Corporate Environmental Assessment by a Bank Lender: a social constructionist perspective L32027302479

Full Final Report of Research Activities and Results

Background

Banking and the environment first became an issue in the 1980s when banks in the US recognised the risk of lender liability. Traditionally the lending situation has been viewed as one in which a lender balanced the financial risk of a borrower defaulting on repayment against financial return, supported by security as appropriate. Underpinning such a lending process is recognition that the banking community is vulnerable to the (mis)behaviour of their borrowers. During the 1980s and early 1990s legal turn towards strict liability regimes governing environmental clean up legislation particularly in the US were seen to undermine the use of security as a risk mitigation option for banks.

Much has been written regarding emergent fears of lender liability for the environment during the 1990s Statements by banks on the environment and research studies have shown that lenders fear that they may suffer financial loss if held directly or indirectly liable for the environmental damage by their borrowers or tarnish their reputation through association with a polluter (BBA, 1993; Robbins and Bissett, 1994).

Today the US situation has been clarified and the US lender's position almost totally resolved by the Asset, Conservation, Lender Liability and Deposit of Insurance Protection Act 1996 (Jewell and Waite, 1997; Ulph et al., 1999). Research studies have revealed that, in general, lenders appear to have appropriate environmental due diligence procedures which will provide them with an adequate defence against direct and indirect environmental liability (Barrett, 1994; Coulson, 1997).

The obvious financial basis for risk management does not however deny that there is a more fundamental ethic underlying product development and banks are increasingly claiming that this is the case. Increasingly banks are publishing statements on the environment and offering so called green loans promoting environmental protection (see for example UNEP,1997; PriceWaterhouse Coopers, 1999; Coulson, 2001).

While researchers have placed particular emphasis on lender liability for the environment as a potential motive for action few researchers have lifted the corporate veil of financial institutions to reveal the level of environmental assessment within lending processes and lender rationalities for environmental consideration. This research project seeks to address this imbalance by providing an insight into the development and use of corporate environmental assessment (CEA) techniques in a commercial lending bank, Lloyds TSB plc. The theoretical starting point for enquiry within the project is doctoral research by Coulson (1997) highlighting the development of CEA and the influence of 'culture' (cf. "Cultural Theory" - Douglas, 1978 and Thompson et al., 1990) upon a bank members environmental management rationality. 'How' and 'why' a bank lender conducts CEA become interrelated questions that are addressed.

One of the main challenges in adopting a culture theory is establishing cultural boundaries. Cultural typologies have been applied at a range of societal and institutional levels, however, the flexibility of cultural theory to such application has been questioned. In terms of cultural theory, this project is a qualitative range-finding study designed to examine cultural boundaries and identify four ways of life. No attempt was made to quantify data. Drawing insights from previous research on institutional cultures, emphasis is placed on ways of organising as opposed to "organisations" (see for example Rayner, 1986; Thompson, et al., 1986). According to cultural theorists we should be able to see the full range of "sub-cultures" in any one organisation. With this in mind, the project examines why (as shown in Coulson, 1997) the voice of the lender appears to be that of the hierarch.

Objectives

The objectives of the project, as set out in the original application, were:

- to extend theoretical and practical results of doctoral research addressing the social construction of corporate environmental performance considerations within bank lending processes;

- to examine the development and use of corporate environmental assessment techniques by members of a commercial lending bank ;
- to provide conceptual insights on the development of corporate environmental assessment techniques for academics and practitioners across a range of disciplines and orientations;
- to strengthen the personal skills of the proposed research fellow by building upon doctoral research and practical experience; and
- to provide a basis for further research and practice concerned with environment assessment.

Methods

Research was undertaken in the form of a case study facilitated by Lloyds TSB Group plc. The case study was carried out between October 1997 to December 1998 during which time Lloyds and TSB were in the process of operational merger and undergoing a period of pronounced institutional change. This provided an opportunity to witness new policy development and confirmation.

The focus of research was membership of the bank's lending function. To open up the perceptual and social process requires (by its very nature) a detailed qualitative approach. Emphasis was placed on participant observation to evaluate lenders' rationalities for assessment. This allowed hermeneutic analysis of symbolic action and interaction among those working in the lending function including reference to rules, commonly applied labels, routine practice and rhetorical story telling.

