actions, yet they form vital components of the company duty to respect rights.

It is also essential to understand that business has two types of responsibilities for human rights abuses or violations: *direct responsibility* and *complicity*. Direct responsibility includes the abuses caused by a company's own actions. Complicity is the responsibility companies have when third parties with whom they have relationships, such as suppliers, the state, contractors, or joint venture partners, abuse or violate human rights in activities related to company operations. A company may be complicit if it assists, endorses, or encourages the abuse or violation, or if it knows about the violation or ought have known about the violation, but does not take measures to prevent, stop, or mitigate the violation.

The governance gap

At the heart of the obstacles to human rights implementation is a governance gap - the fact that many states fail to integrate human rights law into their policy, law and practice. If national policy, law and practice do not measure up to the standards and principles of human rights law, companies may need to create their own system to identify their human rights obligations and take due diligence measures to fulfil them. In the worst case, the company may choose to refrain from investing, after evaluating whether it is able to engage in business operations in the state at all without directly abusing human rights. For example, if women are not legally allowed to work, or if they are not permitted by law to work in the company of men, companies may abuse human rights simply by following local law and regulation. Addressing this implementation gap by the state often presents the main challenge for businesses.

The second challenge that companies face is that they may be complicit in violations or abuses of human rights, either by the state or other parties, such as suppliers. For example, if the state evicts indigenous people from their traditional land without obtaining free, prior and informed consent, and the company, knowingly or without adequate due diligence, purchases and uses the land in its operations, the company may be said to be complicit in the state's violation. Similarly, companies that source goods or services from suppliers that use child or forced labour may be complicit in such abuses if the company did not take adequate measures to manage the supplier relationship and identify, prevent and mitigate abuses.

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[23] This is referred to as the Ruggie Framework, from the *Report of the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises, presented by Professor John Ruggie, April 2008.*

All companies whose operations directly impact their own personnel or local communities run the risk, however small, of abusing human rights directly or through complicity in state violations.[24] This risk can be identified, prevented or mitigated by taking extra care in due diligence processes through the use of human rights compliance assessment or impact assessment tools, such as the HRCA.

Where the human rights and financial worlds meet

Retail banks are the financial business operations that most closely resemble the kinds of operations described above, but the lion's share of financial services are provided by financial actors to other companies who then engage in business activities so that the human rights risks are found somewhere down the business chain. Thus the human rights and financial worlds meet, to a great extent, in the zone of complicity, where the financial services supplier potentially enables other business activities that abuse human rights. The argument is simple: if capital contributes to the establishment of company operations, business ventures or production processes in which the rights of communities and workers are abused, and cushions against losses threatened by risk, including human rights risk, then it is potentially complicit in those abuses. A second type of enabling link arises where capital and financial services are provided to companies or industries that exist to serve or reap the benefits from other industries or operations that are heavily engaged in activities that abuse human rights.

> The human rights and financial worlds meet in the zone of complicity, where the financial services potentially enable other business activities that abuse human rights.

Two examples of these enabling links are presented in illustrative brief case studies in Annex 6. Consider a historical example, the transatlantic slave trade from the 1600-1800's, and its partner industries, shipping and sugar. This example was selected owing to the rich and emerging documentation availed by financial actors themselves, and due to the financial instruments used to support the trade, which continues to be relevant in today's financial practices. Financial actors provided credit, maritime and other insurance and trustee services to sugar and weapons merchants, shipbuilders, and other business actors engaged in the complex mosaic of the 'Triangular trade'. The second case study presents the modern example of coltan extraction in the eastern Democratic Republic of Congo (DRC), and the transport, processing and electronics industries that profit from those resources. A growing percentage of the world's coltan supply is sourced from the DRC, where armies and militias have warred to control this and other commodities. In this case financial institutions provide credit and other financial services to transport companies and coltan processors that transport and refine the raw materials. In both of these examples, fundamental human rights violations are intricately linked to a range of interlinked businesses, all of which are supported and enabled by financial services.

How provision of finance can fuel conflict, and how some private banks have invested or laundered wealth amassed by heads of state alleged to have participated in war crimes, has also been analysed in a number of publications.[25] But it must be kept in mind that human rights are at risk in situations of both conflict and peace, and the full range of human rights is relevant. The enabling link between financial service provision and abuse of human rights becomes most visible in situations of extreme conflict, but the relationship is present in a wide variety of industries and scenarios. For example, the Norwegian Government Pension Fund disinvested from Walmart, a US based retailer, due in part to abuses of labour rights and discrimination against female employees in the United States. These were systematic abuses taking place in a highly developed country with no significant internal conflict.

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[24] Companies, multinationals, SMEs are by definition producers, manufacturers, creators of a final product. The production process involves a series of physical acts, performed in several locations, in which the rights of human beings, communities and workers might be affected and violated. In this sense a company has direct responsibility within the entire course of its operations for the implementation of sound human rights policies, environmental preservation or damage, and good governance.

[25] See: UNEP FI, *Investing in Stability: Conflict Risk, Markets and the Bottom-Line*, Mareike Hussels, Geneva 2004.

A mapping of actors and assets

With these perspectives in mind, we turn to the task at hand—exploring the possibilities for integrating human rights criteria into financial sector processes. An appreciation of the variety and range of actors and institutions in the financial sector is essential for assessing the potential and feasibility of developing an FS HRCA tool. Each financial sector actor works with different processes and products. Treating diverse financial actors as part of the same group would result in findings that would be questioned by the proposed users of the tools. Thus it is essential to identify investors' and other actors' demands and needs, and tailor the frame of reference and language to each type of actor.

As part of the team's preliminary findings, it was decided to target investors with a *long-term-only approach*. The existing research and ESG literature and initiatives are created by and for long-term investors.[27] Long-term investors, whether pension funds, investment funds, asset owners or managers, are different from *transactional* investors[28] because their policies and processes incorporate a long term vision of investments and their impacts. Investors with long-term strategies—sustainability and vision incorporated into the whole set of assets and interlinked investments[29] —have the greatest potential for a comprehensive ESG strategy, because it is in their interest as owners and managers to incorporate any relevant factor affecting long-term performance, so as to fulfil their investment mandates.

Pension funds, sovereign wealth and mutual funds, asset managers and owners, investment firms, banking institutions in their asset management, and investment and private banking branches, generally fall within this category. The research also shows that banks and investment management have made the most significant progress in this field, and their structure and work allows for better ESG integration, understanding and operationalisation. Institutions such as research *providers, extra-financial service providers, indices or rating agencies* are also relevant actors in the dialogue about developing an FS HRCA,[30] because they possess the industry information and, in many cases, competency in social issues as well.

Large banks are active in a wide range of industry service and product areas. '*Universal banks*' cover a wide range of banking functions, including traditional activities, such as lending, deposits and retail banking, and other operations, including insurance and pension provision, asset management, private banking and wealth management. Their role as capital provider is particularly important for society. The majority of banks engage in project finance and corporate banking schemes. These also include asset management through bank-branded investment funds.

In contrast to universal banks, *asset management* through funds, including *mutual, investment and pension funds*, has a more definite scope, and these assets are established and administered according to an investment prospectus or mandate. The primary aim of the prospectus or mandate is to guarantee maximum capital return to members and investors. The key distinction between asset management and banking is that asset management focuses on ownership of investment, typically through equities and a significant engagement in the capital markets. Fund managers are concerned about assuring longer maturity to the capital invested; therefore they preferably invest in fixed-income assets and projects with a long return on capital and equity.

A great deal of asset management is a long-term affair, and therefore asset managers have an interest in thorough research and analysis about the value of assets before they invest or provide credit to them. Mainstreaming extra-financial issues into all institutions has become a strategic aspect of data and investment research management, together with branding and reputation issues.

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[26] *Norway dumps Walmart Stock,06.06.06*, http://www.aftenposten.no/english/business/article1341741.ece. Accessed on 5 February 2010.

[27] Accountability, *Mainstreaming Responsible Investment*, in collaboration with the World Economic Forum, Simon Zadeck et al., Geneva January 2005.

[28] Investors with a short-term trading strategy centred on short-term maximization of profits and revenue through structured financial transactions. Zadeck et al., Ibidem, p. 19.

[29] Zadeck et al., Ibidem, p. 21.

[30] The recent Who Cares Wins report, *Future Proof?*, applies the paradigm we are acknowledging, dividing the relevant actors in Asset Owners, Asset Managers, Research Consultants, Data Providers and Rating Agencies.

Actors and assets such as *hedge funds, brokerage houses, insurance, derivatives, private equity and variable income investments* have proved difficult to include in the present analysis. Hedge funds involve a great deal of short-term products, and the actors and the assets are not compatible with long-term only thinking. Structured finance, built on a series of complex intermediate operations linking one asset to multiple others, to future dividends, or to funds of funds, makes it difficult to create a feasible methodology that includes social concerns, considered not to be significant to valuation. The high frequency of transactions and the volatility of these assets also make long-term thinking irrelevant. Moreover, it is a considerable challenge to track financial operations and movements of capital which may span several territorial sites and pass through various financial entities, especially considering operations with private equity. For these reasons, this survey focuses on long-term-only actors and assets.

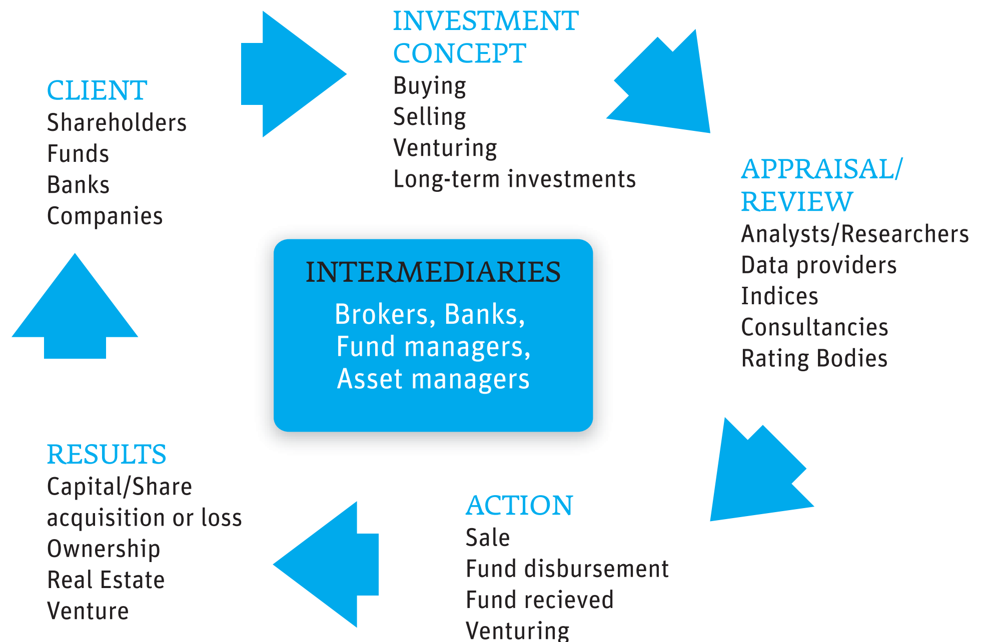
ESG: strengthening the link

In order to understand the investment process, link it to it social responsibility, and identify the right entry points for social criteria, we must look at the investment value chain, and all the steps and actors involved in it. Thereafter we will describe the possibilities of ESG integration.

