Business Case for Sustainable Banking in Thailand

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Lead Researcher: Sarinee Achavanuntakul

Researchers:

Sasiwimon Khlongakkara

Seri Paveenchana

Koranis Tanangsnakool

Rapeepat Ingkasit

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SAL FOREST

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Executive Summary

Today, the concept of "sustainability" has entered the parlance of various business sectors worldwide, and is becoming accepted broadly as business practices that are in line with sustainable development. As indispensable intermediaries in the economy, financial institutions therefore have an indispensable role to play in the era of sustainable development.

This research aims to review the "sustainable banking" landscape worldwide, and articulate potential business benefits for commercial banks in Thailand if they were to adopt sustainable banking practices.

"Sustainable banking" concept and initiatives

Although there are banks that have been operating with the commitment to sustainable development for the past three decades, both the concept and business case for "sustainable banking" were crystallized only in the first decade of the 21st century. In 2007, International Finance Corporation (IFC), an arm of the World Bank that finances the private sector, concludes that sustainability for banks has two components: *"The first is managing environmental and social risks in strategic decision-making and lending… The second component is identifying opportunities for innovative product development in new areas related to sustainability. This entails creating financial products and services that support commercial development of products or activities with social and environmental benefits. A growing cluster of these opportunities have evolved and includes renewable energy, energy efficiency, cleaner production processes and technologies, biodiversity conservation, microfinance, financial services targeted to women, and low-income housing. Business models that address these dimensions are yielding new clients and markets. They are also helping financial institutions differentiate themselves from competitors, improve their reputation among key customers and stakeholders, attract new capital, and generate goodwill and support from stakeholders."*

Worldwide, there is a rise of financial institutions that incorporate "social responsibility" into their strategies, operations and internal culture. Some of them call themselves "green bank" and provide financial services to environment-friendly and ecosystem restoration projects. The rapid growth of "sustainable banking" as concept and practice is in line with emerging awareness of negative impact from "unsustainable" banking. Banks that attempt to be "sustainable" gradually stop supporting unsustainable projects e.g. fossil fuel energy production, and instead broaden funding opportunities in renewable energy or environment-friendly projects. Some banks on this pathway support projects that generate positive social impact, including micro loans for poverty reduction, accessible services for disable people, etc.

Meanwhile, several "sustainable banking" standards, alliances, and awards are emerging. Chief among them is the Equator Principles (EPs), designed as a standard for responsible project finance lending. Equator Principle signatories voluntarily commit to integrating the EPs with their internal lending processes and procedures, and undertake not to support projects in which the client will not or is unable to comply with the EPs. On the recognition front, *Financial Times* and International Finance Corporation (IFC) have been giving FT/IFC Sustainable Finance Awards for environmentally and socially responsible banking and investment every year since 2006.

United Nations Environment Programme (UNEP) published "UNEP FI Guide to Banking & Sustainability" report in 2011. Moreover, in 2009, sixteen sustainable banks from around the world came together to form Global Alliance for Banking on Values (GABV). It is an independent network of banks using finance to deliver sustainable development for underserved people, communities and the environment, based on Triple-Bottom-Line principle. GABV works with 25 bank members from 25 countries, reaching 10 million people with unmet needs.

Business benefits of sustainable banks

Empirical results of research on the relationship between a bank's financial performance and its social and environmental performance parallel that of other businesses. Some researchers find a significant relationship between a bank's financial performance and its CSR activities, and find that CSR is negatively correlated with non-performing loans. (Wu & Shen, 2013). Others find that the largest banks appear to be rewarded for their social responsibility, as both size adjusted ROA and ROE are positively and significantly related to CSR scores (Cornett, Erhemjamts, & Tehranian, 2014).

In 2013, the Global Alliance for Banking on Values (GABV) published the results of research that compares sustainable banks (defined as members of the GABV as of March, 2013) and Global Systemically Important Financial Institutions (GSIFIs). The research examined results for 2003 to 2007 (pre-crisis), 2008 to 2012 (post-crisis), and over a ten-year cycle, i.e. between 2003 and 2012. With the collapse of Lehman Brothers in 2008, signaling the 'tipping point' of the most recent financial crisis, these time periods essentially capture two very different eras of the banking system. The degree to which a bank finances the real economy is measured from the portion of assets on its balance sheet that are devoted to lending. They found that loan to total assets ratio of sustainable banks is nearly double that of the GSIFIs, and it remains core to their activity. In addition, sustainable banks rely much more on client deposits to fund their balance sheet compared with GSIFIs. This focus on deposit taking is not only another example of a focus on the real economy, but also reduces the liquidity risk of their funding strategies.

Sustainable banks also had strong capital positions, relative to the GSIFIs, especially as measured by the equity/total assets ratio. At the same time, high levels of capital did not reduce their appetite to lend, challenging claims by some larger financial institutions that higher capital requirements lead to less lending.