Access to institutional life was critical to the success of the research project. It was the subject of a confidentiality agreement including a formal bank review and approval of publications. The resultant research archive cannot be placed in the public domain. However, this agreement may have significantly enhanced the research because during the project the researcher was provided with unexpected access to anonymous client files for the purpose of reviewing documentary evidence of CEA. Of note is the fact that as an accountant, the researcher was welcomed as "someone who speaks our language" to be kept at a reasonable arms length but able to develop a position of trust on this basis.

The research was conducted in three stages. The first stage was an examination of formal documented bank policy on corporate environmental assessment within the lending process. Rationales for policy development and deployment were explored with policy makers and lenders involved in policy formation. The full examination involved documentary review, a series of personal interviews and focus group meetings with GER members, review of training materials, and observations were made at environmental training workshops.

The second stage focused on a questionnaire survey conducted with local lending officers across the institution to gauge their level of policy awareness and response and establish an initial impression as to the level of environmental assessment being conducted within the bank. The questionnaire was piloted in two regional bank offices. Questionnaires were issued to 2000 lending officers across the Group. Care was taken to recognise the full extent of any newly formed group. An acceptable response rate of just over twenty five per cent was achieved.

The final stage of research was an experiment in which two hypothetical lending cases were examined in detail, through interviews and focus groups with lenders. This facilitated an evaluation of specific assessment techniques. The cases were derived from real situations in the bank's during the prior financial period. Lenders involved in pilot case reviews noted that they found it difficult to follow other notes on such judgmental issue difficult. In a normal lending situation, it is likely that the borrower would be an existing customer with whom the lender was familiar. The cases under consideration were therefore posed as "new lends".

The lending-case files, including financial statements, valuation reports and environmental consultants' reports, were provided by the bank in an anonymous form. During the course of case examination, lenders were provided with an initial case outline. Additional information was provided on request to simulate a 'real' lending process. The case studies were supplemented by observation of centralised help-line operations and specialist reviews. Throughout the final stage of investigation extensive access was gained to client files to illustrate examples of CEA routines practice.

Results

Corporate environmental assessment (CEA) is becoming common practice in Lloyds TSB. To understand 'how' and 'why' this is the case requires a detailed analysis of 'policy' and patterns of interpretation by the bank's lenders. Of particular significance for future studies is the distinction drawn between policy (embodied in formal statements) and the recognition of informal policy ascribed to lenders. Evaluating lending roles highlights the influence of 'culture' (cf. Douglas, 1978 and Thompson et al., 1990) on rationalities for CEA and the importance of recognising cultural boundaries according to ways of organising is established. Cultural labeling applied to results corresponds to those applied by Rayner (1986) to institutional sub-cultures.

Bank 'policy'

The Lloyds TSB environmental policy framework forms an integral part of internal credit risk policy beginning with a short paragraph entry in the internal credit risk policy document. The policy extract confirms prior research results that lenders' fear liability for the environment[i] (Barrett, 1994; Robbins and Bissett, 1994; Ulph et al. 1999).

The focus of policy makers attention is 'policy' embodied within the Group's Environmental Risk Handbook. This is a detailed framework document that provides a desktop step by step guide on how to conduct CEA. It offers a flexible approach allowing lenders to interpreted case 'facts' according to their risk perception and lending experience (Coulson & Monks, 1999).

A formal audit of working papers is conducted at random intervals. Team leaders are held to account for deviations from 'policy'. Policy makers proposed that, given CEA is a relatively new issue, auditors would take a lenient position if policy application were ambiguous. Thus, control of CEA and policy adoption rests with team leaders. Examination of policy implementation and risk perception is not therefore purely an issue of establishing policy awareness, and control verification and testing as has been the approach in some general lending studies.

Lending roles

In Lloyds TSB, as in most clearing banks, lending roles are characterised according to responsibility for loan processing activities and/or level of delegated authority to lend up to a given facility value. Loan processing involves initial administration by junior officers, through to decisions to lend by sanctioning officers (from here termed lenders). It is part of each bank member's delegated responsibility to follow a bank policy.