The mechanics and logic of investment valuation and decision-making

An investment is a process involving numerous stakeholders: companies, financial intermediaries and institutions and national and international regulators. Clients and managers are involved in the first stage of the investment process, at the point when proposals for investment are made. Analysts and researchers apply the principles of due diligence in gathering information about the investment, carry out financial research, and collect information from indices, rating agencies and professional consultancies if needed. This part of the chain builds up the financial and material arguments that support the value of the asset, which are translated into financial calculations that take into account the return on investment and incorporate risk into the valuation. After proper appraisal, managers or owners, sometimes assisted by specialized consultants, make a judgment about the investment and take concrete action—selling, buying, divesting or investing. The results of the decision are returns or losses on the capital investment to the gain or loss of the share or capital owner. This process is not linear as it might sound, because a number of interlinked actions take place before and after each step and many actions are delegated to third party professionals who carry on the due diligence processes or take action on behalf of owners and managers.

The actors in this process can be represented by the chart as follows:



This graphic incorporates elements of Accountability, Mainstreaming Responsible Investment, in collaboration with the World Economic Forum, Simon Zadeck et al., Geneva January 2005, p. 29.

> For social indicators to be identified and incorporated throughout the investment cycle, they must be regarded as having relevance in the same way that economic indicators do.

When applying ESG to the investment value chain, two main findings emerge. First and foremost, the determination of what is material appears to be the greatest methodological challenge to integration of social factors: she or he who determines what is material is the most powerful actor in the inclusion of social issues into the valuation process. Second, enhancing the inclusion of material ESG factors in the investment will only benefit investment decision-making, and is entirely consistent with fiduciary duty.

The pivotal concept of materiality

The valuation process determines the value of an asset (the price of a stock, or the estimated value and future earnings of investment projects), and determination of materiality is the door to that process. If a fact or issue is perceived to affect return on investment beyond a certain threshold, it is considered material and is factored into the valuation process. The practice of materiality identification is based on mainstream financial indicators of risk and opportunity, which are usually defined by quantitative figures.

The materiality of ESG is pivotal to its integration into financial sector analyses and tools. For social indicators to be identified and incorporated throughout the investment cycle, they must be regarded as having relevance in the same way that economic indicators do. Financial sector actors perceive materiality to be very clear-cut and even scientific, but the concept and its application in the financial sector are circular: factors become material when enough people perceive them to be material.[31]

[31] Zadeck et al., Ibidem, p. 24. This statement has also been a recurrent assertion during interviews with stakeholders.

THE CHALLENGE OF THE MATERIALITY CONCEPT IN BRIEF

The human rights framework starts from a universal perspective in which rights and duties, and the possibility of violations and abuses, are potentially relevant in all areas of human activity, whether the link to a violation is direct or indirect. The basic assumption is that human rights are pertinent wherever rights holders are potentially impacted.

The financial analysis framework isolates its definition of relevance to only those issues that are currently perceived by a narrow group of individuals (researchers and financial analysts, primarily) as affecting returns on an investment above a certain threshold.

Several factors operate as obstacles to the perception of relevance, including the understanding of social issues and their impact generally, gaps in information and the challenge of quantifying qualitative incident-based information for easier digestion. Moreover, the threshold is a boundary for otherwise relevant issues to enter the analysis. The basic assumption is not relevant unless first proven materially relevant.

Interpretation of material issues does not happen in a vacuum. It is built upon the evolution of economic and social factors, and encompasses issues considered relevant at the time of the valuation. It follows that value is in part determined before the actual calculations are made, by the a priori decision about what is relevant.

The frequent shifts in the assessed value of assets demonstrate that what builds value is not only what is tangible or quantifiable, but also intangible. 'Intangibles' are *'non-physical factors that contribute to or are used in producing goods or providing services, or that are expected to generate future productive benefits for the individuals or firms that control the use of those factors'*.[32] Some intangibles typically considered material by analysts are innovation, branding and human and organisational capital.

In the field of CSR and SRI, the 'intangible' factors are the environmental, social and governance variables likely to impact current operations and future sustainability, and which affect share value by posing a risk or opportunity. Understanding how these factors link to the value of assets is essential to making the case for their materiality. The value drivers that most closely link to environmental, social and governance issues are risk and cost structures as well as reputation and branding.

Risk

Risk is a concept central to finance, as investments are in great part determined according to financial and return risk evaluation. Non-financial risk is an evolution of the same concept, but it is harder to quantify and is often merged into topics such as country or political risk. These new elements are new forms of already existing risk categories[33] that exist to incorporate risk into cost predictions and structures.

Some ESG factors that were not perceived as risks two decades ago are now systematically integrated into asset valuation today. For example, pollution has only recently become quantifiable, and companies have developed methods of demonstrating their performance in this area through carbon emission measurement and reporting, and company 'green' strategies. Increased regulation of CSR and the environment has also contributed to the acknowledgement of these intangibles as material, because economic fees and regulatory initiatives can cause the depreciation of value and lead to the fluctuation of share price. Another example is where tighter anti-corruption measures have been taken. In these examples, legal regulation, new methodologies or technical possibilities thrust an issue that was previously not perceived to be risky into the zone of concrete risk, and in this way these issues became material. The factor that changed was not the pollution or the corruption, but rather the interest, will, and possibly the tools for measurement of risk. This broadening of financial sector understanding of material risk factors demonstrates that social factors, generally still not regarded as material, can be incorporated into the valuation process in the future.

Brand value

Reputation and branding are other drivers of materiality, and could propel social issues into the spotlight. A brand is not only the image the company or investors send to their shareholders and society, but rather is the image society independently builds based on factors not always under the company's control. For example, unexpected reputational scandals have emerged as a result of independent civil society movements. Companies rarely have the luxury of overlooking reputational damage, as it can directly affect share price through litigation costs and loss of customers. Institutions with a national or public mandate such as national pension funds have the potential to be particularly vulnerable to social issues that impact their reputation, because the public may be obliged to contribute to such funds, and also may have higher expectations of such institutions.

[32] Business for Social Responsibility, *Business brief: Intangibles and CSR*, Allen White, February 2006.

[33] Centre for Financial Market Integrity, *Environmental, Social, and Governance Factors at Listed Companies. A manual for investors*, 2008.

VALUES ADDED: THE CHALLENGE OF INTEGRATING HUMAN RIGHTS INTO THE FINANCIAL SECTOR © DANISH INSTITUTE FOR HUMAN RIGHTS 2010

Especially in the case of publicly listed companies, reputation is intangible and investors recognize its relevance. Social factors appear to be the most feared reputational risk, as they garner a great deal of public attention and are 'sticky', meaning that any reputational damage is hard to repair. It is clear from interviews and research that when companies care about their brand and price, they care about being labelled as responsible and being placed on SRI indices and portfolios. Expanding the reach of SRI inclusion has great potential from this perspective.

Financial analysts and the materiality of social information

The work of analysts is the foundation of the investment process. Analysts translate information and research into an appraisal, which acts as a recommendation for an investor to accept or decline an investment proposal. Analysts work in specialized teams within financial institutions or external consultancies, and typically work with financial information and apply financial modelling and corporate strategy and industry analysis techniques to estimate the value of assets. Financial analysis may take place in a variety of institutions, and analysts may be employed by sell-side research houses, in-house financial institutions, brokerage houses or rating agencies.

Most analysts are aware of extra-financial factors, especially from a risk perspective, but most are not trained in social issues, and many organisations are reluctant to invest in capacity building or improving the competencies of their analysts.

With this key role in the determination of materiality, analysts pose both the challenge and the key to ESG integration. The materiality of social issues is often overlooked unless it is presented in familiar packaging as a potential impact on an asset's value. As a result, social issues are understood superficially, if at all, and are frequently marginalized.[34] Moreover, many analysts are incentivized to look at short-term risks and opportunities, and to meet only the demand for strictly numerical risk evaluations.

Only recently have analysts been subject to the growing demand for incorporation of qualitative ESG information. However, surveys and reports reveal that even when it is commissioned, ESG analysis may be treated only superficially by mainstream financial teams.[35] Many extra-financial issues are bundled into the label of 'political risk',[36] and might reach valuations only at a generic level.[37] 'Interpretive costs', the resources required for internalizing and factorizing this kind of extra-financial research and risk elaboration, then present another obstacle.[38] Most analysts are aware of extra-financial factors, especially from a risk perspective, but most are not trained in social issues, and many organisations are reluctant to invest in capacity building or improving the competencies of their analysts. This casts doubt on the thoroughness and accuracy of integration of extra-financial social information into the financial analysis process.

Indeed, it is not only the analysts that have gaps in their understanding of social issues. Most institutions that work with ESG issues group them into a 'social investment and responsibility' category. Social issues may include human rights, labour rights, workplace conditions, community relations, emerging and developing countries issues, civil society pressures, animal welfare, diversity, genetically modified organisms, living wage, political contributions and corruption, political risk and sexual harassment. Some actors include community investing in this understanding, but since it resembles philanthropy rather than corporate responsibility, it is excluded from our definition. The priority that actors assign to each topic varies widely. Social issues considered 'local' are preferred to international or external ones. Unsurprisingly, the most tangible issues identified in the financial sector are those that are closest to project operations, such as workplace health and safety, diversity and financial literacy.[39]

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[34] UNEP FI and World Business Council for Sustainable Development's Young Management Team, *Generation Lost: Young financial analysts and environmental, social and governance issues*, Geneva 2004.

[35] See: ECCE, *Use of Extra-Financial Information by Research Analysts and Investment Managers*, William Jaworski, March 2007.

[36] Hummels and Wood, with PricewaterhouseCoopers, *Knowing the Price but also the Value? Financial Analysts on social, ethical and environmental information*, Boston College September 2005.

[37] Hummels and Wood, with PricewaterhouseCoopers, *Knowing the Price but also the Value? Financial Analysts on social, ethical and environmental information*, Boston College September 2005.