Comparing financial returns of sustainable banks with GSIFIs provides a more complex picture. Sustainable banks have historically stable return on assets, although at levels below those reported by GSIFIs prior to the crisis. However, sustainable banks provide resilient financial returns over the period with lower levels of volatility. With regards to returns on equity, the GSIFIs perform better, on average, over the period. However, again there is more volatility and post-crisis returns are lower for the GSIFIs. In addition, the lower level of equity/assets for the GSIFIs means that a portion of these higher returns come from greater leverage, implying greater risk. Investors and others should therefore expect higher returns on their equity investments in GSIFIs, given both higher degree of leverage and greater volatility of the returns.

Business case for sustainable banking in Thailand

The above-mentioned concepts, standards, initiatives, and research findings suggest that the ethos of sustainable banking is proven in practice mainly through 1) responsible lending practices and 2) financial inclusion focus (i.e. extending banking practices to the underserved population).

We found that the commercial banking industry in Thailand is still far behind on both fronts, but there is a number of potentially significant business benefits for Thai commercial banks from adopting sustainable banking practices, in light of many banks' aspirations to become regional players in the ASEAN Economic Community (AEC), as well as enabling environment including rapid growth of smartphone usage that can serve as springboard to tap into hitherto underserved markets.

Overall, the "business case" for Thai commercial banks to adopt sustainable banking practices can be summarized in the following table:

Aspect of sustainable banking / Potential business benefits	**Better risk management**	**Increasing market share of existing client base**	**Entering new market**
Responsible wholesale lending	Yes – Integrating social and environmental impact criteria into lending process, especially project finance, can help reduce • risks of lawsuits • reputation risks, and • financial risks that stem from unmanaged social and environmental risks, especially projects that have potentially large adverse social and environmental impacts which are not sufficiently contained or addressed by existing regulations.	N/A	Yes – By targeting emerging enterprises that generate net social and /or environmental benefits, such as renewable energy, organic farming, and community development.
Responsible retail lending	Possible – If better consumer protection is combined with financial education to reduce risks, e.g. repayment risks from over-indebtedness. Topics of particular interest to financial consumers include personal debt refinancing and better	Yes – through integrating financial education into product delivery or point of sale in such a way as to become "selling point" and generates consumer appreciation. For example: increasing deposit rate and reducing lending rate for frequent savers.	N/A

Aspect of sustainable banking / Potential business benefits	Better risk management	Increasing market share of existing client base	Entering new market
	disclosures of fees.		
Improving financial access	N/A	N/A	Yes – Microfinance products, particularly lending and remittance, will be of interest to underserved market in Thailand. Commercial banks may overcome the limitations of traditional model by utilizing new channels, such as • Mobile banking • Cooperation with existing local community banks or saving groups

Further information for these business cases is summarized below for each component.

Business case for responsible wholesale lending in Thailand

With regard to "responsible" lending practices, most commercial banks in Thailand are still vaguely aware of the concept, relying only on directives and regulations from Bank of Thailand (BOT) as bank regulator. Several international institutions such as the International Finance Corporation (IFC) have arranged sustainable banking seminars and Equator Principles conferences. Nonetheless, Thai banks still conduct haphazard social or environmental activities through their CSR campaigns which are largely unrelated to their expertise and normal business operations. Social, environmental, and governance (ESG) risks are still seen mainly as "compliance risks," with the implicit assumption that such risks are sufficiently contained in relevant legal and regulatory frameworks.

However, this assumption is growing increasingly at odds with reality. Thai banks are aggressively expanding their reaches into the neighboring countries such as Myanmar, Laos and Cambodia, in anticipation of the upcoming ASEAN Economic Community (AEC), while democratic institutions in those countries are still sorely lacking, leading to significant ESG risks that are not internalized in the legal and regulatory framework, meaning that they are largely unseen from Thai banks' perspectives.

The Baht 115-billion Xayaburi dam in Laos, the first large dam being built in the mainstem of Mekong River, is a case in point. The dam is funded by a consortium of Thailand-only banks. As of September 2013, the construction is continuing apace despite numerous concerns being raised by scientists and environmental experts as to the dam's potential devastating impact to river ecosystem, agriculture, livelihoods, and food security of millions of people. The project could significantly reduce fishery catch and biodiversity, a major source of income for millions of people along the Mekong River, extensive river erosion and flooding, water contamination, and resettlement of thousands of poor and vulnerable fishers and farmers. Moreover, it also threatens to undermine the authority of Mekong River Commission (MRC), the intra-regional body under which Xayaburi was the first project.

The Laos government gave the green light for dam construction, despite objections from Cambodia and Vietnam and recommendation of the MRC's Strategic Environmental Assessment (SEA) to delay the project for 10 years while further studies are carried out. The World Bank has endorsed SEA's findings and confirmed that it will not fund any of the Mekong mainstem dams.

In July 2014, the Supreme Administrative Court has overturned previous decision of the Administrative Court, agreeing to hear the lawsuit that members of the local communities near Xayaburi dam construction site brought against Electricity Generation of Thailand (EGAT) and other government agencies. The trial is expected to begin in 2015.

