

The Financial Crisis: An Environmental, Social and Governance Perspective





SOCIAL INVESTMENT ORGANIZATION

The Canadian Association for Socially Responsible Investment

June, 2009

On behalf of the Social Investment Organization, I'm pleased to present this report, *The Financial Crisis: An Environmental, Social and Governance Perspective*.

As the voice of the socially responsible investment industry in Canada, we believe that the roots of the financial crisis afflicting economies around the world lay in the hidden balance sheet risks of environmental, social and governance issues.

As this report clearly illustrates, these risks were not plainly identified to investors by the originators of asset-backed securities that were so prevalent even a year ago. As a result, investors did not clearly know what they were buying. When the true nature of these securities finally came to light, the effects were catastrophic, resulting in massive losses to investors, and a drag on economic growth.

This episode has lessons for long-term investors of all types, whether or not they approach investment from a socially responsible perspective. It also contains lessons for regulators, who need to address the deficiencies in the disclosure rules to create an environment of open and transparent information on environmental, social and governance issues.

We consider the issue of ESG transparency to be one of the most important public policy priorities facing the capital markets. That's why we were pleased to commission this report, using funds from the Fund for Action on Investment Responsibility (FAIR).

FAIR is an innovative fund of the Tides Canada Foundation, and a project of the Social Investment Organization. Its mandate is to advance research and education on public policy to encourage investment in sustainable and socially responsible activities.

We encourage you to read this report, and to urge investors, policy-makers and regulators to heed its advice.

Sincerely,

A handwritten signature in black ink that reads 'Eugene Ellmen'.

Eugene Ellmen
Executive Director

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Executive Summary

The current financial crisis has exposed a number of structural and functional weaknesses in the global financial system. Some consensus has been reached on the main contributing factors to the crisis, many of which have long been the focus of a subset of the investment community known as socially responsible investors. The Socially Responsible Investment (SRI)¹ community has actively campaigned and engaged with public companies on issues such as executive compensation, transparency and predatory lending for more than two decades.

This report examines the root causes of the financial crisis from the environmental, social and governance (ESG) perspective employed by the SRI community. The report describes the progression of the crisis, places it in the Canadian context and analyzes the factors that are most relevant to socially responsible investors; namely governance and executive compensation, subprime and predatory lending, transparency and disclosure, securitization and systemic risk. It also comments on the role of regulatory gaps throughout the system.

The report also highlights similarities between the financial crisis and the issue of climate change, and describes how lessons learned from the financial crisis can be applied to the climate change crisis. Finally, it provides a synopsis and assessment of the actions of the SRI community leading up to and during the crisis and makes recommendations for long-term investors and policy-makers.

In our analysis of the SRI community, we found that it was ahead of the mainstream financial community on issues like corporate governance, executive compensation, predatory lending and transparency – all significant contributors to the crisis. However, with few exceptions, the SRI community did not foresee the crisis any better than did the mainstream financial community.

Nonetheless, the crisis does reinforce the critical importance of two tenets of SRI, specifically, the value of long-term investing and the necessity to identify and measure hidden risks. In fact, the SRI community can take credit for laying the groundwork for the recent broader acceptance of concepts such as shareholder oversight of executive compensation and enhanced reporting.

While socially responsible investors clearly care about ESG issues from a values perspective, they also typically link ESG performance with long-term financial performance. However, in many instances this link needs to be better established and the financial consequences of ESG issues better defined.

The financial crisis has drawn attention to issues of concern to the SRI community and, despite its negative consequences, represents an opportunity to further the objectives of the community.

With respect to climate change, another key focus of the SRI community, in addition to the devastating environmental and social problems that will result if the process continues unabated,

¹ SRI is also commonly known as sustainable investment, responsible investment, and environmental, social and governance (ESG) investment.

we identify some potential problems on the political and financial fronts that could serve to exacerbate this already grave situation.

First, governments are displaying an admirable single-mindedness in addressing the financial crisis, but there are concerns that this is diverting attention and resources from addressing the unprecedented risks posed by climate change. Second, the developing market for carbon has the potential to resemble the subprime lending market if regulators and investors do not proceed with care and caution. Finally, while investment in renewable and cleaner forms of energy production and distribution are critical elements of any genuine effort to mitigate the effects of climate change, the growing level of support for and popularity of alternative energy technologies could be providing fuel for the next speculative bubble.

Based on our analysis, we make eight recommendations; four targeted at long-term investors and four for policy-makers and regulators:

For long-term investors

- Fully integrate ESG factors into investment decision-making processes.
- Call for greater transparency on ESG factors.
- Support executive compensation that rewards long-term performance.
- Use the lessons of the financial crisis to anticipate and mitigate the effects of future crises.

For policy-makers

- Mandate disclosure on ESG issues by corporations.
- Mandate disclosure on ESG issues by institutional investors.
- Mandate shareholder advisory votes on executive compensation.
- Establish a system for national enforcement of securities regulations in Canada.

Introduction

The financial crisis that has gripped the global economy is the result of a variety of complex and interconnected factors, with consequences that have affected every sector of the economy.

This report examines the root causes of the financial crisis from the perspective of the SRI community, which focuses on ESG issues. Social and governance issues play a prominent role in the crisis, while the fallout from the crisis has the potential to impact efforts to address serious environmental threats such as climate change.

The complexity of the crisis makes it difficult to identify and accurately assess the importance of every contributing factor. As such, this report makes no attempt to do that. Rather, the report describes the progression of the crisis, places it in the Canadian context² and analyzes the factors that are most relevant to socially responsible investors. The report provides a synopsis and assessment of the actions of the SRI community leading up to and during the crisis and, finally, provides some recommendations for long-term investors and policy-makers.

The report draws on information from a variety of publicly available sources, including shareholder resolutions databases, investment reports, industry list serves and newsletters, academic studies and mainstream media.

² Because the crisis originated in the U.S., much of the analysis and many of the examples provided in this report refer to the U.S. financial market. A Canadian perspective is provided wherever possible and applicable.