[38] Zadeck et al., Ibidem.

Specialized non-broker research providers in Europe and North America have emerged as key informants of social information in the investment process, filling the gap left by their counterparts in financial institutions.

Finally, even when social issues are successfully identified and information is sought and used by financial actors, the quality of the data is often questionable. Media and civil society reports about company social performance may not be accurate, even-handed or verified by neutral or independent sources. If the financial world cannot rely on systematic and high-quality information, its value to the integration of human rights into analysis will be questionable.[40]

These factors combined may have the impact that when social information does enter into the materiality calculation, the quality of that information may not be high and it may be filtered by the media, or other priorities rather than a systematic human rights based analysis. All in all, the way social issues are currently handled undermines the effectiveness of investment analytics, which claims that no analysis is valid without taking into account all information that is relevant to creating an informed judgment.

Because part of the analytics industry has lagged behind, many specialized non-broker research providers in Europe and North America have emerged as key informants of the investment process, filling the gap left by their counterparts in financial institutions. These providers—EIRIS, RiskMetrics and Ethix, to name a few—meet the need for qualitative data identification and management, and sell enriched analysis to financial institutions. Methodologies of extra-financial research vary, and come in the form of narrative tools and guidelines, sophisticated portfolio management and screening tools, banking industry analytics and indices. However, even these experts may lack quality data relating to human rights, because, as the present study consistently identified, the sources of information are publicly available information usually sourced through the internet. Annex 3 presents a detailed outline of the tools and analytical instruments available to investors through commercial and non-commercial channels.

Fiduciary duty

When research and analysis are concluded, prospective assets must pass one more level of scrutiny before being approved by shareowners or investment managers. Only a small portion of assets are administered directly by asset owners, and asset management and decision-making is typically delegated to a service provider, for example an asset manager, who is vested with asset management responsibility. Pension funds, mutual funds, investment funds, and asset management branches of banks all act as securities managers on behalf of the owners, who may be individual investors, companies or other funds. The primary obligation of managers is to administer assets in the best interest of their owners—principally by creating the best possible return on investment. This is known as *fiduciary duty*, and it regulates the relationship between owners and fiduciary agents. Fiduciary agents invest and allocate assets and manage funds according to an investment philosophy or mandate, follow active or passive investment strategies, assess their clients' needs and act as their representatives through proxy voting or engagement initiatives, and bear the responsibility for the fund's performance. If asset managers interpret their fiduciary duty to be the promotion of short-term performance, it will be less likely that they will take social issues seriously.

A report commissioned by the UNEP FI, known as the Freshfields Report,[41] represented the first step toward the integration of ESG into managers' fiduciary responsibility. The report showed that, despite widespread industry notions to the contrary, it is possible to include ESG concerns into decision-making and still fulfil fiduciary duty. The report was followed in 2009 by an even clearer study on the implications of ESG for fiduciary duty, which is becoming fiduciary 'responsibility'.[42] A prudent fiduciary agent attentively maximizes performance, taking into account every existing risk and opportunity for the scope of delivering the best result to beneficiaries. Including ESG factors is necessary, and it enhances but does not

[39] One example would be the work by Danske Bank in Denmark in financial literacy initiatives for clients and children.

[40] See for example the interesting work done on this concept by Aaron Bernstein, *Quantifying Labor and Human rights portfolio risk*, Capital Matters, No.4, June 2009.

[41] Freshfields Bruckhaus Deringer, *A legal framework for the integration of environmental, social and governance issues into institutional investment*, October 2005.

It is possible to include ESG concerns into decision-making and still fulfil fiduciary duty.

replace all the other elements of an investment decision. But it is left to managers to weigh social and environmental issues in their evaluations.

Another component of decision-making is internal organisational management within financial institutions: the roles, responsibilities, and decision-making powers. Many institutions separate the work of the financial and extra-financial research teams, which ends in the disempowerment of the analysts and managers that work on extra-financial factors. SRI managers and researchers appear to be excluded from the final decision about investment in an asset, though their contribution is incorporated into the research at an earlier stage. Systematic integration of ESG could significantly change this balance.

A second relevant process in weighing the impact of ESG factors in investment decision making is to remit the decision to a board or group of managers with the duty of expressing an assessment on a series of screened investments in light of a SRI commitment. This setup is observed more frequently in institutions with dedicated SRI teams and departments. This can have a significant positive impact in terms of strategically bringing ESG into the 'boardroom' and aligning management's and analysts' interests.

Finally, it is noteworthy that even the process of decision-making by asset managers and trustees includes additional intermediaries or 'gatekeepers' such as investment advisors, consultants or other fund managers. Social concerns may need to be addressed differently by these actors as well.

Concluding remarks

This section outlined the basic concepts of human rights and finance, the elements of a financial value chain, and the challenges associated with adding human rights to the complicated valuation mosaic. We have stressed difficulties and limitations identified in the debate, and these are the points of departure from the human rights perspective. However it must not be forgotten that there are good examples of integrated approaches to the social aspect of ESG such as the Norwegian Government Pension Fund.[43] The Fund has taken a firm stand against contributing to human rights abuses through its activities, and has become known in the past years for surprising, and sometimes unpopular, divestments from international companies. Its mandate is sustained by the Ethical Guidelines and a specially established and independent body, the Council on Ethics,[44] has decision and recommendation powers over investments and shares.

Nonetheless, we have chosen to focus on the human rights challenges in the financial sector rather than the few islands of excellence that already exist because the large majority of actors are still lagging behind. We are aiming at that group as the recipient of our work to promote human rights awareness and our contribution to the creation of a shared and accessible framework for human rights integration in finance.

[42] UNEP FI Asset Management Working Group, *Fiduciary Responsibility—Legal and Practical Aspects of integrating environmental, social and governance issues into institutional investment*, UNEP FI, July 2009.

[43] The Government Pension Fund website: http://www.regjeringen.no/en/dep/fin/Selected-topics/the-government-pension-fund.html?id=1441

[44] http://www.regjeringen.no/en/sub/styrer-rad-utvalg/ethics_council.html?id=434879 Accessed on 19 February 2010

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SECTION III
Findings

In this section, we present findings drawn primarily from the informant interviews and the desk study, with a particular focus on the feasibility of developing a tool based on the HRCA. The main findings have been grouped into two parts: *Findings about the Integration of Social Information into the Investment Value Chain* and *Findings about the process and methodology for development of a financial sector HRCA tool.* These findings will form the foundation for our final recommendations and conclusions.

1. Integration of Social Information into the Investment Value Chain

Understanding integration of social information

The term 'Integration' is used differently by different actors and there is no shared and uniform methodological framework for integrating social information into financial processes.

As one of our interviewees explained, the greatest problem for ESG and responsible investing is the lack of an official or endorsed framework for the duties of business vis à vis human rights, in a field in which a premium is placed on precise figures. What constitutes integration of social issues into the financial sector is still not fully developed or agreed upon. In principle, complete integration would be the process of incorporation and assimilation of extra-financial issues into financial processes, methodologies and practices. It would have the objective of producing a financially sound valuation, and then assessing whether to invest, and if so, how to engage with investments that present a potential human rights risk. However, some actors compartmentalize ESG integration into special products, or isolate ESG considerations to one or two steps of the financial analysis and investment process. Moreover, additional actors may participate in social research through outsourcing to research providers.

Financial sector actors generally do not have a clear and consistent understanding of social issues, in particular human rights.

Most institutions group ESG into a generic social investment and responsibility category. Within this group a wide range of issues are covered, including human rights.[45] The priority that actors assign to each topic varies widely. Social issues considered 'local' to the institution are preferred to international or external ones. Unsurprisingly, the most tangible issues in the financial sector are those that are closest to project operations, such as workplace health and safety, diversity and financial literacy.[46]

Financial sector actors recognize that different assets present different challenges concerning the relevance and assessment of human rights.

There is a striking difference in how and whether financial actors recognise and address the potential human rights risks in their financial instruments and investments. The relevance of human rights to project finance is universally recognized, but as regards asset management, the relevance and potential link seems to be harder to grasp. The materiality of human rights is questioned, and thus the development of a process for translating this presumption of risk into practice is proving slow and intermittent. This constitutes the principal barrier for human rights mainstreaming.

Integration into the organisation

Financial actors have a weak capacity to integrate human rights information into their institutions.

While industry surveys reflect an increasing awareness and recognition of ESG as relevant to the sector,[47] comprehension of social issues and their operationalisation into organisational processes is much weaker. In organisations where ESG practice is visible, issues concerning environment, society and governance are often grouped together under one category, department or

[45] Other issues covered are: labour rights, workplace conditions, community relations, emerging and developing countries issues, civil society pressures, animal welfare, diversity, genetically modified organisms, living wage, political contributions and corruption, political risk and sexual harassment.

[46] One example would be the work by Danske Bank in Denmark in financial literacy initiatives for clients and children. See http://www.danskebank.com/en-uk/about-us/news-archives/Pages/Financial-Literacy.aspx, Accessed 18 February 2010.

[47] See UNEP FI *If you ask us.. Understanding corporate sustainability disclosure requests*, North American Task Force UNEP FI, Washington DC November 2008; and *The working capital*, UNEP FI, Washington DC July 2007; from the Who Care Wins Initiative, *Investing for Long-Term Value. Integrating environmental, social and governance value drivers in asset management and financial research—A state of the art assessment*, Conference Report, onValues, Zurich October 2005.

policy commitment (i.e. SRI departments, Ethical Departments). However, the distribution of resources and priority vary greatly among them. The environment and governance are often given a higher priority, with social issues running third, which is also reflected by a lack of specialised in-house capacity or expertise. Most organisations admit to having undertaken an ESG commitment without having the capacity to handle the "S" - social issues- and the interviewed stakeholders consistently expressed a need for strategic guidance and education of management and analysts in social issues.

Most financial institutions compartmentalize and restrict human rights and general social issues into a particular set of products and to a narrow step in the analysis and investment process.

In many organisations, scrutiny of social issues is isolated to SRI-specific funds and the process of targeted asset screening. In others, the only products screened are company-branded products, with the result that not all of available products are screened.

Integration into analysis and research

Research is the backbone of investment processes and the area where most progress in the integration of social issues has been witnessed in the past years. However, there is a clear distinction between in-house research systems and outsourced research processes.

In-house research departments are the norm and have responsibility for fundamental financial research, with only few institutions having a dedicated extra-financial research body. However, the most common practice related to research of social issues is to outsource it to specialized research providers.