Many researchers, such as Srivastava (2007), argue that banks should consider social and environments even in their analysis of project financing as (i) management of social and environmental risks in strategic decision making and lending will increase financial stability through decreasing non-performing loans, and (ii) it will create opportunities for development of financial products and services with social and environmental benefits. All these help banks better compete. Accordingly, the banking business is moving away from the so called 'conservative banking' with risk-aversion approach, to 'sustainable banking' with growth approach. Moreover, the integration of sustainability with management system will result in tangible benefits: the horizon of market will be enhanced because new area of lending sources will be identified, and the reputation and overall goodwill of the bank will increase manifold.

Business case for responsible retail lending in Thailand

The Office of Consumer Protection Board (OPCB), under the Office of the Prime Minister, has the overall responsibility for consumer protection in Thailand. With regard to financial services, OCPB has regulations on credit cards, hire purchase cars and motorbikes, hire purchase electrical items, and loans for personal use. The office co-operates with each of the relevant financial authorities for the purposes of public relations and dispute resolution. OPCB oversees random investigations to ensure financial institutions are complying with regulation on loan contracts, and also undertakes investigations in responsible to complaints with regard to deceitful advertising.

In the past few years, Bank of Thailand (BOT) has issued many circulars to commercial banks in order to improve financial consumer protection. For example, in 2012, BOT issued a circular regarding sale of security and insurance products that requires commercial banks to disclose information related to product offering to customers sufficiently and appropriately, as well as to protect consumer rights. This is in response to complaints from many consumers regarding "forced" product bundling offered by banks, especially the bundling of insurance with loans products.

However, financial consumer protection regime in Thailand still falls short of international standards, such as The World Bank Good Practices for Consumer Protection and Financial Literacy, in some key areas. For example, there is still no standardized APR (Annual Percentage Rate) regulation, no mandatory cooling-off period, and no standardized loan application forms, allowing many banks to disclose no details of relevant fees and interest rate calculations. This gives rise to widely divergent quality of financial product disclosures, as illustrated in our survey of commercial banks' credit card application forms summarized in the following table.

Bank:	Krung Thai Bank PCL	SCB PCL	Kasikorn Bank PCL	TMB PCL	BAY PCL	Bangkok Bank PCL	CIMB THAI PCL	Thanachart PCL
Card:	KTC Credit Card	SCB Credit Card	K-Credit Card	TMB Credit Card	Krungsri First Choice	BBL Credit Card	CIMB THAI Credit Card	Thanachart Credit Card
Clear Interest rate calculation	No	No	No	No	No	No	No	No
Clear Fees	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Clear Penalty Fees	Yes	Yes	Yes	No	Yes	No	Yes	No
Installment payments	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes
Font size (1=best)	4	4	3	2	1	5	5	1
Cooling-off period	No	No	No	No	No	No	No	No
Language simplicity (1=best)	3	4	2	2	3	3	3	3
Confidentiality protection	Yes	No	No	No	Yes	No	No	Yes

Source: Credit card application forms

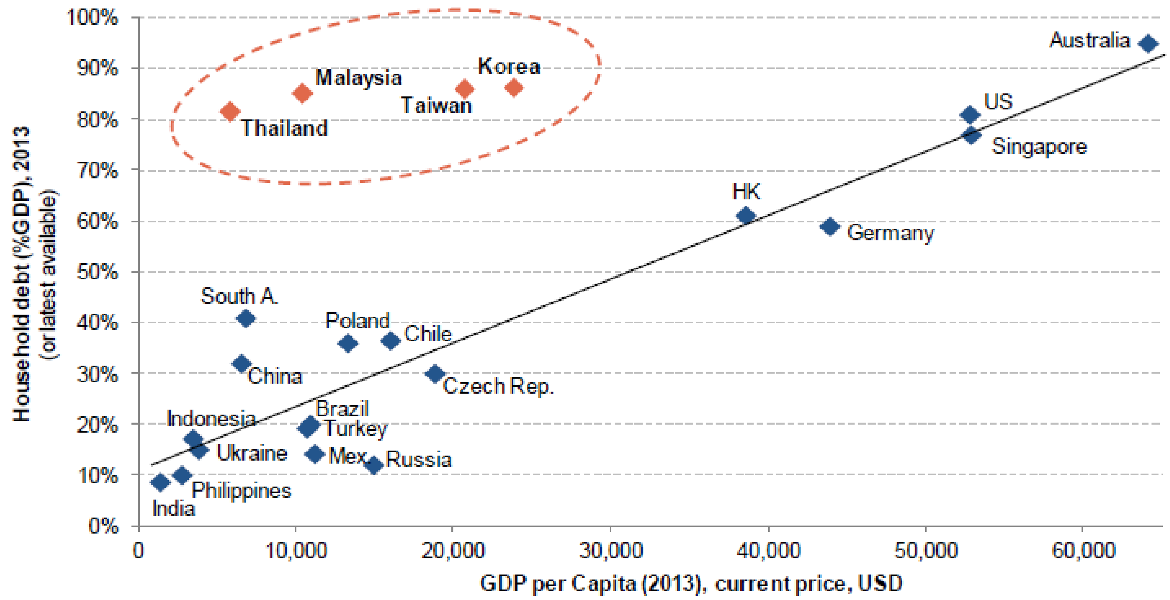
In 2012, the Bank of Thailand has set up the Financial Consumer Protection Center (FCPC, hotline 1213) which aims to systemically enhance its financial consumer protection mandate for commercial banks and non-bank financial institutions (NBFIs). Government-run Specialized Financial Institutions (SFIs) are supervised by the Bureau of Financial Policy and Financial Institutions within the Ministry of Finance. The responsibility for SFI consumer protection lies with the Bureau of Financial Inclusion Policy Development (FIPD).