Background

During much of 2007 and 2008, the U.S. financial system suffered a series of shocks related to the collapse in value of mortgage-backed securities and the resultant freezing of credit markets. During that period, the U.S. government bailed out investment firm Bear Stearns, allowed Lehman Brothers to fail, effectively nationalized mortgage giants Fannie Mae and Freddie Mac and insurer AIG, passed a bill authorizing a \$700 billion³ bailout package and unveiled a \$250 billion plan to purchase stakes in the country's nine largest banks—all designed to reassure the markets and get credit flowing again.

The effects were also felt globally. A significant shock occurred on August 9, 2007, when BNP Paribas, a leading French bank, announced that it was suspending three of its investment funds due to a "complete evaporation of liquidity" in the market.(1) Through the balance of 2007 and 2008, a number of European countries took action to rescue their financial systems. In November 2008, the International Monetary Fund (IMF) approved a \$2.1 billion loan for Iceland following the October collapse of the country's banking system.(2)

Now, in the first half of 2009, the global economy is in a state of crisis, the duration and severity of which will not be known for some time. Equity markets are off substantially, jobs have been lost by the millions and the world economy is mired in a deep recession.

The crisis has its roots in the U.S. housing market. Following the dot-com bubble⁴ of the

late 1990s, the U.S. Federal Reserve increased the money supply and lowered interest rates to their lowest levels in 45 years in an effort to stimulate the economy. This, along with a general loosening of mortgage credit, fuelled an unprecedented real estate boom, one in which, according to the S&P/Case-Shiller national home-price index, housing prices in the U.S. appreciated by an average of 12 per cent per year from 2000 to 2005. (3)

The boom also resulted in a marked increase in subprime lending in the mortgage market. Subprime mortgage loans are made to borrowers that are unable to qualify under traditional criteria due to weakened credit histories or reduced repayment capacity as measured by credit scores, debt-to-income ratios or other criteria. According to the U.S. Federal Reserve, approximately 20 per cent of all new mortgages issued in 2005 and 2006 were subprime.(4)

Because subprime mortgage loans have a higher rate of default than prime mortgage loans, they are priced based on the risk assumed by the lender. Many subprime mortgages included a low initial interest rate that stayed fixed for two or three years and then reset to a much higher rate. Other common features included low or zero down payments, monthly payments that covered only mortgage interest or mortgages that were granted with no documentation with respect to ability to repay the loan.

Between 2004 and 2006, U.S. interest rates rose from one per cent to over five per cent,(5) triggering a slowdown in the housing market and a significant increase in mortgage

³ All figures in U.S. dollars, unless otherwise noted.

⁴ A speculative bubble from 1995-2001, during which the stock markets in Western nations saw rapid

growth fuelled by the Internet sector and related fields.

delinquency and default rates. Default rates on subprime loans rose to record levels. The impact of these defaults was felt throughout the financial system because of an innovation called “securitization.”

In the mid 1990s, subprime lenders began reselling loans in bulk to Wall Street banks. The banks, in turn, packaged bigger pools of securities into complex financial products such as collateralized debt obligations (CDOs), and carved them into tranches, each with a different level of risk and return. Because of the way they were structured, some CDO tranches achieved triple-A ratings, even though they contained subprime loans. CDOs and other securitized products attracted investors from all over the world, including traditionally conservative investors such as commercial banks, insurance companies and pension funds.

Another recent financial innovation is the credit default swap (CDS), a type of insurance contract in which the buyer of the CDS makes a series of payments to the seller and, in exchange, receives a payoff if a credit instrument—such as a CDO—goes into default. Like all insurance products, a balance

is maintained unless there is a major unforeseen or catastrophic event.

In this environment, the bursting of the housing bubble started a cascade of failures. Mortgage delinquency and default rates spiked, causing significant problems for lenders, particularly those—like Fannie Mae and Freddie Mac—that were active in the subprime market. Because of securitization and the interconnectedness of financial markets, this led to the collapse in value of mortgage-backed securities and put investment banks like Bear Sterns in distress. As the CDO market collapsed, insurance companies—like AIG—that had significant positions in the CDS market became vulnerable—this was the unforeseen and catastrophic event. These events ultimately caused credit markets to freeze, cutting off a crucial source of funds for consumers and businesses.

The manner in which the financial crisis unfolded shows that financial innovations that were ostensibly designed to distribute and absorb risk instead multiplied it, in ways that neither regulators nor investors anticipated.

Figure 1: A Visual Overview



The Canadian Context

The Canadian economy has suffered significant disruption from the effects of the global financial crisis—as have the lives of many Canadians. However, Canada has weathered the financial crisis better than most nations and is expected to recover more quickly.

The Canadian economy, as measured by GDP, contracted by 3.4 per cent in the fourth quarter of 2008, compared to 6.2 per cent in the U.S., 6.0 per cent in the United Kingdom and 12.7 per cent in Japan.⁽⁶⁾ The Bank of Canada projects that the Canadian economy will contract by 3.0 per cent in 2009, followed by 2.5 per cent growth in 2010. This compares

favourably with projections for the U.S. (-2.4 per cent and 1.2 per cent in 2009 and 2010, respectively), the European Union (-3.6 per cent and -0.2 per cent) and Japan (-6.2 per cent and 0.1 per cent).⁽⁷⁾

With respect to employment, Canada lost approximately 375,000 jobs between October 1, 2008 and March 31, 2009, reaching an unemployment rate of 8.0 per cent, which is only slightly better than the unemployment rates of 8.5 per cent and 8.3 per cent for the U.S. and the European Union, respectively.⁽⁸⁾ ⁽⁹⁾ ⁽¹⁰⁾

While Canada has not been fortunate enough to avoid the collapse of global equity markets, to date it has experienced a quicker recovery than many other markets. One-year returns for the period ending April 30, 2009 for the S&P/TSX Composite Index were -30.70 per cent. Over the same period, the S&P 500 and the MSCI World Index lost 35.31 per cent and 40.88 per cent, respectively.⁽¹¹⁾ As of April 30, 2009, year-to-date returns for the S&P/TSX Composite Index were 5.11 per cent, while returns for the S&P 500 and the MSCI World Index were -2.50 per cent and -2.61 per cent, respectively.⁽¹²⁾

The strength of the banking system is receiving much of the credit for Canada's strong performance relative to other nations. In fact, Canada's banking system is being touted in many quarters as a model for bank reforms in other countries.