While larger institutions and some universal banks possess the internal capacity to undertake all steps of the analysis, very few do their own in-house social research, and rather often outsource it. The specialized research providers used in the sector include sell-side/buy-side research specialists, brokerage houses with a good research capacity and non-broker extra-financial research providers. Many interviewees were satisfied with outsourcing, as it spares the organisation the efforts of re-thinking their organisational structure and creating dedicated social issues teams. Only one institution reported that it was in the process of strengthening its internal capacity, because it had made a strategic decision that ESG issues are 'core' and that certain aspects of ESG cannot be outsourced.

Investors are also reported to have greater confidence in the quality of outsourced research, reflecting an overall recognition that social issues require expertise. Moreover, at all levels it is understood that the digestion of social information by financial analysts or investment managers must be mediated by other experts. In other words, the languages of human rights and financial analysis are different, requiring experts who are fluent in those fields and discourses.

Outsourcing research may lead to additional conflicts of interest.

Financial institutions defer heavily to the reports of the research providers. Many research providers also offer services in active engagement following their consultancy reports and recommendations. A few informants noted that research providers that also offer active engagement services might be tempted to recommend a solution of active engagement regarding a prospective asset, rather than other possibilities, and thereby enhance the prospects of providing active engagement services to the same institution.

Integration into fundamental analysis

It is still important that financial actors pursue the present practice of conducting financial analysis and social research as parallel processes, because of the evidence that investors are willing to make some decisions based on values instead of value.

The view that full integration of ESG information will have a greater impact on the organisation, and result in increased awareness and ESG performance, is gaining adherents among those with ESG commitments and commitments in

line with the UN Principles of Responsible Investment. Although this represents a greater number of investors and assets than just a few years ago, the financial sector is still moving only slowly in this direction. A number of stakeholders emphasized the importance of maintaining parallel and separate processes of assessment of social issues and fundamental analysis, contending that this will guarantee the quality of the social research and prevent social issues from disappearing into the other material information. They pointed to the fact that some financial sector decision-makers appear willing to decline to invest in assets with significant problems related to particular social issues, and they are able to do this because the social issues are visible. The social issues are visible because their impact on value is not integrated into financial analysis. At this juncture, for the purpose of increasing the attention to social issues, maintaining social research as a parallel analysis to the financial analysis is probably an appropriate strategy to ensure visibility.

The quality of social information provided by research providers is sometimes reported to be weak, reflecting the under-reporting and under-quantification by analysts of social information.

Research is highly demand-driven by clients, who tend to regard social issues as not material and thus low priority. This low prioritization by clients may then create a cycle in which the quality of the research is not high. For example, research providers gather data only from publicly accessible sources, primarily the Internet and from companies themselves, which limits social research to data sets that may not be systematic, accurate or objective. This negatively impacts the quality of the information and the extent to which it enters financial processes in a meaningful way.

The qualitative nature of social data perpetuates a cycle whereby it is trapped as being considered immaterial.

The qualitative nature of most social data is considered to be a particular challenge and analysts have trouble integrating it into their analyses. This creates a vicious cycle in which social data are not understood or considered to be material because they are not numeric. A consequence of this is that research efforts to make it quantifiable may not be optimal.

As a result of these challenges, a social issues assessment system would be welcomed by the sector as a means of systematizing qualitative data that is otherwise hard to integrate.

Most informants welcomed initiatives toward a more systematic assessment of social issues. Many report an appreciation of international standards such as the SA8000 and coverage by NGOs like the work of the Fair Labour Association.[48] Many knew about the HRCA, and two research providers said that HRCA reports by companies had substantially enriched their research. Some institutions use the HRCA Quick Check to obtain an overview of relevant human rights issues.

Integration into investment decision-making processes

Financial institutions have a wide variety of investment decision-making processes, which differ as to how and where social information is taken into consideration. This has a bearing on the methodology of developing a Financial Sector HRCA tool.

Many institutions delegate decision-making to a group of analysts and managers, which may exclude SRI managers and researchers from the final decision. Another process that is more common in institutions with mainstreamed ESG functions is to remit the decision to a group of managers who express a joint judgment on screened investments in light of a SRI commitment. This latter case could bring ESG closer to the 'boardroom' and involve a different set of actors or participants in development of a FS HRCA.

[48] The FLA documents company practice through a public database called the 'Tracking Charts', reporting alleged labour and human rights violations on factory sites in many countries.

Integration into Engagement Practice

Negative screening as a strategy of handling ESG issues is losing ground to active engagement, the strong preference of all financial sector companies interviewed, even when serious social risk issues are identified.

As mentioned previously, screening filters are used to build SRI portfolios: *negative screening*, and *positive screening. Engagement strategies* are the second type of strategy, in which an investor or a group of investors use their influence to improve or maintain the ESG performance of an investment.

Negative screening and divestment are choices of last resort, and engagement is the preferred methodology of most of the financial actors surveyed. Investors share a widespread perception that going forward with investments is in the interest of companies and investors, even when social risks appear to be significant. Moreover, engagement and active ownership presents the only opportunity to affect company operations from the inside, particularly because divestment can mean putting company shares into the hands of other investors that are less interested in ESG integration.

Financial institutions increasingly pursue engagement strategies with investments, but several informants raised doubts about the quality of the engagement processes, suggesting that engagement serves as a useful 'fig leaf' for financial actors that intend to go forward with the investment under any circumstances.

The general failure to use benchmarking in engagement processes poses a risk that engagement strategies will not have positive outcomes.

Engagement processes have considerable potential if they are undertaken with a clear objective and followed up. They also appear to be a learning exercise for both investors and investees, and a tool for obtaining visibility, and finally, most successful when investors act collectively. Unsurprisingly, there is a remarkable difference between light engagement (communication assurances, periodic updates with companies) and heavy engagement (monitoring, follow-up, precise performance requirements and communication). Heavy engagement processes are more likely to result in substantial policy and practice changes within companies, particularly regarding human rights assessments and reporting.

However, it emerged clearly from the informant interviews that the objectives, quality, and outcomes of engagement strategies could be improved. At the most basic level, many informants were not even aware of the outcome of their engagement processes, and did not know what did or should happen when an investment failed to address the issues of concern raised during the engagement process. This gap became more explicable when the consulted informants reported that they lacked a system for benchmarking engagement processes and lacked compliance indicators for companies.

As a consequence, the possibility of developing such a human rights benchmarking system suitable for their work was well received. Such an enhanced engagement benchmarking system could include elements defining engagement—duration, modalities, expected outcomes and deadlines, communication, voting options. It might also incorporate elements concerning investees to be tailored by industry or sector, or on a single case basis, which would include the specific issues to be addressed (i.e. global policy level/ operational level, type of human rights abuse and suggested remedy) and the nature of the information to be requested (CEO statements, records referring to adoption of new policies, field visits to assess change).

Systematizing social data would increase the value of the engagement process by providing concrete guidance and the means of assessing compliance and progress.

Training in human rights and development of benchmarking instruments seem to be lacking in all organisations, but could potentially increase the value of engagement processes.

Please refer to Annex 3 for a detailed and comprehensive synthesis of the most used methodologies and tools for integration of extra-financial information into financial valuation and practice.

2. Findings about the process and methodology for development of a financial sector HRCA tool

End Users and Partners

The end user group of the FS HRCA must be a subset of the financial sector, because the different types of financial actors have different needs.

Such a tool must fit into the processes of financial analysis and investment decision-making, and this process varies depending on what the financial institution does and the assets that it handles. The tool must also reflect the pace of analysis and decision-making in the type of institution and be tailored to different operational paradigms.

Developing a tool as a collaborative process among a number of peers in the financial sector is ideal but potentially risky. At the beginning of the process it could be more effective to engage in a partnership with one interested actor rather than a group of peers in the industry.

With one significant exception, informants were highly attuned to the competitive environment in the financial sector and the social research industry. This gave rise to a reluctance to take new initiatives that might be risky in terms of the bottom line. Only two financial institutions (excluding research providers and consultants) were optimistic that group collaboration on the creation of a common industry tool would be possible. At the same time, some of the banks were aware of being perceived as 'behind' others in terms of their public reputation, suggesting that individual banks might be interested in pursuing development of such a tool as an individual initiative.

Irrespective of whether development of the FS HRCA takes place as an individual or an industry initiative, it will continue to be essential to maintain links to the multistakeholder and industry initiatives that are underway.

The preparatory phases of FS HRCA development must include capacity building of financial sector actors on social issues.

Awareness of human rights is generally low in the financial sector, with the exception of specialized research providers. This is directly relevant to the question of materiality and how human rights are relevant in particular assets and processes. All actors need to understand where human rights become relevant, what they are, and how to present and decode human rights information in a way that matches the processes of the financial sector.

Research providers are important intermediaries between companies and financial institutions, and the FS HRCA should be developed with their participation.

Research providers serve as gatekeepers to financial institutions and investors, and it will be essential to devise an FS HRCA that incorporates their needs, builds upon their role and harnesses their considerable expertise. While they acknowledged that the HRCA would be an excellent source of information to clarify companies' human rights risks, and some had used an investment prospect's HRCA report in their own analysis, they also indicated indirectly and directly that they regarded the FS HRCA to be competition to their business.

Research providers' products related to social and human rights issues are self-similar in terms of methodologies and data sources – and contain similar gaps - common shortcomings that further highlights the need for systematic social information and analysis at operations level and in the financial sector.

Research providers have developed tools for helping financial and other types of companies assess social risk, which are proprietary. Some tools are sophisticated, such as the one described by EIRIS, part of which is an advanced database which can be filtered according to a number of factors, and can be tailored to a client's needs and ESG interests. However, the team found that the tools are generally based on the same publicly available social data and incorporate country and industry risk as their methodologies. Research providers' information sources consist primarily of company-provided information and publicly available information obtained through the media.

The nature of this data reflects the gap in human rights awareness and analysis at operations level, and passes that gap on into the financial sector's analysis. Because the information is provided by the prospective asset and the media, it may be biased, inaccurate, or contain important omissions. The media has a tendency to focus on particular high-profile issues such as child labour, while ignoring other social issues, such as abuses of migrant labourers. Information obtained through publicly available sources also contains the reports of journalists, NGOs and other sources that may not have checked their information or which may not be objective or fair. Similarly, company-provided information may not be objective, and may also not be prepared by persons who are well-versed in social issues.

Research providers have indicated that the increased use of the HRCA, industry tailored HRCAs or the HRCA Quick Check at company operations level would enhance their research. They would not necessarily regard the reports as reflecting the factual situation, but rather as evidence of good management procedures vis à vis social issues.

Financial analysts will also be important partners in developing a FS HRCA, in order to advance a common understanding of how social issues can be recognized as material.