In terms of CEA, at the top of the lending structure sit formal policy makers in Group Environment Risk (GER). The GER team is composed of former lenders who have been retrained in environmental assessment and given day to day responsibility for environmental policy making and operational management within the Group. In practice, environmental responsibilities are delegated to lenders to begin on receipt of the "Handbook" (Lloyds TSB, 1998).

<u>Environmental specialists – the competitive individualists</u>

Lenders view the GER team as Lloyds TSB's lending <u>and</u> environmental experts and the GER membership see success in the eyes of lenders as critical to maintenance of their role. Any contentious issues on environmental risks are predominantly decided by GER subject to the minimum of formal procedures. Their rationality for management is founded on the view of risk as an opportunity seeking new combinations to create wealth through businesses seeking wealth creation through sustainable development.

GER members do not see themselves as environmental experts outside the institution. Considering the social construction of environmental risk perception and group boundaries, of particular note is GER memberships frequent consultation with a panel of external environmental consultants. The consultants provide up to date technical environmental expertise but are not viewed as credit experts and "in-house experts" translate their advice into environmental credit risks. Some loan applications are additionally referred to specialist services within the bank such as legal advisers for contract negotiation or valuers of security.

Following cultural theory, the GER memberships appear to be *competitive individualists* (per Rayner, 1986). Building on research by Coulson (1997) it is noteworthy that the typical borrower is unlikely to meet a GER lender directly. They are more likely to meet a lender ascribing to the lending hierarchy.

<u>The lending hierarchy</u>

Loan processing is the administrative responsibility of local teams. Most lenders noted that case referral within the loan sanctioning hierarchy creates an obligation on them to follow bank 'policy'. For these lenders their use of standardised "checklists" reflects their adherence to policy rules. Formal case referral within the lending team takes place if lending decisions fall outside of their authority or they may informally refer cases to colleagues for advice.

When considering the implementation of new procedures such as CEA, lenders noted that reference to guidance materials was associated with issues of familiarity and informal discussions and referrals were more frequent. Lenders expressed confidence that both the environment and the bank would be protected if borrowers complied with legislation and policy rules were followed.

Experience of financial loss was viewed by lenders as the main influence on their perception of environmental credit risks. Reference to lending cases was firstly personal, secondly collective to "bank cases" and finally to anecdotes of cases experienced by other banks. Of less influence were high profile cases of corporate environmental incidents such as the Shell case. Parallels can be drawn between this result and previous results by risk researchers who refer to the influence of so called "critical incidents" on perception.

As a result of environmental lending experience, lenders with a high environmental risk portfolio (as classified according to borrower industry and location) acknowledged a decreasing need to reference guidelines on CEA due to reliance on rules of thumb or so called 'mental models'. Mental models become a habit, as lenders adapt policy to suit their portfolios and internalise resultant procedures. Reliance on so called mental models of assessment by experienced lenders has been revealed by a number of researchers studying general lending procedures (Berry et al., 1993; Berry, Crum and Waring, 1993). This result has significant implication for further research in this area by highlighting the importance of mental modeling in decision making and the importance of a qualitative approach to studying CEA.

Acceptance of the CEA policy framework is not, however, free from conflict. New routines have been encouraged by those with lending authority, providing assurance that CEA meets the practicalities of cost and timeliness but all lenders do not share this hierarchical affiliation to bank 'policy'.

<u>The so called elite lenders – more competitive individualists</u>

A distinct group of individualists were noticeable who considered themselves to be amongst an elite group of expert lenders. The group saw no need to manage environmental issues other than to seek economic opportunity and personal success. Some in this group had no experience of CEA and rejected proposed policy procedures and colleagues stories of environmental assessment in favour of personal expertise and experience. They noted that the policy framework was "flexible" enough to allow for the unique nature of lending decisions and they could justify policy deviations. A question raised by policy makers is - how to influence an older, experienced bank members to conduct CEA if they believe the environment is not an issue and they occupy a relatively isolated position sanctioning small loans?