Proponents of Canada's system point to a number of factors, including the fact that Canadian banks face more stringent regulations in some critical areas, such as required leverage and capital ratios, and charge higher fees than their counterparts in the U.S. To date, no major Canadian financial institution has failed or required direct government infusions of capital.⁵ In fact, Canada's five largest banks were all profitable in the last quarter of 2008.

In addition, regulations related to mortgages—on both the lending and borrowing side—are different in ways that helped Canada avoid the crippling mortgage crisis that occurred in the U.S. For example, in the U.S., Federal Housing Administration

⁵ The Government of Canada has, however, purchased a substantial number of insured loans from financial institutions and has played a central role in supporting the availability of credit and removing potentially distressed assets from bank balance sheets.

programs allowed mortgages with only a three per cent down payment, while in Canada if a down payment is less than 20 per cent of the value of a home, the mortgage holder must purchase mortgage insurance. In addition, mortgage interest is not tax deductible in Canada. Finally, mortgages in many states are non-recourse, which means that if the borrower defaults the lender can seize the collateral but the lender's recovery is limited to the collateral, even if the value of the property is insufficient to cover the outstanding loan balance. Canadian mortgage holders are held strictly responsible for their home loans and banks can launch claims against their other assets.

Despite the strengths of the banking system, Canada has been affected by the subprime mortgage crisis; in part through subprime loans held by Canadians but more so through an investment vehicle known as asset-backed commercial paper (ABCP).

ABCP is a short-term investment vehicle, with a maturity that is typically between 30 and 90 days, containing a parcel of assets such as credit card receivables, automobile loans, trade receivables and mortgages. Like other securitized products, the appeal of ABCP was that it offered a higher-yielding alternative to Treasury Bills and other short-term securities.

The ABCP market in Canada consisted of two types of ABCP products; bank-sponsored ABCP and non-bank sponsored ABCP. Both received triple-A credit ratings, with the non-bank ABCP offering slightly higher yields.

ABCP in Canada traded in the exempt market for short-term debt, which meant that ABCP issuers were not subject to regulatory requirements for prospectus filings or continuous disclosure.

Because ABCP consisted of short-term notes backed by longer-term assets, the companies that issued ABCP were forced to continually seek refinancing for maturing notes, so typically arranged with banks to provide emergency liquidity. The liquidity agreements contained provisions that providers of emergency funding—mostly foreign banks—would only provide such funding in the case of “general market disruption,” meaning liquidity would be provided only if commercial paper could not be issued by any issuer at any price.

In August 2007, when it became clear that some of the assets behind the ABCP contained risky loans such as subprime mortgages in the U.S., ABCP issuers were unable to roll over their maturing notes, causing the ABCP market to freeze.

When the ABCP market froze, bank-sponsored ABCP issuers continued to roll over their ABCP with minimal disruption. Banks bought back much of the ABCP, returning significant amounts of ABCP to their balance sheets. As a result, some liquidity providers asserted there was no “general market disruption” and refused to provide liquidity to non-bank issuers. Without liquidity support, the non-bank ABCP market in Canada ceased to operate.

In response to the collapse of the ABCP market, a private sector committee called the Pan Canadian Committee of Third Party ABCP Investors proposed an agreement in December 2007, whereby the illiquid ABCP would be exchanged for securities with longer maturity dates, in the hope that a market would emerge and investors could recover some of their money. Although large institutional investors expressed satisfaction with the proposal, about 1,800 small retail investors protested. The restructuring was finally approved in April 2008 after Canacord

Capital, which had about 1,400 of the 1,800 small investors as clients, agreed to repay them in full, plus accrued interest. The agreement was completed with a \$4.4 billion Cdn guarantee from the federal government and the governments of Alberta, Ontario and Quebec and passed in January 2009. All parties relinquished the right to sue over losses caused by the crisis.

Contributing Factors: An ESG Perspective

Governance and Executive Compensation

Background

It is unequivocal that weaknesses in corporate governance contributed to the global financial crisis. Broadly defined, corporate governance refers to the rules or processes by which businesses are directed and controlled. Clearly, many financial companies were not being governed properly if they were permitted to take the extreme risks they did. Corporate governance crusader Carl Ichan summarizes it thus: “The credit crisis we find ourselves in is a direct manifestation of board members' lack of oversight. Alarm bells should have gone off in board rooms as crisis loomed, but many boards looked the other way.”(13)

Indeed, much is being written about lack of oversight that led to the overleveraging of financial institutions and their exposure to risky investment products such as securitized mortgages. A great deal of attention is also given to executive compensation and the degree to which executives were provided with huge incentives to take risks with a focus on short-term results.

Actions and Response

Corporate governance has long been a central concern of socially responsible investors, who have actively been seeking improved governance in several areas, including, independent boards, greater shareholder rights and, of course, executive compensation. This work has been carried out through the submission of shareholder resolutions, proxy voting, engagement with

corporate executives and boards, lobbying and education.

In Canada and the U.S., shareholder resolutions addressing governance issues—most of which were filed by socially responsible investors—make up the vast majority of all shareholder resolutions. In Canada for example, in the 2008 proxy season, governance proposals accounted for 76 per cent of all shareholder resolutions, totalling 133 separate proposals. During the past five years, this number has never dipped below 70 per cent.

There is a stark contrast in the level of support these resolutions receive from socially responsible investors and from mainstream investors. A study published by the Canadian Social Investment Organization (SIO) in 2007(14) found that corporate governance resolutions filed from the period June 2005 to June 2006 received a combined 63 per cent support from SRI mutual funds and only 27 per cent support from mainstream mutual funds.