Irrespective of the type of institution that becomes the intended end user of a tool, the question of how human rights risk can be regarded as material is essential. As noted earlier, financial analysts have difficulties in quantifying social issues, including human rights. Therefore it is essential to involve financial analysts in the process from an early point, in order to increase their literacy in social issues and to identify a common ground and language through dialogue. The aim will be to ensure acceptance and usability of an FS HRCA by an important group of end users.

Methodologies and asset classes

Different methodologies must be developed for assessing human rights risk in assets with different sources of value creation and social risk.

The assets involved in the financial sector are very different from each other, in terms of the underlying source of value creation and source or location of the initial human rights risk. The FS HRCA must accommodate these differences, by incorporating different methodologies and modules.

Methodologies similar to those used for social risk in supply chains will be a part of the tool, because the relationships between the investor, the initial source of value creation and social risk is similar to those in a supply chain.

In some cases, the investment is a company, with a risk of direct human rights abuse, but other assets are simply shares of an asset that is several steps removed from the operation where value is created and human rights risk is located. For example, pension funds often own shares of indexed funds and portfolios managed by other actors. These assets may contain a mix of different types of

assets, each of which may be several steps away from the point of risk of human rights abuse. A traceability system covering all financial intermediaries and responsibilities must be established. Moreover, with this system in place, it will be indispensable to make clear that investors have an independent responsibility as a part of this chain.

Self-assessment, reporting and financial institutions

The first challenge in developing a tool for the FS HRCA will be to identify the tool's scope: 360 degree self assessment, or assess social factors in products and services.

The existing HRCA tools cover respect for human rights in the full range of companies' operations, including its duties in its internal operations (e.g. labour practices vis à vis employees) and its external impact (e.g. impact of its products or services). However, most of the informants in the study, and particularly banks, did not see the significance of, and the need for, self-assessment of their internal operations. This perception is partly based on the fact that many financial institutions are based in developed, industrialized countries, and presumption of good human rights practice in such countries. It also ignores the fact that many companies headquartered in Europe hold assets in emerging markets outside of Europe, and possibly also that CSR and GRI reporting staff might not have in-depth knowledge of all aspects of their company's financial operations.

In view of this constraint, two scenarios must be built into planning the FS HRCA. First, that an introductory dialogue about the substance and significance of human rights will be the first step of any process, even when involving the most convinced financial actors. Second, that a modular, sequenced approach to tool development may be effective, focusing first on the functions or section of company operations where social risk is acknowledged (such as product and service lines) and moving onto the 360 degree assessment approach once awareness is raised and relevance of social risk has been accepted.

The HRCA and GRI FSSS

Financial institutions recognize the GRI FSSS as the reporting framework for the financial sector, although they are generally ambivalent as to ESG reporting. Nonetheless, this framework has the most potential for combining with HRCA methodology and indicators.

The desktop study and consultations revealed that the GRI FSSS has been accepted as legitimate by the financial sector. Leveraging the FS HRCA on this existing platform will have a number of advantages, including strengthening an accepted initiative framework and avoiding creating a new process for financial actors.

The identification of the GRI FSSS as the backbone and framework of a FS HRCA is fundamental, so it is useful to flesh out the relationship of financial institutions and CSR or ESG reporting. Though the GRI FSSS is accepted at face value, it is still regarded with some ambivalence by some financial institutions, who regard it as too extensive. Although financial actors appreciate the potential of the GRI FSSS, very few actually use them.

Financial institution reporting is not as widespread as CSR reporting in other sectors, and the financial institutions that do report employ a variety of approaches. The majority of institutions do not systematically report, though some do have ESG and SRI policies in place. Some large financial institutions, including universal banks and some investment firms, engage in periodic reporting in sustainability or CSR reports, and others release issue papers or thematic research related to their operations.

In consultations, some informants explained this gap as arising because reporting was not seen as relevant enough to justify the allocation of resources for the research and reporting process. Institutions without a branding or CSR team appear to be the least likely to have reporting procedures, and all expressed doubts about adopting external reporting guidelines. This logic is backed up by a financial argument: Companies in other sectors may be interested in reporting because they are listed on major stock exchanges, whereas most financial

institutions are not commercially traded. Unsurprisingly, it was the listed banks and institutions that regarded reporting as more important.

In most interviews, the team inquired about informant institutions' use and perception of reporting guidelines and initiatives, and the GRI seemed to be the most widely accepted model, followed by general ethical principles such as the Wolfsberg Principles. The recently released GRI FSSS is the only initiative dedicated specifically to setting a standard and creating a sustainability disclosure framework for financial institutions. It is well known in the sector, although it has not yet been widely implemented, possibly due to their recent publication (2008).

In spite of the slow uptake of the FSSS guidelines, the team identifies a merging of the HRCA into the GRI FSSS as having the greatest potential for the way forward. The HRCA can fit well within the GRI FSSS, and with some development of the social indicators, the resulting tool can enable companies to enlarge their focus on social factors without adding a new parallel reporting system. The HRCA is an internal performance assessment methodology focused on human rights, while the GRI is an external reporting framework based on the concept of sustainable development, which covers environmental, economic and social factors. The guidelines divide financial services into four categories: retail banking, commercial and corporate banking, asset management and insurance, and they adapt the existing GRI performance indicators to the sector. The human rights indicators in the GRI framework are incorporated into the social factors.A financial adaptation of the HRCA would fill out and develop the GRI. It would be essential to develop these indicators with industry expertise, enabling actors to look internally at their operations to develop a tailored tool.

However, the FSSS has some limitations and gaps. The FSSS's social indicators reflect the practice of compartmentalizing human rights that is common in the sector. The indicators do not capture the complexity of human rights implications in finance. See Annex 5, for GRI Indicators and HRCA methodology at a glance.

An additional challenge to this approach will be the financial institutions' attitudes and understanding of the GRI and FSSS. The existing GRI framework is regarded as too ambitious by many institutions, despite their acknowledgement of its validity. It is described as time-consuming and demanding. Moreover, some informants dispute the validity of the human rights GRI indicators (such as HR1 and HR2), based on the assumption that European-based operations are low-risk for human rights issues.

3. Recommendations for developing a financial sector HRCA tool and process

The Danish Institute for Human Rights is interested in deepening its engagement with the financial sector and in partnering with one or more financial institutions that can bring its expertise on financial processes and the operations and priorities of financial institutions.

A partnership between DIHR and one or a group of specialized financial institutions in the industry will be useful to building the required understanding of financial reasoning and metrics. Discussion roundtables coupled with awareness raising in social standards and human rights compliance exercises would be important activities at the outset. This 'literacy' exercise will fulfil the objective of clarifying and defining human rights for the financial sector and outlining a preliminary methodology for quantification. The HRCA indicators and methodology could serve as a starting point in improving interpretive mechanisms for social and human rights information. Social investment forums and other stakeholder initiatives could be the facilitators of this dialogue.

Universal banks and institutional asset owners, in Denmark and abroad, may be useful partners in building such literacy and simultaneously pursuing a better methodology for human rights self-assessment and reporting, consistently with their organizational settings and their societal role. This collaboration could lead to a specific training module and foster better financial responsibility in communication and reporting through the development of a Financial Sector HRCA.

Moreover, DIHR together with other research organizations should accelerate the development of industry-specific and country-specific HRCAs, and do so with the input of specialized financial analysts. As part of this, an interface could be developed that would enable the HRCA reports to produce information that can be read by financial analysts in their language—the language of numbers and finance.

Possible additional next steps:

- *To enter into dialogue with financial analysts that specialize in industries where DIHR already has experience, such as the extractive, pharmaceutical or food sectors, with the objective of identifying the criteria and language that are relevant to them and would enable them to identify human rights factors as material.*
- *To strengthen the country risk criteria in the HRCA, in order to lay the groundwork for integrating country risk into all industry HRCA versions.*

An increase in financial awareness and responsibility can become a catalyst in driving this change and contributing to the respect for and the realization of human rights while nourishing economic growth — resulting in the business of business not just being business, but rather the right kind of business.

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ANNEXES

Annex 1. Stakeholders consulted March-June 2009

Telephone conferences:

- Barclays Bank, Philippa Birtwell, Head of Public Policy
- Credit Suisse, John Tobin-de la Puente, Director of Public Policy and Sus tainability Affairs, and Bruno Bischoff, Public Policy and Sustainability Team
- GES Investment Services, Helene Regnell, Head of Research
- Ethix SRI Advisors, Reinhilde Weidbacher, Research Coordinator, and Anna Massarc, Analyst
- EIRIS, Stephen Hine, Head of International Relations; Louise Tippet, David Cockburn, Dawn McLaren, Social Research Team
- Insight Investment, Rory Sullivan, Head of Responsible Investment
- Sarasin Bank, Eckhard Plinke,
- Sally Britton Consulting, Sally Britton, CEO
- UBS, Christian Leitz, Head of Corporate Responsibility Management, and Yann Kermode, Group Environmental Policy
- UN PRI Engagement Clearinghouse, Valeria Piani, Project Manager

Interviews:

- ATP Pension Fund, Ole Buhl and Susanne Pedersen, SRI Advisory Team
- Bank Invest, Lærke Sørensen and Michael Hovard Ekmann, Fund Man agement
- Danske Bank, Tina Obel Lope, CSR Team, and Kristian Højland, Supply Chain Management; Thomas Kjærgaard, Head of SRI
- DanWatch, Anne Sofie Poulsen, Research and Advocacy Team
- Merkur Bank Denmark, Lars Pehrson, Director
- PriceWaterhouseCoopers Denmark, Linna Palmqvist and Jessica Nyman, Consultants

Correspondence:

- UNEP FI Human Rights Work Stream, Cristina Gueco
- onValues, Ivo Knoepfel

Annex 2. Indicative questionnaire for stakeholders

- Introductory note about DIHR and HRCA:
  - Short Explanation
  - Project outline and short explanation: financial sector and human rights
- Organizational setting of the institution interviewed:
- Concerning your involvement in responsible investment practices and human rights:
  - What are the motivations behind this choice and how easy is to keep up to your international commitments, especially to its Human Rights/ Governance/Environmental focus?
  - What is the meaning of human rights in your organization?
- XXX operates in different divisions (i.e. Retail and Commercial Banking and Global Asset and Investment Management):
  - How do they operationalise ESG and human rights in all these areas?
  - Where do you think is the greatest scope for a Human Rights approach?
  - How do you regard the UN PRI initiative? Why are you/are you not a signatory?
- Clients:
  - Information about their clients; who they are etc.
  - Are ESG and sustainable investment guidelines drafted and chosen together with the client, given by the client or given by XXX with some personalization for each client?
  - What are clients demands regarding social issues, if any?
- Research and Analytics:
  - How is research on assets and investment done?
  - Do you rely completely on your own research or employ specialized rating, research or advisory providers for your investment assessments? Is it advantageous to have all in-house if you do? Is it better to keep extra-financial and financial research as two separate processes?
- Human Rights and Analytics:
  - How are Human rights addressed? i.e. Norm-based screening; Incidents-based screening.
  - Do you rely on existing tools? What are the limitations and advantages of the tools in use?
  - Do you use tools in a format that makes it easy to quantify risk from a HR perspective?
  - How are they quantified if they are?
  - Is this assessment performed by financial experts or the SRI/extra-financial team?
- Decision on Investment:
  - We learned from research and previous interviews that usually financial and extra-financial analyses are two separate processes, integrated in the final phase by the manager/analyst who decides on the investment opportunity. Who makes the decision about an investment at XXX?