Overall, the financial product on which consumers lodged the highest number of complaints with FCPC is credit card, followed by personal loan, commercial loan, and hire purchase respectively. In 2013, over 53 percent of all complaints FCPC received are relating to loans: number one is request for assistance on debt restructuring, queries on interest calculation that caller felt is incorrect, and complaints regarding high fees for late payment (some institutions charge 200 to 450 Baht or higher regardless of debt balance, and even for payment that is only one day late).

Financial complaints lodged at Foundation for Consumers, which caters to lower-income consumers, highlight a distinctive consumer vulnerability which is not seen in the FCPC report. This vulnerability is over-indebtedness problem. Complaints regarding late payment, being prosecuted for debt delinquency, refinance, and direct debit loan repayment, all of which indicate over-indebtedness problem, approximately account for 75 percent of total complaints the Foundation received in 2013.

Complaints from financial consumers as summarized above are in line with macro situation. Household debt in Thailand has been increasing for several years, reaching 82 percent of GDP as at the end of 2013, making it among the most indebted country in Asia in terms of this data, alongside Malaysia, Taiwan, and South Korea. In a press release in April 2014, FitchRatings warned that “Systemic risks would rise if household debt growth does not slow down. These risks could become an increasing source of asset-quality problems - particularly if a worse-than-expected slowdown amidst Thailand's political turmoil results in sharp rises in unemployment and inflation. This increases the contingent liability risk the sovereign could face if support for the banking sector is required in the event a large economic shock undermines capacity for households to service debt.”

Household debt (as a % of GDP) vs GDP per capita



Source: SG Cross Asset Research/Thematics, BIS, Central banks, IMF

Financial complaints data summarized above, as well as household debt information, suggest that there are likely significant business benefits from improving retail lending practices of the bank. Benefits seem especially attractive in 1) designing products that increase consumer incentives to save and reduce debt burden, and 2) integrating financial education into retail product delivery.

Business case for improving financial access in Thailand

On the financial access front, Thailand currently enjoys relatively high levels of access to formal financial services, but mostly on the deposits side. The 2013 FinScope survey reveals that 77 percent of the adult population (18 years and older) have deposit accounts at commercial banks, and another 21 percent use other formal financial services. Almost all adults (98 percent) therefore use some form of formal financial services. Using comparative data for similar usage surveys (World Bank Findex), Thailand has the highest financial usage figures in Southeast Asia.

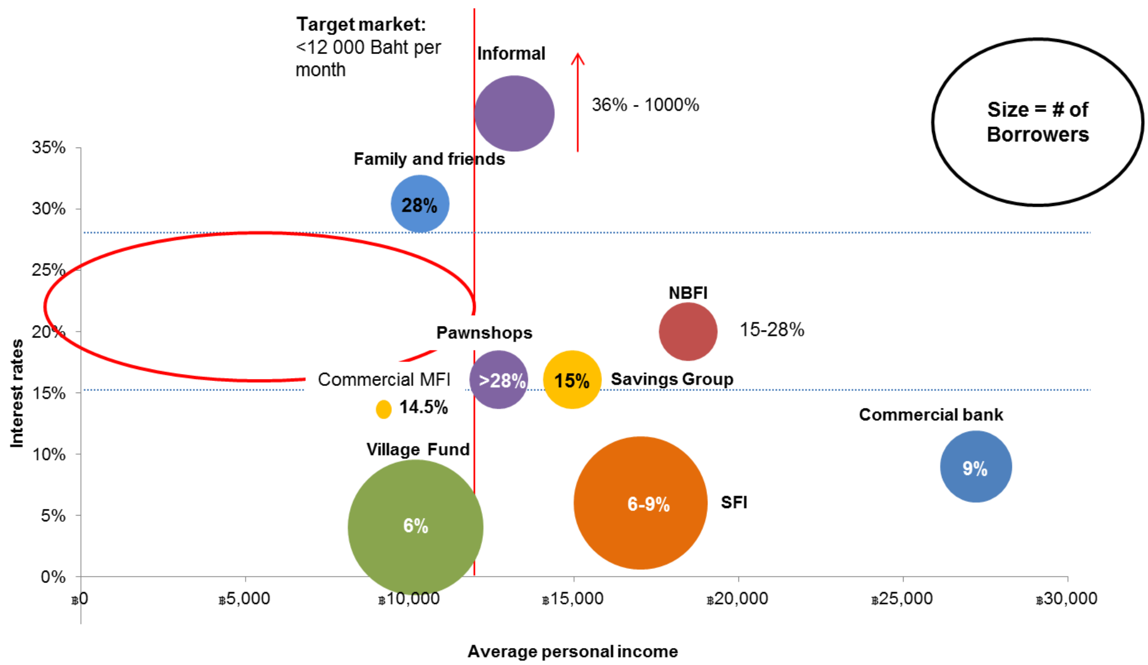
As with all such data, these figures mask considerable diversity including localized exclusion and privation. For example, Asian Development Bank reports that some 38 percent of low-income families have used one or two types of financial services, while another 16 percent do not use financial services at all. Almost 80 percent of middle- to high-income families use three or more types of financial services. Nearly half of low-income households do not borrow, as compared with 27 percent of middle- to high-income households. About 28 percent of low-income households do not have access to savings products compared with 6 percent from middle- to high-income groups (ADB 2011).