These resolutions included proposals to do away with dual-class shares, limit executive compensation, separate the role of CEO and board chair and ensure the independence of the nominating committee.

While poor overall governance failed to prevent some corporations from operating recklessly, one particular aspect of corporate governance, namely executive compensation, is generally recognized as a significant contributing factor to the global financial crisis. In the words of U.S. Treasury Secretary, Timothy Geithner, "You had a crisis magnified

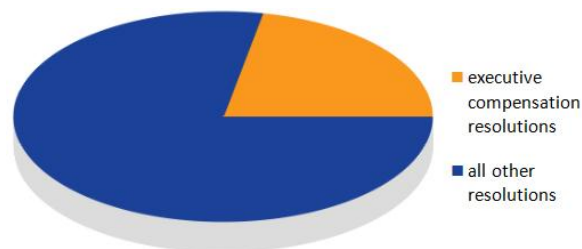
by the fact that people were paid to take huge amounts of short-term risk."(15)

The SRI community has been concerned with excessive and ineffective executive compensation for some time. This concern, in part, was and remains rooted in ideas of social justice and a sense of fairness related to the fact that top executives often earn hundreds of times the amount of mid- and lower-level employees. However, the concern can equally be described as a concern for the financial health of companies, as CEOs and other top executives receive large payouts that are unrelated to the financial performance of their companies.

A 2006 study of companies on the S&P 500 Index by The Corporate Library(16) showed very little correlation between the largest percentage increases in total executive compensation and long-term value creation. Most people are familiar with recent events at A.I.G., where senior executives of the nearly bankrupt company were about to be paid large bonuses and other compensation, including \$19 million in remaining payments to Martin J. Sullivan, the company's former CEO before the U.S. Attorney General intervened in early 2009.

Despite the shared concern over executive compensation today, the SRI community had little support when it began working on this issue. According to the SIO study mentioned above, even as recently as 2006 mainstream funds gave a combined 8 per cent support to resolutions addressing executive compensation, while socially responsible mutual funds gave a combined 58 per cent support.

Figure 2: Executive compensation resolutions (Canada: 2004-2009)



In contrast, since the full extent of the financial crisis has been revealed, "say on pay" resolutions, which ask that shareholders have an annual advisory vote on senior executive compensation, are receiving majority support at several Canadian companies and prompting other companies to voluntarily adopt such mechanisms.

In the U.S., "say on pay" proposals are also receiving record levels of support, though this must be in part related to the fact that The American Recovery and Reinvestment Act of 2009 (TARP) calls for mandatory shareholder votes on executive compensation at the 400 firms that have received federal assistance.

Large institutional investors, in Canada, Europe and the U.S., largely following the lead of early SRI pioneers, are playing an increasing role in addressing executive compensation. The Canada Pension Plan Investment Board (CPP Investment Board), for example, with over \$100 billion Cdn in assets under management, has made executive compensation a key area of focus in its engagement strategy. In its 2008 Report on Responsible Investing, CPP Investment Board describes meeting with companies to encourage improved compensation disclosure and stronger links between pay and performance.(17)

On the policy front, socially responsible investors can take credit for helping to bring about significant governance reform by regulators and lawmakers. In the U.S., for example, the Social Investment Forum (SIF), the U.S. trade association for professionals and institutions working in SRI, was successful in 2008 (in concert with other concerned investors) in blocking actions to limit the right of shareholders to file resolutions. Also, after significant lobbying by the SRI community, in May 2009, the SEC proposed rules to greatly expand proxy access, granting shareholders the right to nominate directors.

In Canada, one of the most important victories for the SRI community came in 2001, when the SIO and its members were part of a successful lobby to amend portions of the Canada Business Corporations Act (CBCA) that governed shareholder resolutions. Prior to the changes, companies could reject the circulation of shareholder resolutions for a wide range of reasons. These restrictions made it very difficult for shareholders to address legitimate environmental, social and governance concerns on the proxy. For example, prior to the changes, only registered shareholders could submit resolutions, excluding the vast majority of individuals who were beneficial shareholders.

While socially responsible investors can claim success in laying the groundwork that enabled corporate governance, and in particular, executive compensation to come to the forefront of public and government attention, there are two areas that have received less attention than perhaps they should have in light of the financial crisis.

First, while SRI analysts have long been concerned with executive compensation that is excessive and insufficiently related to clear performance targets, to date less attention has been paid to the short-term nature of

compensation plans, which encourage executives to adopt short time horizons and focus too closely on short-term share price rather than long-term value.

Secondly, by focussing on senior executives, the large equity-based incentive plans and cash bonuses offered to lower-level executives have largely been ignored. It is true that the disclosure of this information is not mandated as it is with top executives, but we have seen how these compensation packages encourage the most egregious risk-taking behaviour. For example, it was the executives of A.I.G.'s financial products unit that undertook many of the complex financial transactions that pushed the company to the edge of bankruptcy.

Subprime and Predatory Lending

Background

As previously described, subprime lending is the practice of extending credit to borrowers with credit characteristics that disqualify them from loans at the prime rate. "Subprime" refers to the risk associated with a borrower, not to the interest rate being charged on the mortgage. To compensate for this increased risk, lenders charge subprime borrowers a premium, such as a higher interest rate or some other less-favourable borrowing terms. While the term "subprime" has come to be associated with mortgages, subprime lending encompasses a variety of credit types, including mortgages, automobile loans, credit cards and payday loans.

Predatory lending, which refers to unethical lending practices in the subprime market, is the practice whereby a lender deceptively persuades a borrower to agree to abusive loan terms. Predatory lending involves unfair,

deceptive or fraudulent practices by lenders during the loan origination process.

About 21 per cent of all mortgage originations in the U.S. from 2004 through 2006 were subprime, up from nine per cent from 1996 through 2004. Subprime mortgages totalled \$600 billion in 2006, accounting for about one-fifth of the U.S. home loan market. (18)

Predatory lending is particularly problematic from an ESG perspective, as it involves unfair or even fraudulent practices, often targeted at racial minorities, new immigrants, the elderly, the less educated and people with a proven record of not paying their debts on time. In addition, the fallout from the many factors surrounding subprime lending has resulted in a massive loss of shareholder value.