- Is there an ethical fund manager or a portfolio manager that concludes the investment analysis? Are portfolio managers well trained and experienced to understand and digest non-financial issues?

- Financial Services and Human Rights:
  - Do you perform screening of financial institutions?
  - What HR issues are the most relevant within financial services? Are financial actors aware of their HR impacts?
- If there was a tool you could use to measure social issues in the financial sector, what would you want it to do?

  i.e. Clear indicators to integrate investment decision processes?
  A tool/ set of indicators to be integrated in larger and already existing methodologies—indices, GRI?

Annex 3

Case studies of tools and methodologies for integrating social issues into the financial sector

The majority of the tools described in this annex are proprietary tools owned by investment and extra-financial research providers. Others belong to the family of stock exchange indices and general guidelines available for free to users.

1. Guidelines and narrative toolkits

Guidelines and principles of responsible investment are general indications to investors, financial specialists and companies on how to evaluate an investment prospect or a larger project, and make an informed decision, about factors including extra-financial issues. The guidelines are sector specific, thematic, or general.

Two examples of the free guidelines are the Principles for Responsible Investment and the Private Equity Council principles, which are voluntary and provide a general overview of what should be considered relevant when assessing an investment. Investors and specialists should take into consideration the following issues when evaluating investment prospects:

- *include ESG themes;*
- *engage in stakeholder engagement;*
- *provide and guarantee fair governance structures, and law compliance;*
- *commit to respect the human rights of the people affected by their investment activities in accordance with their fiduciary duties.*

Sector specific guidelines usually focus on one industry sector, such as the extractive or food industry (for example, the EITI and IPIECA guidelines for the oil and gas industry). Other toolkits are tailored for specific instruments or sub-sectors in finance, for example the Rights and Democracy Human Rights Impact Assessment for Foreign Investment Projects. A tool for the pension industry is the Eurosif Pension Toolkit, a booklet guide designed for pension funds and institutional investors to learn in a structured way about SRI and design strategies that are consistent with performance and fiduciary duty and each fund's investment values.

Thematic guidelines relate particular ESG themes, and specifically clarify in practical terms what the issues at stake are and how they can be operationalised. The UNEP Financial Initiative is notable in this area, having produced toolkits in the form of guidelines and questionnaires for the banking industry and financial players at large. Of particular note is Human Rights Guidance Toolkit, a product of a multi-stakeholder initiative coordinated by the UNEP FI Human Rights Work Stream and UNEP members from the banking industry It is designed to meet investment requests in corporate lending and project finance, and provides a user-friendly set of questions that cover all major human rights topics, give institutions a thorough picture of what to screen their investments against. It is intended to be incorporated into each bank's methodology. The feedback we gathered from asset management institutions participating in the initiative reveals nevertheless the inadequacy of the tool for investment practices given its lending focus. Many appreciated the learning process and consultations that led to the tool, but admit its user-unfriendliness for portfolio managers and analysts.

These initiatives respond to the identified need for guidance and related to ESG issues, and they provide an easy and quick understanding of the most pressing issues at a superficial level. Nevertheless, the content of the guidelines tends to be only indicative, often mirroring the framework of commitments but not providing measurable and validated benchmarks to assess matters of risk and performance returns. This is a gap given the current state of the sector, where quantifiability is an important part of financial reasoning. Quantification of social subjects, to the extent that it is done at all, is found in specific tools provided by consultancies and research providers on proprietary and commercial terms.

VALUES ADDED: THE CHALLENGE OF INTEGRATING HUMAN RIGHTS INTO THE FINANCIAL SECTOR © DANISH INSTITUTE FOR HUMAN RIGHTS 2010

2. Tools and methodologies

In this section, we refer to the body of tools and methodologies that have been developed by research providers. The team has gathered this information through the interviews and through websites, and did not have full access to the details of the methodologies because most are proprietary and not available in the public domain. However, the information gathered from different sources indicates the following trends.

Specific tools and methodologies are designed with a specific objective and target users are usually very specific. The most sophisticated tools are produced by investment and research consultancies and management companies; they have proprietary right protection and address various investment actors and investment possibilities. Some tools are screening and management instruments that examine companies directly.

Such tools screen and examine prospective assets against indicators and parameters that vary according to the tool's purpose, both in terms of finance and ESG. They can be catch-all tools, to be applied throughout portfolios, or have a narrow specificity: target one financial actor (funds, private investors, pensioners), focus on only one ESG topic (i.e. use of green or social criteria only), or be tailored according to investors' values and needs at the time.

The methodology usually in place is company screening where specific information about a company is gathered through reports, indices, and external data, with the purpose of depicting the most rigorous portrait of one specific business. When tools provide portfolio management services this methodology can be limited to the more indirect process of screening assets already owned mostly according to indices. A chart of the most used and popular methodologies can be found below. Most tools are information management tools: they help organize in a structured and financial-friendly manner all the publicly available extra-financial information, and adapt it to investors' needs and value-based portfolio designing.

The common starting point is to gather and screen available sources: company reports and statements, media coverage, NGOs reports and newsletters, for example. The Business and Human Rights Resource Centre website is also cited as being a major source of reliable information about companies and incidents. Some tools/providers are linked to NGO and civil society networks, and have immediate access to advocacy initiatives and investigations that include a specific company. The second main source of information is gathered by the company or asset itself, by engaging with companies and requesting additional information which can be in the form of reports, clarifications or policy descriptions.

Most research providers employ the classic approach of screening information on management processes and incidents related to ESG against frameworks provided by international law and voluntary initiatives, such as the UN Global Compact, the OECD Guidelines for Multinational Enterprises, all major human rights and ILO conventions, the Kyoto and Montreal Protocol and anti-corruption treaties. On a second level, specific indicators provide guidance for an evaluation: the quantity of CO^2 consumption can be environmental indicators. A quite reactive approach is the use of incident-based screening to measure social performance: respect and compliance with human rights is measured on emissions or water an accident (ex-post) level. Social risk is measured through the number and frequency of incidents, allegations and violations, all of which would be predictable information if a systematic ex-ante assessment on policy and operations was made available to analysts and researchers.

The quality of this approach is highly dependent upon the availability and nature of the information in the public domain and raises doubts about the correctness of analysis.

Table 2 : Overview and Description of Tools for Integrating Social Information in Financial Analysis[49]

Research providers and consultancies	Tool description
GES Global Ethical Standard	Global Ethical Standard, Risk Rating and Controversial tools: indexed company screening according to environmental, social and governance standards. Analyses and recommendations exclude companies from investments if they have committed violations, have been sanctioned for misbehaviour, or have admitted their involvement.
EIRIS	Ethical Portfolio Manager: software providing a selected database according to the clients' ESG requests that allows monitoring and real-time access to company news and evaluations. Performance in social issues is measured through country risk, mitigation capacity (policies, management and reporting on human rights) and alleged breaches or stakeholder issues. Convention Watch: tool used to identify any controversies and breaches involving the company of any international convention related to human rights, environment, and governance.
SAM Group	*SAM's methodology and analysis™*: companies selected from Dow Jones Sustainability Index (2500 companies), then screened for non-financial information through research, questionnaires, stakeholder consultation, expert networks, and quantitative portfolio construction (alpha generation[50] through incorporation of these data). This approach aims at producing a portfolio value based on security price and sustainable fair value. *Sustainability Tool*: consultable database of over 1000 sustainable companies, ranked according to the SAM sustainability criteria and SIMS (Sustainable Information Management System), and divided by country/sector, and sustainability ESG scores
ASSET 4	ASSET 4 methodology: the Four Pillars-evaluation model: Economic Performance, Environment, Social, Corporate Governance. They have 250 KPIs indicators (not disclosed) that they use to evaluate companies, portfolios, sectors or regions, and support institutions committed to the UNPRI. *assetmasterProfessional*: tool for investor and asset manager which provides portfolio management and customization against ESG indicators. *assetmasterExecutive*: tool for companies, investor relations and CSR officers: 90 industry-specific, customizable extra-financial KPIs (not disclosed) to enable corporate users to monitor the extra-financial performance and risk of their own company and its peers. *Sovereign Supra*: specific for sovereign wealth funds and country risk assessment. 150 KPIs on environment, social and governance aspects (not disclosed) based on extensive research on the selected country/company. Information is gathered also from a network of NGOs: Amnesty, Freedom House, the UN, HR Watch, WWF.

[49] In recent months, while this report was being drafted, many research providers merged with other institu tions, such as ASSET 4 being acquired by Thomson Reuters, KDL by RiskMetrics, Jantzi Research and Sustain alytics. We decided to leave all the references to the tools and methodologies to the original provider, despite the later acquisitions.

[50] The alpha coefficient indicates how an investment has performed after accounting for the risk it involved. In an efficient market, alpha equals the return of the risk free asset: $E(\alpha) = r$. The alpha is particularly relevant in an active investment strategy.