Thai commercial banks still have not entered the low-income market, both urban and rural areas, leaving the field to state-owned Specialized Financial Institutions (SFIs) such as Bank for Agriculture and Agricultural Cooperatives (BAAC) and Government Savings Bank (GSB). Commercial banks not only hitherto neglected the lower-income markets, but have also historically been "following" economic development in Thailand rather than "leading" it. When comparing outstanding commercial loans per capita with gross provincial product (GPP) per capita for 2011, we find that the lower GPP, the lower outstanding loans in that province. Bangkok is a significant outlier: its resident has approximately 1.04 million Baht loans each, or 2.1 times income per capita of 485,672 Baht.

The first FinScope nationwide survey in Thailand, conducted in 2013 as part of ADB's Financial Inclusion research project conducted for the Ministry of Finance, across 6,000 adult individuals provides some interesting opportunities to analyze the nature of indebtedness in Thai households. Some key findings include:

- Of households currently with outstanding debt (44 percent), 38 percent of these believed that they were over-indebted.
- At least 12 percent of all borrowings are taken out in order to repay other debts.
- Amongst the indebted the poor are more over indebted; those with monthly income is below 3,000 Baht have debt burdens of nearly 3 times their annual income (most probably nearly all consumption debt).
- Farmers (62 percent) are the most indebted group in Thailand followed closely by government employees (59 percent).
- Informally employed such as farmworkers and those receiving wages from an individual (e.g. domestic workers), and those relying on remittances; are also commonly indebted but are only able to borrow small amounts through mostly informal sources.
- Levels of savings in Thailand are not very high by global standards. In contrast to debt at 77.7 percent of GDP, in 2011, household savings were 5.3 percent of GDP, and 45 percent of households, or 9.09 million, were not capable accumulating any significant savings.
- 64 percent of individuals save less than 2,000 Baht per month.

Given the financial behavior of Thais and existing loans landscape as summarized in two charts from FinScope survey on the next page, we propose that the market is still wide open for financial institutions to serve those with less than 12,000 Baht monthly income, at the lending interest rate between 15-28 percent per annum. Potential business models that may be feasible for these conditions includes: co-operation with local community banks and savings groups to act as "paying agent" or "collection agent" for banks, as well as mobile banking models that have the capacity to convert "e-money" into real cash.



Insurance
- Majority of risks covered are by the community and the state
- Private insurers cover motor vehicles and credit-life

Savings
- 80% of people feeling they can trust banks with their money, but majority use for moving cash (remittances)
- Deposits at SFI's (GSB) are growing at more than 30% a year

Credit
- Many households, especially farmers, regarded these as a "cash flow lifeline"
- Borrowers are prepared to accept widely divergent interest rates

Institution	Consumer Loans	Micro-Loans (<THB 200k)	Deposits	Remit-tances	Payments Collection	Pre-paid / Stored Value Cards	Insurance /risk protection
Government							✓✓✓
Commercial Banks	✓✓✓	✓	✓✓✓	✓✓✓	✓		
SFI: BAAC	✓✓✓	✓✓✓	✓✓	✓	✓		✓✓
SFI: GSB & GHB	✓	✓✓	✓✓✓	✓			✓
NBFIs	✓✓✓	✓✓✓					
Credit Unions / Co-Ops	✓✓	✓	✓✓				
Village Fund	✓	✓✓✓	✓				
Moneylenders / Pawnshops	✓	✓✓					
Post Office				✓✓	✓		
Private Insurers							✓
Community-based institutions							✓✓✓
Modern Trade Outlets					✓✓✓	✓✓	
Mobile Network Operators				✓	✓✓	✓✓✓	

Payments
- 65% of utility payments are made at 7-Eleven stores
- Mobile payments are growing exponentially

Degree of usage
Low ✓ -
High ✓✓✓

Chapter 1. Research Background

1.1 Background and Rationale

By all accounts, the 2008-2010 global financial crisis was a watershed moment in world history of finance in that many of the world's largest banks received massive injections of public funds to stay afloat, prompting unprecedented scrutiny into banking operations, bankers' compensations, as well as raising questions as to the desirable role of banks in society. "Sustainable banking" became a catch-all phrase behind the rallying call for banks to rediscover their traditional role in fostering community development, as well as redefining their mission to support sustainable development.