Actions and response

The SRI community in the U.S. has been active on subprime and predatory lending for the past decade. According to the Interfaith Center on Corporate Responsibility (ICCR), the first shareholder resolution directed at predatory lending was filed in 1999, and at least two-dozen have been filed in total.(19)

According to data provide by ICCR and As You Sow, between 2004 and 2008 at least seven shareholder resolutions directly addressing subprime and predatory lending were filed in the U.S.(20)(21)

The SRI community's engagement with Associates First Capital provides a good example of its early approach to engagement on this issue. In May 2000, shareholders of the company voted nine per cent in favour of a resolution asking the company to develop and enforce policies to bring an end to its predatory lending practices. The nine per cent vote of support was viewed as a success

because it was enough to allow for the resolution's resubmission the following year.

At around the same time, the SIF launched a national campaign to promote community investment and to raise awareness about and stem the rising tide of predatory lending.

The Associates First Capital resolution was one of three predatory lending resolutions filed by shareholders that year, but was the only one to come to a vote. The other two were omitted by the SEC. A similar shareholder resolution at Associates First Capital in 1999 was omitted by the SEC, which ruled that "general conduct of a legal compliance program" was considered an "ordinary business" question.(22)

Not surprisingly, after the full extent of the financial crisis was revealed, socially responsible investors filed a larger number (at least 17) of shareholder resolutions addressing subprime and predatory lending issues in 2009. The focus of shareholder proposals shifted somewhat for the 2009 campaign, with the filing of proposals targeting predatory credit card practices at three of the country's largest banks.⁶(20)

The SRI community has also been active on the issue on other fronts, notably lobbying, education and research. For example, in 1999 the Coalition for Responsible Lending led an effort that resulted in the passage of the *North Carolina Predatory Mortgage Law*, making North Carolina the first state to enact legislation to curb predatory mortgage lending.(23)

The SRI community, primarily through organizations that are active in community

⁶ Similar proposals at four other banks were withdrawn after discussions with the banks led to positive outcomes.

economic development, has produced a number of studies on subprime and predatory lending, highlighting issues such as the high cost of predatory lending, the effectiveness of anti-predatory lending laws and the effect of race and ethnicity on the price of subprime mortgages. A recent study(24) refuted claims that the *Community Reinvestment Act* contributed to predatory mortgage lending.

The financial crisis has also served to highlight the importance of Community Development Financial Institutions (CDFI), which provide an alternative to subprime and predatory lending by, among other things, supporting homeownership in low-income communities that have been traditionally underserved by banks. At the time of writing, there are more than 1,000 CDFIs operating in the U.S.

Finally, there is a noteworthy example of a case where SRI researchers were ahead of mainstream analysts when it came to predicting the financial crisis. In October 2006, based on the sharp increase in the value of loans made to subprime borrowers between 2001 and 2005, Innovest Strategic Value Advisors (now a division of RiskMetrics Group) analysts concluded that a large number of these subprime borrowers would not be able to pay off their loans. Innovest predicted that the impact of the inevitable spike in foreclosures would be felt throughout the capital markets because of the securitization of the underlying mortgages. It would be inaccurate to state that nobody else had predicted the financial crisis at this point—some economists had made similar predictions—but Innovest’s analysis was certainly out-of-step with accepted wisdom on Wall Street. (25)

More recently, in an October 2008 white paper entitled *Credit Cards at a Tipping Point*, Innovest predicted that credit cards would be

the next victim of the ongoing credit deterioration.(26)

The SRI community in Canada has been less active on predatory and subprime lending. According to data provided by the Shareholder Association for Research and Education (SHARE), no shareholder resolutions addressing issues related to subprime and predatory lending were filed between 2004 and 2007. A total of nine resolutions addressing ABCP and high risk mortgages were filed in 2008. (It should be noted that these resolutions were filed after the ABCP market froze in August 2007.) No shareholder resolutions addressing subprime and predatory lending were filed in 2009. This lack of activity is largely due to the fact that predatory and subprime lending are much less prevalent in Canada.

It is important to note that Canadian SRI fund managers have been active on the issue of predatory and subprime lending through their holdings of U.S.-based companies. For example, in November 2000, The Ethical Funds Company (then known as Ethical funds Inc.) co-filed a shareholder resolution at Citigroup following the company’s acquisition of Associates First Capital, which, as previously described, faced a resolution earlier in the year asking the company to end its predatory lending practices.

Transparency and Disclosure

Background

Transparency is a popular word in financial circles today. Investors are demanding it and regulators are promising it. There is little debate that the financial crisis was in large part due to the opaque nature of financial innovations like CDOs. In short, investors didn’t know what they were buying.

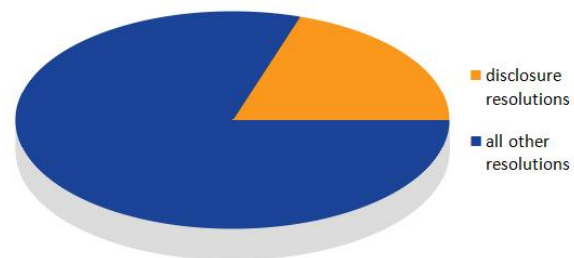
Institutions thought they were making prudent investments when they purchased the highest-rated portions, or tranches, of CDOs. In writing about subprime-mortgage-backed securities, a recent Economist column provided a succinct description of the problem. “These instruments...can have prospectuses of about 500-600 pages, most of which are devoted to intricate legalese. Yet, inexplicably, they do not contain the information about individual loans that is needed to detect default risk.”(27)

Actions and Response

The SRI community has long been a champion of transparency. Through research, shareholder action, engagement, lobbying and education, socially responsible investors have worked for increased disclosure from companies, mutual funds and pension funds. Socially responsible investors believe that transparency and accountability are inextricably linked and disclosure helps to identify risks to long-term performance.