In seeking to answer this question, it became apparent that such lenders were, in fact, increasingly recognising personal economic opportunities in pursuing CEA. They began to notice that good environmental management was integral to good all round management, producing improvements in corporate financial performance. Thus, CEA was motivated by economic gains and only indirectly for environmental policy purposes.

During the research it was possible to distinguish former Lloyd's from former TSB employees. The first indication was physical separation of Lloyds and TBS by office spaces to facilitate parallel running of "systems" and operation of team portfolios. Further "cultural" distinctions became visible through active participation in bank lifestyles. The individualists recognised above tended to be former Lloyds members from what they perceived to be the superior (e.g. bigger and better) bank in the partnership.

The "experienced" egalitarians

In conducting the case experiment, one particular group of lenders came to light that needed no convincing that the environment was an issue. The group had been subject to "full" consultation on environmental policy, being distinct for their symbolic (and historic) involvement in CEA. They were lenders positioned in middle management from small bank offices who had spent their career to date with the bank (in particular TSB but not exclusively). Consultation on environmental policy had brought the group together and their friendship had developed through appreciation of environmental management. While based in offices that spanned the UK, members of the group maintained communication and helped each other by 'chatting' through environmental case stories.

The group was distinct from those individuals trading risk and reward and those seeking to protect the bank. When asked about their experience of CEA they referred to "unique case experiences" and dissatisfaction with procedures. They had been consulted by GER on policy making for their story telling qualities. However, they did not ascribe to a common method of assessment only a need for environmental management through cooperation and a close relationship with ones borrowers. Following cultural theory the group appear as egalitarians but are at an unusual propinquity.

Agricultural experts – competitive individualists or egalitarians

A significant divergence from general opinion on CEA was noted among survey respondents identifying themselves as agricultural lenders. They had been subject to a "specialist" training programme dedicated to providing agricultural expertise (similar to training GER members) of which an integral part was CEA. In serving a "subsidiary lending" role they had either been inadvertently excluded or gone unrecognised in prior research. Given their specialists role agricultural lenders felt that they should be largely viewed as free from policy prescriptions. While noting that agriculture was all about the environment, their views on management fell into two groups. The first group saw nature as benign with no need for environmental management unless associated with a need to conduct CEA to evaluate the success of specialist niche market opportunity. Following cultural theory, agricultural lenders within this first category could be termed *competitive individualists* (see Rayner 1986). The second group recognised natural resource depletion as an increasing "problem of our time" and noted that the level of environmental interaction required for farming and the nature of agricultural processes posed a high credit risk requiring attention. This second group of lenders went as far as naming farms along with petrol stations as examples of very high risky activities and following cultural theory appear to be *egalitarians* (see Rayner 1986).

Those "isolated" from decision making - the stratified individualists

The recognition of this group is important to complete the illustration of Cultural Theory's four sub-cultures that exist within the boundary of the Lloyds TSB lending function membership.

The survey revealed that one group of "lending officers" fell outside the scope of the banks environmental policy and were not required to conduct CEA. The reason for isolation was twofold: for some lending authority had been removed for the purpose of restructuring and subsequent centralisation of procedures, others were trainees restricted to processing applications with no decision making authority.

Those for whom authority to lend had been removed viewed themselves as qualified to make decisions but had become redundant, employed only to process loan applications and monitor portfolio performance. They evidenced significant resentment to this change, manifested in a high level of concern and dissatisfaction with procedures that they saw as exposing them to lender liability without being able to influence or control this exposure. Like new recruits they felt that they were isolated and were not knowingly taking risks. They returned the questionnaire as part of their role but felt that they couldn't really contribute to the survey and resented not being formally consulted on policy making. Restructuring was an issue unique to this case at the time of research. Limited access during doctoral research by Coulson (1997) failed to recognise the feeling of isolation and its effect on new employees.

Following cultural theory, those isolated form a second cultural group the *stratified individualists* (see Rayner 1986). Like the GER membership they are unlikely to meet borrowers personally but recognition of their role and risk perception is particularly important when considering their potential career progression and associated policy requirements. At present the isolates view themselves as sitting outside the policy framework.