Worldwide, there is a rise of financial institutions that are committed to fostering social and environmental values. They incorporate "social responsibility" into their strategies, operations and internal culture. Some of them call themselves "green bank" and provide financial services to environment-friendly and ecosystem restoration projects. The rapid growth of "sustainable banking" as a concept and practice is in line with emerging awareness of negative impact from unsustainable banking. Banks do not have direct impact but through providing finance to companies with significant social, environmental and economic impacts, they indirectly affect the environment, ecological system, and livelihoods. Banks that attempt to be "sustainable" gradually stop supporting unsustainable projects e.g. fossil fuel energy production, and instead broaden funding opportunities in renewable energy or environment-friendly projects. Some banks on this pathway support projects that generate positive social impact, including micro loans for poverty reduction, accessible services for disable people, etc.

Meanwhile, several "sustainable banking" standards and codes of conducts are emerging. Chief among them is the Equator Principles (EPs), which was designed as a standard for responsible project finance lending. Equator Principle signatories voluntarily commit to integrating the EPs with their internal lending processes and procedures, and undertake not to support projects in which the client will not or is unable to comply with the EPs. As of October 2014, 80 financial institutions in 35 countries have officially adopted the EPs, covering over 85 percent of international project finance loans in emerging markets. However, there are only five from Asia, which are from India, China and Japan. None of financial institutions in the Association of Southeast Asian Nations (ASEAN) has yet adopted the EPs.

Aside from the Equator Principles, there are several initiatives that are promoting sustainable banking. For the past seven years, Financial Times and International Finance Corporation (IFC) have been giving FT/IFC Sustainable Finance Awards for environmentally and socially responsible banking and investment. UNEP published "UNEP FI Guide to Banking & Sustainability" report in 2011. Moreover, in 2009, sixteen sustainable banks from around the world came together to form Global Alliance for Banking on Values (GABV). It is an independent network of banks using finance to deliver sustainable development for underserved people, communities and the environment, based on Triple-Bottom-Line principle. GABV works with 25 bank members from 25 countries, reaching 10 million people with unmet needs. Since Rockefeller Foundation co-funded early stages of GABV's financial capital and impact metrics action track, the experience of GABV and Rockefeller Foundation will be instrumental in promoting both the sustainable banking concept and its social impact metrics elsewhere, such as Thailand.

If the ethos of sustainable banking is proven in practice mainly through 1) responsible lending practices and 2) financial inclusion focus (i.e. extending banking practices to the underserved population), the commercial banking industry in Thailand is still far behind on both fronts.

With regard to responsible lending practices, most commercial banks in Thailand are still vaguely aware of the concept, relying only on directives and regulations from Bank of Thailand (BOT) as bank regulator. On responsible consumer lending, BOT has never issued regulations on interest rate and fee disclosure standards such as APR (Annual Percentage Rate), and only recently issued a circular to forbid forced bundling of retail products after receiving numerous complaints from financial consumers.

On responsible commercial lending, several international institutions such as the International Finance Corporation (IFC) have arranged sustainable banking seminars and Equator Principles conferences. Nonetheless, Thai banks still conduct haphazard social or environmental activities through their CSR campaigns which are largely unrelated to their expertise and normal business operations. Social, environmental, and governance (ESG) risks are still seen mainly as “compliance risks,” with the implicit assumption that such risks are sufficiently contained in relevant legal and regulatory frameworks. However, this assumption is growing increasingly at odds with reality. Thai banks are aggressively expanding their reaches into the neighboring countries such as Myanmar, Laos and Cambodia, in anticipation of the upcoming ASEAN Economic Community (AEC), while democratic institutions in those countries are still sorely lacking, leading to significant ESG risks that are not internalized in the legal and regulatory framework, meaning that they are largely unseen from Thai banks’ perspectives.

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The Laos government gave the green light for dam construction, despite objections from Cambodia and Vietnam and recommendation of the MRC’s Strategic Environmental Assessment (SEA) to delay the project for 10 years while further studies are carried out. The World Bank has endorsed SEA’s findings and confirmed that it will not fund any of the Mekong mainstem dams.