Over the last five years, a significant proportion of shareholder resolutions in Canada and the U.S. have focused on greater disclosure. In Canada, such proposals account for roughly a quarter of all resolutions. In the most recent proxy season, 50 proposals were filed, seeking such things as: the disclosure of compensation paid to consultants and advisors, a report on climate change risk, a report on the implication of investments in Burma and improved sustainability reporting. Such proposals, most of which have been filed by the SRI community, have received intermittent support from the mainstream financial community. In 2008, for example, a proposal filed by the Nathan Cummings Foundation called on Ultra Petroleum Corporation to report on its response to climate change. The proposal attracted an unusually high 36 per cent support from shareholders.

Figure 3: Disclosure resolutions (Canada: 2004-2009)



A notable example where socially responsible investors were ahead of the mainstream with respect to the financial crisis is evidenced by shareholder resolutions submitted by Mouvement d’éducation et de défense des actionnaires (MEDAC) to several of Canada’s largest banks in October 2007. The resolutions, filed in the midst of record highs for the U.S. stock market, called on these financial companies to disclose their interests in hedge funds and high-risk mortgage loans. Support for these proposals did not reach above 19 per cent. It should be noted that while equity markets were doing well at the time the ABCP market had frozen and warnings about an imminent financial crisis were coming from a number of quarters.

Transparency has been a central concern of large institutional investors who are guided by responsible investment guidelines, as evidenced by the United Nations Principles for Responsible Investment (PRI), established in 2005. Signatories to the PRI, who include some of the world’s largest asset owners, commit themselves to six key principles built upon the belief that ESG issues can affect the performance of investment portfolios. One of the six principles states that: “We will seek appropriate disclosure on ESG issues by the entities in which we invest.”

Indeed, institutional investors have formed impressive coalitions that call on companies

for greater disclosure. The Carbon Disclosure Project, for example, comprised of nearly 500 institutional investors, makes annual climate change information requests to more than 3,700 corporations across the globe. Its goal is to encourage companies to measure, manage and reduce emissions and climate change risks and impacts.

On the regulatory front, the SRI community has long been active in lobbying for mandatory disclosure of ESG information. Guided by the adage that “what you see is what you get and what you don’t see is what gets you,” socially responsible investors have made numerous submissions to regulators and government panels making the case that ESG factors are risks to long-term performance that are being ignored by traditional reporting.

For example, in its submission to the Canadian Expert Panel on Securities Regulation, the SIO called for ESG disclosure in issuer’s annual filings and accounting reports, including Management’s Discussion and Analysis. The SIO also advocated for enhanced disclosure of the ESG policies of investment funds, and that pension funds be mandated to disclose their ESG policies and impacts. Despite a growing body of research that shows these factors are important to long-term financial performance and sustainability, these recommendations were not included in the panel’s final report and recommendations.

It is fair to say that like the mainstream financial community, the SRI community failed to fully appreciate the risks inherent in the financial markets leading up to the global crisis. Socially responsible investors, by and large, were not clamouring for greater disclosure of subprime-mortgage-backed securities or for more meaningful and accurate credit ratings.

However, the current crisis does provide grim evidence of the problems caused by a lack of transparency and the proper disclosure of risk. Until the broader investment community embraces the notion that social and environmental issues are critical to the long-term performance and sustainability of companies and, in fact, represent real potential risk, it seems likely that calls for greater transparency will go unheeded.

Securitization and Systemic Risk

Background

As described above, securitization is a structured finance process that involves pooling and repackaging of cash-flow-producing financial assets into securities, which are then sold to investors. The business of securitization is largely conducted in what is known as the shadow financial system, outside the jurisdiction of financial market regulators.

Systemic risk refers to the risk or probability of breakdowns in an entire financial system, as opposed to breakdowns in individual parts or components. It refers to the risks imposed by interlinkages and interdependencies in a system or market, where the failure of a single entity or cluster of entities can cause a cascading failure, which could potentially bankrupt or bring down the entire system or market.(28)

The securitization of subprime mortgages in the shadow financial system, itself a source of systemic risk, in combination with the systemic risk inherent in the global financial system has been widely recognized as a major contributing factor to the financial crisis.

From the perspective of socially responsible investors, this represents a perverse

extension of predatory lending, as the dubious lending practices described above were used to make large amounts of money on the backs of poor people with bad credit.

Actions and Response

Publicly available data suggest that socially responsible investors in Canada and the U.S. have not focused on the issues of securitization and systemic risk, either leading up to or since the height of the crisis.

No shareholder resolutions directly addressing securitization were filed in either Canada or the U.S. between 2004 and 2009. With respect to systemic risk, it is difficult to imagine how one would file a resolution with a single institution that targets an inherent

weakness in the global financial system. Accordingly, no shareholder resolutions addressing systemic risk were filed in either Canada or the U.S. between 2004 and 2009.

In addition, there has been very little discussion about these issues within the SRI community in public forums such as list serves and newsletters.

In hindsight, it is clear that the combination of securitization and systemic risk was one that warranted the attention of socially responsible investors, regulators and others. However, it may be understandable that this risk wasn't fully recognized, given the complexity and opacity of these structured financial products.

Climate Change: lessons from the financial crisis

The financial crisis and climate change share some fundamental characteristics. Both are a consequence of speculative and narrow interests superseding the common interest, both evolved dramatically over the current decade and both have global implications. Both are also about risk and how it is priced and managed—and the consequences when risk management goes wrong.

There are also some fundamental differences. First, while the worst impacts of the financial crisis are likely to pass within a few years the impacts of climate change could be felt for centuries. Second, as European Commission President Jose Manuel Barroso stated at the Globalization Council in Lisbon in November 2008, the risks posed by climate change are much larger than those posed by the current global financial crisis.

Mr. Barroso also said the troubles affecting the world economy should not be allowed to distract from more serious risks posed by climate change: "One thing we have learned from the financial crisis is that, if we ignore risk building up in the system, it is much harder to manage that risk. We must recognize it early and tackle it."(29)

With respect to efforts to mitigate climate change, the SRI community can use the lessons of the financial crisis to deal with some of the potential consequences of climate change and anticipate potential problems building up in the system that is developing to address the issue.