Summary of lending rationalities

The question of how CEA "techniques" work and are perceived to work is portrayed as an issue of social solidarity and cultural agreement. Learning becomes the subject of social positioning. Emphasis is placed on environmental 'policy' development and communication among bank associations and within individual bank organizations to support a plural rationality for CEA within the lending process. Documentation and use of standardised operating procedures within a bank is representative of a unique set of beliefs shared by bank members which highlights the influence of cultural traditions on information demands of lenders. Social solidarity among those engaged in banking activities is symbolised with reference to active negotiation of environmental liabilities and a legitimate social role.

For those negotiating with the Bank, the majority of lenders with whom they are likely to deal will be hierarchs, unless they are specifically seeking agricultural finance. If by chance they deal with one of the few egalitarians or individualists within the Bank, they are still likely to be subject to CEA but for slightly different reasons.

Cases of corporate environmental assessment

As noted previously, the final stage of analysis involved a detailed examination of two lending cases. One involved finance to support a housing development on a potentially contaminated site near a local watercourse and the other involved expansion of a metal plating works handling hazardous chemicals. In both cases lenders had raised environmental concerns and worked through to the benefit of the customers, finance was provided when issues were resolved. It is noteworthy that the research process clearly influenced lenders' environmental risk perceptions and lenders, keen to understand the real case outcomes, were enlightened by their colleagues case experiences.

The detailed structure and formality of CEA (see previous reference to mental models) varied significantly according to roles and relationships made visible through policy constraints and lending experiences noted previously. However, lending teams and individual lenders identified and assessed largely the same key environmental risks arising from three elements, Land, Processes and Management. Land uses, now and in the past is examined, to protect the Bank from direct liability. Processes operated by the customer and the management of those processes are examined to protect the Bank from indirect and reputation risks (see further Coulson, 2000).

Lenders seek to acquaint themselves with a customer's operations and resource management from input through to outputs and waste disposal. Operations are considered against current and foreseeable legislative requirements that the customer has to manage and respond to. Against this position the lender considered how well the customer managed the issues identified.

In accordance with the policy framework, CEA is typically carried out in three stages. First, a desktop review of the application is undertaken to gain an initial impression of risk; and secondly, an interview and, where possible, site visit, with a borrower is conducted to confirm initial expectations. These first two standard stages fall in line with the lending process in general and results support prior research on bank lending processes (Berry et al., 1993; Berry, Crum and Waring, 1993). A third, more detailed, course of investigation may take place if a high environmental risk is thought to exist. This would involve the lender commissioning a specialist review from a member of the bank's panel of environmental consultants. Environmental credit ratings, or credit scores, are then integrated with general lending criteria to support final lending decisions.

What should be of interest to policy makers is less the level of individual CEA and more the process of consensus formation by which policy and procedures become routines. It is particularly noteworthy that the Lloyds TSB example shows that sharing lending experiences and developing lending frameworks based on industry, customer and regional expertise can contribute significantly to improving levels of CEA. Lloyds TSB lenders have successfully captured environmental issues within their existing economic frameworks. The potential for lenders to move to a position outside this economic framework is questionable.

Finally, lenders noted that if potential risks were visible and the businesses appeared well managed, risk should not be realized and thus lenders were happy to provide finance. In general, lenders guard against the risks of lender liability for the environment while pursuing lending opportunities with companies whose management seeks financial and environmental benefits through sustainable activities as part of financial risk return management.

Activities

Conferences

- Coulson, A. B. (1998) *Bank Lending Cultures and Myths of Nature: A Research Outline.* European Social Science and History Conference, Cultural Theorists Group, Amsterdam, 4-6 March.
- Coulson, A. B. (1998) *Environmental Considerations within Bank Lending Processes*. British Accounting Association Conference, UMIST, Manchester, 1-3 April.
- Coulson, A. B. (1997) *Corporate Environmental Assessment by a Bank Lender.* Centre for Social and Environmental Accounting Research Summer School, University of Dundee, 14-17 September.