Research providers and consultancies	Tool description
Risk Metrics Group	*Sustainability Risk Tools*: Over 300 indicators (200 only social and environmental, not disclosed) used to measure ESG for their clients' portfolio management. Extensive screening and research ON companies on behalf of their clients; tools can be customized to each portfolio preference. Their focus is specifically on risk: compliance, fiduciary, ESG, reputation. *Online and company screening tools*: apply guidelines on portfolios and examine company-specific profiles; screening of global portfolios companies across 200 sustainability criteria. There are also controversial business reports, reputational risk reports, ratings according to the UN Global Compact criteria. *State screening mandates*: designed for pension funds in the US and their managers in order to comply with US laws. Thorough list of companies that operate in countries at risk, with three degrees of company involvement, from physical presence to distant relations. Also a Sudan specific database.
Jantzi Research Group	*Jantzi Research's Best-of-Sector™* investment screening and research: set of more than 200 proprietary indicators. The framework is based largely on a stakeholder model and indicators are grouped into: - Community and society - Customers - Corporate Governance - Employees - Environment - Human Rights - Controversial Business Activities — including alcohol, gaming, genetic engineering, nuclear power, pornography, tobacco, and weapons. Their Portfolio management tools and services assist clients in defining SRI criteria that ensure a balance between environmental, social, and governance concerns and the ability to manage a diversified portfolio. *PortfolioEdge™ Audit*: The tool reveals a portfolio's exposure to environmental, social, and governance risks and opportunities. Guarantees respect to fiduciary duty and ensures portfolio compliance with SRI. *Portfolio Edge Builder™*: develops SRI products for the Canadian market, by providing assistance with ESG investment policy and guideline development for investment decisions, customization and monitoring of portfolios.
Rogers Casey	EQuest: questionnaire (not disclosed) for investment managers, to collect information about investment firms and their strategies. Its aim is to allow managers to update their firm and strategy information in real-time. The analysis is based on various asset classes (equity, fixed income, real estate etc.) and 800 qualitative and quantitative fields of information for the firm's review processes. *MR2*: tool to assess investment managers' performance and due diligence. *InvestWorks*: tool to gather comprehensive information on firms and investment products, through 300 quantitative and qualitative benchmark indicators. Customizable. *Paris*: Performance analysis and reporting information. For investment consultants, financial intermediaries, asset managers, and registered investment advisors: portfolio management, database of investment funds, peers, benchmark; asset performance analysis.

Research providers and consultancies	Tool description
Risk Metrics Group	*Double Diligence®* research process. First, companies are qualified through in-depth financial analysis; secondly, social analysts examine their social and environmental records. Criteria for exclusion from funds are: tobacco, weapons, firearms, alcohol, gambling, human rights issues, nuclear. Their Signature Funds have a negative screening approach, their *Solutions* and *SAGE* (Sustainability achieved through greater engagement) have positive screening and engagement approaches. *Know What you Own®* tool: screening tool for HR in securities owned by the largest US 1000 companies. Companies excluded if engaged in violations, provides direct aid to repressive companies, and fails to respect minimum HR standards.

3. Other methodologies and social issues

There are many methodologies used by both research institutions and banks that do not translate in a tool as such but can be used to complement evaluations and assessments. Many banking institutions with internal research capacity have developed their own methodologies. The most common paradigms are the creation of matrix-like systems that integrate information and ratings coming from different sources and which can be of a different nature.

Sarasin Bank is a good example. Their *Sustainability Rating Matrix®* merges company and industry ratings according to social and environmental criteria and it divides between sector and company analysis. This is an important pattern in the financial industry: investment risk is assessed and incorporated in decisions through a sector approach, as it is more functional to study industry sectors and their specific risks and structure evaluations according to sector characteristics. The industry sustainability evaluation places the company already in a well defined risk area (pharmaceutical risk is evidently quite different from software industry risk) which then is complemented by a detailed investigation on the company for sustainability practice. Thus despite the fact that a company's industry risk is high, it may have a low risk rating on sustainability, and therefore be eligible for investment.

Another methodology from the banking industry worth mentioning comes from the ethical bank Triodos . Being an ethical bank, it presents a clear commitment to social issues, which is reflected in its human rights screening process. This implies rigorous care in assessing company's involvement in repressive regimes, violations, supply chain mismanagement and actions taken at the board level. Human rights are examined as worker-related rights and non-worker-related rights, with an evident focal point on labour rights. Human rights are weighted depending on the industry sector (i.e. labour intensive sectors are riskier than tertiary services) although no quantified indicators are produced. As at Sarasin, this compliance and policy investigation produces firstly a peer to peer industry assessment and secondly a policy level analysis.

Finally, the *German Society of Financial Professionals* (DVFA) recently developed a set of key performance indicators (KPIs) for ESG issues. These KPIs for ESG fall within an international initiative comprising the WICI (World Intellectual Capital Initiative), the Enhanced Business Reporting Consortium (EBRC), and EFFAS (European Federation of Financial Analysts Societies). The developed system of indicators was designed to be expressed in the language of financial professionals and it is a valid academic attempt of ESG translation into measurable and quantifiable data.

The 12 general and 18 sector-specific indicators were developed following a survey of main financial actors and analysts in Europe and internationally, gathering responses from: equity sell-side and buy-side analysts, asset owners and managers, and various institutional investors. The tool can be easily integrated into any financial assessment, as it both relies on financially measurable factors and quantifies intangible issues mainly through numerical percentages.

Social indicators are divided into diversity; percentage of credit loans undergone ESG Screening; Percentage of funds managed in accordance to ESG criteria; financial instruments held in accordance to ESG criteria; investments in accordance with ESG; supplier agreements in accordance with ESG; health & safety of products. Despite the promising outreach and the excellent terminology, these social indicators reflect the localization of human rights issues we have seen in financial practice and do not represent a good measurement for portfolio management.

4. Indices

A final remark needs to be done concerning the methodology of stock market indices. Stock market and exchange indices monitor and rank any listed company according to various criteria in order to measure their performance. These criteria originally reflected merely financial concerns, profitability and returns, but the trend is increasingly moving towards sustainability families of indices that mainly take into account non-financial criteria, to have sustainable portfolios. Indices have not been touched much by the ESG debate which has been more focused on analytics per se; it is worth bearing in mind that they nevertheless constitute the first filter through which companies are brought into the realm of socially responsible investing and it is also through public ratings and indication that most of the price valuation occurs. A few examples of the most common indices follow below.

Table 2 : Indices and their methodologies

Index	Features and methodologies
Dow Jones Family of Sustainability Indices: Provide asset managers with benchmarks to manage sustainability portfolios. Their Indices differ from each other by regional, sector, financial weight or sustainability criteria (i.e. Euro STOXX; the Dow STOXX excluding Alcohol, Tobacco, Armaments and Adult Entertainment). They share their methodology with the SAM Group. www.djindexes.com	Selection criteria focus on risk and opportunity management related to ESG dimensions, and are industry or company specific. Information is gathered through questionnaires, reports, research and direct contact with companies; audit and quality assurance procedures are used to monitor and maintain the accuracy of the input data and results. General criteria include: management practices, supply chain management, human rights, risk and crisis management. (50% of the assessment) Industry specific criteria include: ESG in a particular industry; research and Media and Stakeholder Analysis (MSA). Social criteria weight 22%. Companies are the primary source of information. After selection for inclusion in any of the Dow Jones Indices, companies are constantly monitored to assess their ongoing management and processes related to sustainability (i.e. codes, reporting, crisis, presence in the media). The company selection process for the indices is done based on a corporate sustainability assessment and is carried out by SAM. According to SAM, this assessment allows the calculation of a sustainability performance key-figure for each company. The figure is calculated for every company within the investment universe of the DJSI World. The Corporate Sustainability Assessment can be divided into three levels: the questionnaire compiled by the company, the quality of publicly accessible documents and verification of data and processes.

Index	Features and methodologies
FTSE4Good Index Series: Indices for responsible investors listing companies meeting globally recognized responsible investment criteria in 23 markets. The index is meant to be used by investors, companies (as a reputational badge, to enhance their access to ethical funds), and NGOs (in donor selection, engagement and action). www.ftse.com	Their criteria are developed using an extensive market consultation that involves NGOs, governmental bodies, academics, the investment community and the corporate sector. The pillars are environmental management, climate change mitigation, respect for human and labour rights, supply chain labour standards, countering bribery. Active engagement with companies parallels rating activities. Their disclosed criteria cover the issues of inclusion, supply chain, mining, climate change, countering bribery, breast milk substitute marketing, uranium mining. Each category can be subdivided into sub-criteria, for example supply chain management is assessed through product analysis (agricultural crops, consumer products) and their risk; countries of operation and sourcing; exposure; ILO conventions and working conditions; external auditing; policy structures and ethical codes.
KDL Domini & other indices: Part of KDL Research and Analytics, which provides ESG research for institutional investors. Their clients: investment consultants, institutional and retail money managers, institutional investors, IR officers. Their indices differ in size and theme (400 biggest companies, country, investment asset family, environment/ social specific such as Social Index, Catholic Index, Jantzi Global Environment). www.kdl.com	Their methodology relies on 5 data sources: 1. companies 2. research partners 3. media (12,000 sources) 4. public documents (Security Exchange Committee filings, annual reports i.e.) 5. government and NGO information (U.S. Dept. of Labour, Human Rights Watch, i.e.) Companies are rated in seven areas: environment, community, corporate governance, diversity, employee relations, human rights, product quality and safety. SOCRATES—their own Social Ratings Monitoring database is the methodology used for the social assessment through the following criteria: - community (i.e. charitable giving, innovative giving, support for education) - diversity (i.e. women, disabled and gay/lesbian presence, minority contracting) - employee relations (H&S, retirement benefits, union relations, employee involvement) - human rights (labour rights, indigenous peoples, concerns such as violations, involvement in Burma, Sudan) - product (products for the economically disadvantaged, quality, research and development, concerns such as antitrust, safety, contracting controversies) Controversial business involvement criteria can be companies involved through ownership, licensing or production in: abortion, alcohol, adult entertainment, contraceptives, firearms, gambling, military, nuclear power, and tobacco. In addition to the initial rating, indices are integrated with continuous updates.

Index	Features and methodologies
Calvert Social Index: Calvert Social Index: benchmark constructed for measuring the performance of US-based sustainable and responsible companies. It is a market-capitalization weighted index, meaning that it measures the changes in the market value of the index components as a whole on a daily basis. ——— www.calvertgroup.com	Their proprietary research methodology consists of screening the largest US companies listed on NYSE and Nasdaq, each company being then analyzed by Calvert's research team through own research, media, company contributions, discussion with NGOs and advocacy groups, regulatory agencies. The social audit and criteria cover: governance and ethics, product safety and impact, environment, workplace (labour issues), integrity (some HR issues here), international operations and human rights, indigenous peoples' rights. Investment process methodology: the *Double Diligence®* research process. First, companies are qualified through in-depth financial analysis; secondly, social analysts examine their social and environmental records.

Annex 4

HRCA description and overview

The Human Rights Compliance Assessment Programme

The HRCA is an online programme consisting of interactive questions and indicators, and supplementary resources as well as a supply chain tool. The targeted users are multinational companies, and some versions of the tool have narrower target groups such as companies operational in particular countries. However, the tool can be used by all kinds of organisations, regardless of size and whether the organisation is for-profit, public, or not-for-profit. The HRCA is intended to be used in human rights self-assessment processes, to determine the extent to which the company is in compliance with the duty to respect human rights in their operations. HRCA Version 1.0 has over 350 questions and 1000 corresponding indicators, which cover the full range of human rights in the UDHR and all of the major UN human rights conventions and ILO conventions. HRCA version 2.0 will be launched to the public in March 2010, in an updated and streamlined version containing fewer than 200 questions in the main database, and based on a programme that will provide greater functionalities to users. It will also contain a Build a Company Checklist Wizard that will enable the user to tailor the database to company needs in just a few minutes.