On the financial access front, Thailand currently enjoys high levels of access to formal financial services. The 2013 FinScope survey reveals that 77% of the adult population (18 years and older) have deposit accounts at commercial banks, and another 21% use other formal financial services. Almost all adults (98%) therefore use some form of formal financial services. Using comparative data for similar usage surveys (World Bank Findex), Thailand has the highest financial usage figures in Southeast Asia. However, commercial banks still have not entered the low-income market, both urban and rural areas, leaving the field to state-owned Specialized Financial Institutions (SFIs).

The 1997 financial crisis reinforced the approach of state-provided financial services for the bulk of the population in that it forced the Ministry of Finance (MOF) and Bank of Thailand (BOT) to place the emphasis for commercial bank operations on stability and financial soundness, rather than expanding into what is perceived as higher risk lower income markets. Only thirteen years later has the BOT begun to focus on increasing financial access, with the second Financial Sector Master Plan (FSMP II, 2010-2014) which includes ‘encouragements’ for commercial banks and insurers to move down-market, such as Microfinance Guidelines and Microinsurance Framework (2011), both issued on a voluntary basis. The Microfinance Guidelines has failed to spur interest in providing microfinance by commercial banks, with exception of the majority government-owned Krung Thai Bank (KTB).

Thai commercial banks not only hitherto neglected the lower-income markets, but have also historically been “following” economic development in Thailand rather than “leading” it. When comparing outstanding commercial loans per capita with gross provincial product (GPP) per capita for 2011, we find that the lower GPP, the lower outstanding loans in that province. Bangkok is a significant outlier: its resident has approximately 1.04 million Baht loans each, or 2.1 times income per capita of 485,672 Baht.

Bangkok is the only province in Thailand whose loans per capita is higher than income per capita – national average of this ratio excluding Bangkok is 0.33. In other words, every other province received three times less loans than their province’s per capita income. In 2011, outstanding loans in Bangkok totaled 7.9 trillion Baht, or 71.7% of total outstanding loans nationwide.