The most immediate and obvious consequence of the financial crisis with respect to combating climate change is a shift in focus. To date, reactions of governments to

the financial crisis suggest that it has become their primary focus, at the expense of important issues like climate change. For example, In November 2008 the Government of Canada announced that it would focus almost exclusively on the financial crisis and its consequences.(30)

Another potential consequence is governments pulling back from climate change commitments or failing to make necessary new commitments. An example of this came to light in April 2009, when the Province of Saskatchewan announced that it was reneging on an election promise to reduce greenhouse gases by 32 per cent by 2020, and would instead be introducing a revised, intensity-based target. (31)

In January 2009, The Green Budget Coalition, comprised of 20 of Canada's leading environmental and conservation organizations, released its response to Canada's 2009 federal budget. The coalition expressed disappointment in the budget's failure to support renewable energy and its lack of progress on putting an adequate price on greenhouse gas emissions.(32)

From an international perspective, the Kyoto Protocol expires in 2012 and the global community must negotiate a new agreement in Copenhagen in December 2009. Given the well documented problems with the Protocol, there is an understandable level of pessimism about the potential for forging an effective agreement if the financial crisis persists.

Without question, increased long-term investment in renewable and cleaner forms of energy production and distribution are critical elements of any genuine effort to mitigate the effects of climate change. A concern coming out of the financial crisis is the potential for such investments to be curtailed, as previously described.

However, in recent months a number of commentators have written about another potential problem related to alternative energy—the likelihood of a speculative bubble in the alternative energy market.

One such example appears in the February 2008 issue of *Harper's* magazine, where Eric Janszen⁷ takes the position that bubbles (or asset-price hyperinflations), which were once rare, are now an inevitable part of the modern business cycle. He describes the necessary criteria for creating a bubble and identifies alternative energy as the sector that best meets the criteria. According to Mr. Janszen, an industry is likely to experience a speculative bubble if:

- it supports hundreds or thousands of separate firms financed by not billions but trillions of dollars in new securities;
- it is already formed and growing as the previous bubble deflates;
- it is subject to legislation that guarantees favourable tax treatment, along with other protections and advantages for investors; and
- it is popular among government policy-makers and journalists, and is familiar to those who watch television news or read newspapers.

The article calculates that such a bubble has the potential to create roughly \$20 trillion in speculative wealth, most of which will be employed to increase share prices rather than to fulfill the potential of alternative energy. (33)

According to a 2007 report by Lux Research, venture capital investments into “clean”

⁷ Eric Janszen is the founder and president of [iTulip, Inc.](#) He formerly served as managing director of the venture firm Osborn Capital, CEO of AutoCell, Inc. and Bluesocket, Inc., and entrepreneur-in-residence for Trident Capital.

energy investments totalled \$1.5 billion in 2006, up 141 per cent from the \$623 million of 2005. Over the same period, initial public offerings by companies in this sector rose to \$4.1 billion, from \$1.6 billion in 2005.(34)

Another important area from which lessons can be drawn from the financial crisis is the growth of carbon markets. In recent months a number of organizations have warned about the potential for the development of a “subprime” market in carbon.

In a recent report, entitled *Subprime Carbon? Re-thinking the world's largest new derivatives market*, Friends of the Earth (FOE) warns of the potential for new financial and climate change regulations to create a large regulatory gap, leading to a poorly regulated carbon derivatives market. The end result, according to the report, could be failures similar to those that led to the current financial crisis.

FOE—along with other commentators—suggests that carbon markets will likely become the largest derivatives market in the world. In this context, and factoring the already increasing complexity of carbon derivatives, FOE raises concerns about risky carbon credits based on uncompleted offset projects or projects that fail to deliver promised emissions reductions. Like mortgages, carbon credits are already being securitized and resold in secondary markets. The report recommends that lawmakers include carbon trading in current debates about financial reform. (35)

The World Resources Institute recently issued a statement focusing on how carbon risk has the potential to create significant credit risks across diverse industries, for businesses and investors alike. These include supply chain risks, product and technology risks and regulatory risk. (36)

In a January 2008 report entitled *Corporate Governance and Climate Change: The Banking Sector*, RiskMetrics Group cautions that “banks may be failing to account for underlying risks to a huge class of assets, with tremendous repercussions for the global economy going forward.” The report, which was commissioned by Ceres, indicates that the banking sector is the primary financier of industries that are the major emitters of greenhouse gases, and that the development of regulatory controls and market prices for these emissions will have a significant influence over how banks price securities, assess credit risks and make future investment and lending decisions. The report also suggests that “the time for the banking sector to prepare for these emerging risks and opportunities is now ... as

the value of this property far exceeds the amount exposed to the sub-prime lending crisis.”(37) (38)

Some socially responsible investors have already identified and begun to act upon this risk. For example, Inhance Investment Management filed shareholder resolutions in 2008 with the Bank of Montreal and Toronto Dominion Bank, asking both companies to “review and update risk management procedures, tools and models to address climate risk, based on lessons learned from the sub-prime mortgage crisis.” Both proposals were withdrawn when the banks agreed to assess their risks associated with the carbon market. (39)

The Lessons

The mother of all meltdowns:

- the risks posed by climate change dwarf those posed by the current global financial crisis
- the environmental and social impacts will be catastrophic and long lasting
- climate change must be tackled with a sense of urgency

Proceed with caution:

- the development of alternative energy technologies and carbon markets presents investment opportunities
- it is incumbent upon long-term investors to proceed with caution as they enter and operate in these markets
- the SRI community must work to ensure that these markets develop in a sustainable and equitable manner

Do the right thing:

- SRI has long served as the conscience of the investment community
- it is important not to lose sight of this tradition as developing markets present the possibility that many of the mistakes of the financial crisis will be repeated

Assessment of Actions and Responses

At the time of this writing, the global economy is in a state of crisis. Equity markets are off substantially, jobs have been lost by the millions and the world economy is mired in a deep recession.