Specialized versions of the HRCA have been developed to cater for the needs of different industries, different countries, and for special issues. Different industry applications of the tool have been developed, with specialized questions for the pharmaceutical industry, food industry, extractive industry, and chemicals industry. Other issues covered in specialized checklists include security and the Voluntary Principles and residential housing provided by companies. There are two free tools, the Quick Check and the Dalit Caste Discrimination check. Country versions of the HRCA include a South Africa Quick Check, a Balkans Check, and a China Quick Check.

The target users of all versions of the HRCA are companies who are engaged directly in the means of production of tangible goods and services. In other words, the questions and the indicators presume that the company user is assessing the impact of its own operations on the human rights of individuals about whom it can and should possess knowledge. The range of rights holders potentially impacted includes workers, the local community (in physical proximity of the operations), consumers, and people exposed to the products and advertising or marketing by the company, among others. In addition, the HRCA tests for a company's complicity in violations by the state.

Some of the features of HRCA 2.0 are directly relevant to developing a FS HRCA.

HRCA 2.0 is being designed as a relational database system. The user will be able to respond to a query and make choices according to different criteria, and the programme will generate a tailored checklist according to the criteria. DIHR administrators will have the ability to edit the checklists after saving the results of the query, including deleting, adding and changing questions and indicators, and this feature can be shared with company partners who participate in the development process. This new functionality will substantially increase the potential for efficient and effective collaborative development of new HRCA versions. In conclusion, the HRCA 2.0 will have the potential to offer a platform onto which the FSHRCA can be developed.

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Annex 5

GRI FSSS indicators and HRCA methodology at a glance

Product and service impact indicators	**Comments and suggestions**
Indicators FS1-12	These indicators deal primarily with product and service lines and the institutions' overall management approach to ESG integration. It would be necessary to develop process-oriented indicators for this section, with a specific reference to single processes and not a general descriptive requirement.
Economic performance indicators	**Comments and suggestions**
Two indicators in this section could include a human rights angle. **Core Indicator EC8**: Development and impact of infrastructure investments and services provided primarily for public benefit, through commercial, in kind or pro bono engagement **Additional Indicator EC9**: Understanding and describing significant indirect economic impacts, including the extent of impacts.	The core and additional economic indicators EC8 and EC9 do not include a human rights perspective. The mention of infrastructure investments for public benefit through commercial engagement is an allusion to project and corporate financing, and could be expanded to include a human rights understanding.
Environmental performance indicators	**Comments and suggestions**
Indicators EN1-30	Most of these indicators are very technical. The complete HRCA contains indicators related to water and local community. There is scope for adding a human rights dimension to many of these indicators, for example related to the right to health and right to food, for example.
Social performance indicators	**Comments and suggestions**
Labour Practices and Decent Work Indicators LA1- LA12	These indicators deal primarily with the employed workforce of the institutions—diversity, benefits, unionism, health and safety, training and education. They focus on the labour policies and conditions within the organisation. A possibility for expansion could be adding indicators concerning investment operations and assets, i.e. Are project and investment impacts on labour conditions assessed and understood?
Human Rights Indicators HR1-HR9 divided into 7 Aspects	All relevant human rights issues are covered but the compliance requirements for financial institutions are timid and can be adapted to operations limiting the HR relevance. A better specification of assets and operations is necessary.
Investment and Procurement Practices: Core Indicator HR1 Percentage and total number of significant investment agreements that include human rights clauses or that have undergone human rights screening; Core Indicator HR2 Percentage of significant suppliers and contractors that have undergone screening on human rights and actions taken; Additional Indicator HR3: Total hours of employee training on policies and proce-	These are the most relevant indicators for investment professionals because include the disclosure requirement concerning human rights and ESG screening. There is great potential for expanding this section, concerning for example what kind of human rights screening has been applied. It is also worth noticing that HR1 and HR2 include a definition of investment agreements as 'the range of financing agreements including standard banking, loan agreements, underwriting contracts including insurance agreements.' Reporting on asset management is covered in the policy description (Management Disclosure, indicators FS1-FS12). This separation between asset management and other banking operations has the risk of underreporting and dismissing portfolio management as a policy practice rather than covered by the same compliance exercise. Although there is a good general overview of the issues at stake, there is a lack of specification regarding which operations are under scrutiny. If invest-

dures concerning aspects of human rights that are relevant to the operations **The other aspects covered by the indicators are:** Non-discrimination; Freedom of association and collective bargaining; Child labour; Forced and compulsory labour; Security practices; and Indigenous rights.	ment agreements were defined for HR1 and HR2, the rest of the indicators refer to 'operations' which is most likely subject to limitative interpretation. The jargon is very risk oriented and this seems to be quite welcomed by financial professionals.

Society performance indicators	Comments and suggestions
Indicators So1-So8	These indicators are extremely relevant to community impact, which is a substantial and important part of the HRCA. So1, FS 13 and FS14, So2-So4 and So6 could all be supported by more detailed and precise standards.

Product responsibility performance indicators	Comments and suggestions
Indicators Pr1-PR9	These indicators related to the impact of products on users and the wider community. The HRCA contains several questions about these points, in particular customer health and safety, labelling, and customer privacy. These indicators could be filled out and be given a greater human rights focus by use of the HRCA.

Annex 6

Case studies

Historical financial sector case study: The transatlantic slave trade during the 16th to 19th centuries

Recent research about how the financial sector of North America and Europe served as the backbone of the North Atlantic slave trade reveals the tight links between financial services, the development of the finance industry itself, and the industries tightly linked to transatlantic slavery. Slavery reparation litigation and slavery disclosure laws in the United States have compelled financial companies to report their predecessor banks' past links to the transatlantic slave trade and the practice of slavery.[51] Credit arrangements and insurance provision underpinned all of the critical elements of the 'Triangular trade'—involving the provision of manufactured goods to Africa, capturing Africans and transporting them to plantations in the Americas, and selling products made in the Americas to Europeans, particularly sugar.[52]

Insurance companies wrote slave life insurance policies, which protected slave owners' investment, and were essential because slaves undertook ultra hazardous activities and had short life expectancies.[53] Banks accepted slaves as collateral for provision of credit, and they also provided trustee services to clients in deals involving plantations where slavery was used.[54]

The financial sector's products and services were the lifeblood of these high-risk and high-capital ventures. Triangle voyages (Europe-Africa-Americas-Europe) could last more than 18 months, and required the construction of ships, purchase of European goods, the capture and purchase of humans, loss of life during the Atlantic passage (average of 12-13%),[55] sales of humans to plantation owners, and purchase of products for the voyage home. Business risk was high and necessitated the development of a sophisticated financial industry to ensure the flow of funds to cushion the risk.

There is also a claim that the financial sector developed *precisely* in order to meet the needs of international empire building, and in particular the slave trade.[56] Specifically, this claim argues that London's banking and insurance industry developed to service the slave trade and intricately linked industries (such as sugar).[57]

The richness of these links can be further appreciated by focusing on the Triangle trade's sister industries and their links to slavery. The sugar industry's business model was dependent on slavery because forced migration and slavery was required to ensure a labour force, the indigenous population of the West Indies having largely been eliminated through conquest and disease. The shipping industry specifically serviced the slave trade, designing and constructing purpose-built vessels for the transatlantic slave trade.

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[51] *Slavery Era Disclosure Ordinance, City and County of San Francisco*, Report to the Mayor and Board of Supervisors, Office of the City Administrator, November 8, 2007. http://www.sfgov.org/site/uploadedfiles/oca/SE_Report.pdf, accessed January 5, 2010. For more information regarding slavery reparations http://academic.udayton.edu/race/02rights/repara00.htm;http://www.nationalcenter.org/Reparations.html

[52] *Slavery and the Building of Britain*, James Walvin, http://www.bbc.co.uk/history/british/abolition/building_britain_gallery_02.shtml#one Accessed on 5 January 2010

[53] Chicago City Council Hearing on JP Morgan Chase Manhattan Bank Merger, March 5, 2004, Testimony of Deadria C. Farmer-Paellmann, http://academic.udayton.edu/race/02rights/repara30.html , accessed January 5, 2010.

[54] *UK law firm and bank regret slave trade links*, Wed Jul 1, 2009 By Avril Ormsby. Reuters online http://www.reuters.com/article/idUSL171535320090701 Accessed on 5 January 2010.

[55] *A Brief Overview of the Trans-Atlantic Slave Trade*, David Eltis (Emory University), 2007, on the Trans Atlantic Slave Database, http://www.slavevoyages.org/tast/assessment/essays-intro-07.faces, accessed on 5 January 2010.

[56] Walvin, Ibidem.

[57] *London, slavery and abolition*, Dr Hakim Adi. http://www.bbc.co.uk/london/content/articles/2007/03/23/abolition_hakim_adi_features.html Accessed on 5 January 2010

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Modern case study: Coltan

Modern parallels to the Triangular Trade's interlinking industries abound. Consider coltan mining, whose end product tantalum is found in cell phones. Also known as cassiterites, coltan is refined to produce tantalum, an essential component of electronic products. 80% of the world's reserves of coltan are located in eastern Democratic Republic of Congo (DRC), which currently provides approximately 15% of the world's supply of tantalum.[58] A wide range of companies are knowingly involved in the extraction, transport and use of coltan, including exporting companies, processing companies, and cell phone manufacturers, all over the world.[59] Coltan mining has fuelled civil and international conflict in the DRC, and the conflict and coltan mining itself result in human rights abuses of the right to health and the right to life, alleged forced labour, forced displacement and the right to housing, poor labour conditions. Manufacturers of cell phones and the DRC government have sought to distance themselves from the abuses,[60] and a certification process was reportedly initiated by the government of DRC in 2009.[61]

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[58] Essick Kristi, *Guns, Money and Cell Phones*, The Industry Standard Magazine, Issue Date: Jun 11 2001, accessed 16 January 2010 at http://www.globalissues.org/article/442/guns-money-and-cell-phones

[59] *Report of the Panel of Experts on the Illegal Exploitation of Natural Resources and Other Forms of Wealth of the Democratic Republic of the Congo*, Para 74-76,181-184 and Annex 1 for a list of companies reported to be involved in exportation of coltan and cassiterite to Europe.

[60] Essick Kristi, Ibidem.

[61] Bavier Joe, *Congo to begin coltan certification in 2009*, Reuters. 25 Mar 2008, accessed 16 January 2010 at http://www.business-humanrights.org/Links/Repository/746293

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