Workshops

- Coulson, A. B. and V. Monks (Lloyds TSB) (1998) *Corporate Environmental Performance considerations within Bank Lending Decisions.* Eco-Management and Auditing Conference, University of Sheffield, 2-3 July.
- Coulson, A. B. and R. Cooper (Lloyds TSB) (1998) *Global Change and* C*atastrophic Risk Management*. International Institute of Applied Systems Analysis, Austria, 11 May.

Dissemination to ESRC researchers includes: GEC fellowship holders meeting; seminar at CSEC; Business and Environment Network; inclusion in programme video "Rethinking the questions".

Networks

The Financial Sector Environment Forum (FSEF) was established on 1.11.98 to disseminate results to academics, practitioners and policy makers. Initial funding was provided by the ESRC. To date, FSEF activities have included a series of 6 workshops and a debate on Financing Environmental Futures (see report attached). These events brought together key policy makers from the British Bankers' Association (BBA) and Association of British Insurers (ABI). Future activities include contributions from UK financial sector including Lloyds TSB with promotion by the BBA, ABI and UN Environment Programme.

Outputs

Publications
Referred Papers
- Coulson, A. B. and Monks, V. (1999) Corporate Environmental Performance considerations within Bank Lending Decisions. Eco-management and Auditing, No. 6, pp1-10.

Book contributions
- Coulson, A. B. (2000) *Banking on the environment: risk and rationality*. Part 1, Chapter 5 in The Business of Greening edited by Steve Fineman, Global Environmental Change Series, pp.78-94. London: Routledge.
- Coulson, A. B. (2001) *Corporate Environmental Assessment by a Bank Lender – The Reality?* Chapter 23 in Sustainable Banking: The Greening of Finance, Part 4 Environmental Risk and Banks' Products. Edited by Jan Jaap Bouma, Marcel Jeucken, Leon Klinkers. Published in association with Deloitte & Touche. Sheffield: Greenleaf Publishing.

Reports of the Financial Sector Environment Forum
- Workshop reports make up an edited volume on CEA.
- Coulson, A. B. eds (2000) *Financing Environmental Futures.* ESRC Global Environmental Change Programme. Glasgow: University of Strathclyde.

Work in progress:
- Submission of a draft chapter to a GEC Programme book (with other GEC researchers), and
- A draft paper for submission to Accounting, Organisations and Society entitled "Banking on Hermeneutics".
- A conference paper submitted to the Asia Pacific Interdisciplinary Perspectives on Accounting (July 2001).

Other
- Coulson A. B. (1999) *FSEF continues to attract interest*. GEC-O. Edition 20 Summer, p. 8.
- Coulson A. B. (1999) *Financial Sector Environment Forum.* Social and Environmental Accounting. The newsletter of the Centre for Social and Environmental Accounting Research. Vol. 19, No. 1, p. 18-20.
- Presentations to Durham University Centre for Research on Environmental Thinking and Awareness; Durham University Business School; Forum for the Future; the Environment Agency and Tyne and Wear Business Club.

Impacts

Lloyds TSB pursued the development of a training video and interactive computer package on CEA; and a dialogue was opened with borrowers and other banks on the importance of CEA through presentations at business clubs and the Financial Sector Environment Forum.

Results have also been incorporate into the syllabus of two new degree classes within the BA Honours Accounting options at the University of Strathclyde
- Accounting and Sustainability
- Accounting and Risk

Future Research Priorities

Current work programme:
- Since completing the project the researcher has undertaken the first survey of implementation of the United Nations Environment Programme (UNEP) Statement of Environmental Commitment by the Insurance Industry Initiative commissioned by UNEP providing an industry wide analysis of CEA.

- Other follow up work with the banking sector includes a project on behalf of the Scottish Executive Legal Studies Research Board entitled *Business Finance and Security over Moveable Property* (£71,303 with University of Strathclyde Law Department and System 3).

Future research programme:

- Currently the researcher is involved in negotiations with UNEP to conduct the first joint survey of implementation for the UNEP Financial Institutions and Insurance Industry Initiatives.
- To progress the activities of Financial Sector Environment Forum and explore the application of cultural theory at a sectoral level.

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