One of the goals of this report is to provide an assessment of the actions of the SRI community leading up to and during the crisis. It might be tempting for some in the SRI community to say, “I told you so.” After all, socially responsible investors have been ahead of the mainstream financial community on issues like regulatory reform, corporate governance, executive compensation, predatory lending and transparency—all significant contributing factors to the crisis. However, with few exceptions, the SRI community did not foresee the crisis, the devastating spinoff of the subprime mortgage market and the risks associated with mortgage-backed securities and ABCP. From a financial standpoint, socially responsible investment funds have not fared any better than their mainstream counterparts.

Nonetheless, the crisis does reinforce the critical importance of two tenets of SRI, specifically, the value of long-term investing and the necessity to identify and measure hidden risks and opportunities. Considering how central poor governance and transparency were to the crisis, greater attention to such issues by the broader investment community might help to avoid or lessen the impact of future crises and has the potential to support long-term performance and sustainability. As demonstrated in this report, this is now happening to various degrees.

While the current crisis has brought focus to various ESG issues, the SRI community can

take credit for laying the groundwork for the recent broader acceptance of concepts such as linking executive pay to performance and enhanced reporting. Indeed, the language and tools necessary for improved regulation are well developed and readily available because of the work of socially responsible investors.

Despite its accomplishments, the SRI community must also reflect on areas of weakness that the financial crisis has exposed. While socially responsible investors clearly care about ESG issues from a values perspective, they also typically link ESG performance with long-term financial performance. However, in many instances this link needs to be better established and the financial consequences of ESG issues better defined. For example, in the area of executive compensation, socially responsible investors have long fought for greater links between pay and performance, but there is not a great deal of research and analysis examining the specific consequences of this link. Do equity-based plans that are tied to specific performance targets actually deliver better results? What is the specific risk of plans that do not have well-established links? Furthermore, the SRI community, like the mainstream financial community, did not fully appreciate the potential consequences of compensation packages that encouraged short-term risk taking. Similarly, the SRI community, despite sounding an early warning of the risks associated with predatory and subprime lending, did not appreciate the full magnitude of these risks.

There is a growing body of research that integrates ESG factors with traditional financial analysis. The current crisis suggests that more of this work is necessary and that it

inform, to a much greater degree, the actions and investment choices of socially responsible and other long-term investors.

The financial crisis represents an opportunity to shift the message away from achieving competitive short-term returns. The financial

crisis has demonstrated that focussing on short-term returns can have devastating consequences. Socially responsible investors should take advantage of this opportunity to call for more attention to long-term performance and away from the lure of daily and quarterly returns.

Recommendations

For long-term investors

Fully integrate ESG factors into investment decision making processes.

The management of ESG issues is central to the long-term success of companies.

Accordingly, investment and asset allocation decisions should include comprehensive analysis of ESG factors and their potential to embed risk that may not be revealed through traditional financial analysis.

Call for greater transparency on ESG factors.

Guided by the understanding that ESG factors are important determinants to long-term financial performance, investors should ask companies for full disclosure on ESG issues. Companies should be encouraged, through engagement and shareholder action, to report on policies and performance with respect to ESG issues. Long-term investors must make clear to companies that inadequate disclosure exposes them to unknown risks. Reporting, to the extent possible, should be standardized and integrated with financial reporting.

Support executive compensation that rewards long-term performance.

Board directors should be encouraged to devise pay packages that encourage long-term sustainability. Where equity-based incentive plans are employed, vesting and exercise periods should be increased beyond existing practice.

Use the lessons of the financial crisis to anticipate and mitigate the effects of future crises.

The issues that are central to the financial crisis—lack of adequate governance, lack of transparency, gaps in regulations, the proliferation of opaque and complex financial

products—are not necessarily unique to this crisis. For example, developing markets for alternative energy technologies and carbon appear to possess some of the same potential for failure as the markets for mortgage-backed securities.

For policy-makers

Mandate disclosure on ESG issues by corporations.

Investors increasingly incorporate ESG issues into their investment decision making processes. Accordingly, ESG disclosure should be improved in issuers' annual filings and accounting reports, including Management's Discussion and Analysis. In addition, issuers should be encouraged to adopt international best practices on ESG reporting.

Mandate disclosure on ESG issues by institutional investors.

As is the case in many European countries and Australia, pension funds should be required to disclose the extent to which ESG factors are used in the selection and retention of investments and in proxy voting decisions.

Mandate shareholder advisory votes on executive compensation.

Canadian regulators should mandate that shareholders have the opportunity to make non-binding votes on the compensation packages put forward by corporate boards.

Establish a system for national enforcement of securities regulations in Canada.

The financial crisis exposed significant gaps in securities regulations and enforcement, primarily in relation to securitized financial products and disclosure. It is clear that

companies need to be better regulated and require better oversight of systemic risks.

The Expert Panel on Securities Regulation(40) recently published its recommendations, in which it recommended that the establishment of a single securities regulator to administer a single securities act for

Canada was the best way to ensure effective monitoring and oversight of financial markets. This recommendation was supported by the Canadian Coalition for Good Governance, a coalition of 41 institutional investors that was formed to promote good governance practices in the companies owned by its members.

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About CR Strategies

CR Strategies is a research and consulting firm specializing in corporate responsibility (CR) and socially responsible investment (SRI). CR Strategies was launched in 2007 to help organizations understand and manage the emerging risks and opportunities that come with heightened societal concerns about social and environmental issues. Our services are designed to help our clients merge social, environmental and business imperatives by integrating social responsibility into their core business practices; thereby building public trust and strengthening their reputations and brands.

We draw on our decade of experience in the SRI industry to provide a variety of services to responsible investors, including project management, policy development, research and analysis, engagement and strategic planning.

Our approach is client-focused and collaborative. Our process seeks to build on the planning efforts that have already been undertaken by the client and tap into existing skills, knowledge and experience. We focus on identifying and building internal capacity, thereby helping the client achieve tangible results in a reasonable timeframe.