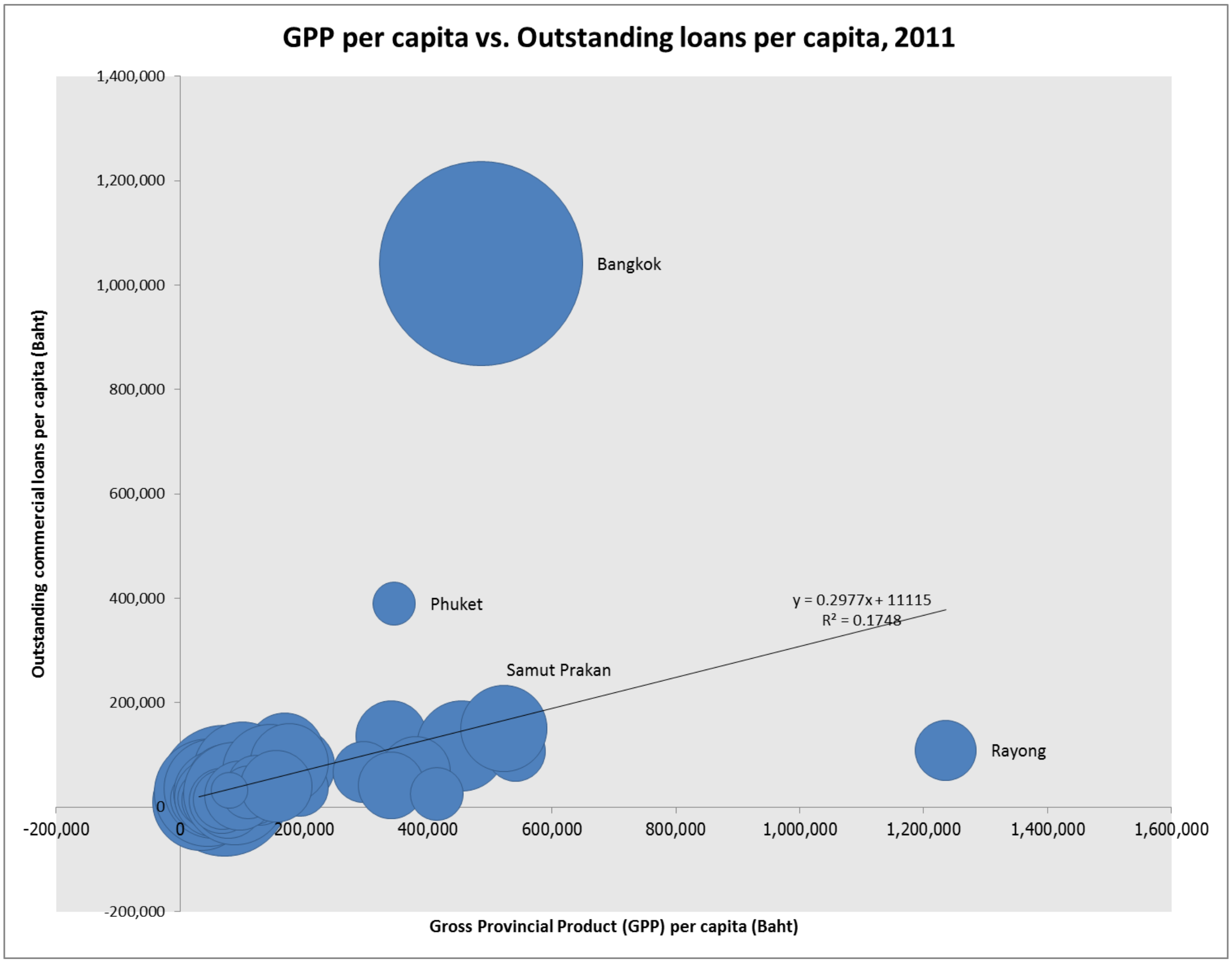

Figure 1 GPP per capita vs. outstanding loans per capita, 2011

Source: Bank of Thailand, NESDB

These historical trends suggest that Thai commercial banks been an important factor in cementing economic inequality in Thailand especially between Bangkok and other provinces, if not widening it. In Thailand, financial development has not ‘led’ economic development as some experts believe; the truth is most likely the other way around. This trend may partly be a result of a shift in government policy: from seeing banks as a key plank in economic development, to trusting the financial markets to freely allocate capital. For example, BOT directives in 1987 set “mandatory lending” criteria for commercial banks as follows: at least 14% of total deposits must be lent to farmers and small and medium-sized enterprises (SMEs) in the same province the banks take deposits from, and 6% of total deposits must be lent to agricultural businesses in the same province. This directive as well as overall “development lending” policy framework was abandoned following the 1997 financial crisis.

Given Thai commercial banks' pivotal positions in ASEAN, especially their lead role as infrastructure lenders in Myanmar, Laos, and Cambodia, and in light of the upcoming ASEAN Economic Community (AEC) in 2015, as well as increasing urgency to reduce the widening economic inequality in Thailand, it is important to begin the process of fostering "sustainable banking" values and practices, to ensure that commercial banking practices in Thailand are aligned with sustainable development, i.e. taking into account not only economic and financial returns, but also social and environmental impact that affect the lives of poor people. In addition to recognizing ESG risks, Thai banks should explore how to integrate sustainability concepts into procedures, strategies and culture, in order to create more "value" to the Thai public and help narrow income gap in the country by means of increasing financial inclusion.

1.2 Objective of this project

1) To increase awareness on the need for "sustainable banking" in Thailand, among government, regulators, financiers, banking industry, and other key stakeholders including the Thai public.
2) To establish "Sustainable Banking Thailand Network" (SBTN), a network of Thai banking, government, and microfinance practitioners who are interested in sustainable banking and are willing to act as "change agents" inside their organizations.
3) To promote sustainable banking practices and standards such as the Equator Principles.

Chapter 2. Sustainable Banking – from Concept to Practice

2.1 Theoretical underpinnings of "sustainable business"

The concept of "sustainability" has been recognized worldwide since The Brundtland Commission report under the United Nations famously defined "sustainable development" in 1987 as development that meets "the needs of the present without compromising the ability of future generations to meet their own needs". The idea of balancing the needs of successive generations fairly is sometimes referred to as "intergenerational equity". Since then, national and international organizations have been increasingly embracing this concept as an integral part of their mission, particularly since the value of economic damage that results from the increasing severity of climate change has climbed higher every year. This is one reason many politicians and businessmen are increasingly aligning their platforms with agenda of the environmentalist campaigners, or at least finding means to cooperate.

Theory of sustainable value creation

Since commercial banks are financial intermediaries that do not directly invest in projects that may be unsustainable, a discussion about sustainable banking discussion should perhaps begin at the evolution of firm value theory.

Over more than half a century since the end of World War 2, profit motive of the corporate sector has largely been ensconced in the "shareholder wealth maximization" paradigm. This paradigm has been popularized by many prominent economists, in particular Milton Friedman, one of the most influential economists of the 20th century. Friedman famously announced "the social responsibility of business is to increase its profits" in his influential 1970 *New York Times* article.[1] However, since the dawn of 21st century, there has been a rising alternative paradigm that is now commonly known as "stakeholder model" in contrast with the dominant "shareholder model" of the firm.

While costs of unsustainable business models become ever more apparent, the "stakeholder model" is increasingly posited as the only model capable of generating sustainable business growth. For example, Fatemi and Fooladi (2013) argue that the current business approach to shareholder wealth maximization is no longer a valid guide to create sustainable wealth: an emphasis on short-term results has the unintended consequence of forcing many firms to externalize their social and environmental costs. An unwavering faith in the markets' ability to efficiently uncover long-term value implications of short-term results has created many considerable environmental and social damages.

Sir Nicholas Stern, one of the world's leading climate change expert, wrote in his 2006 report that "Climate change is a result of the greatest market failure the world has seen."[2] Given grave social and environmental challenges that lie ahead, business-as-usual practices cannot be sustained. Therefore, a

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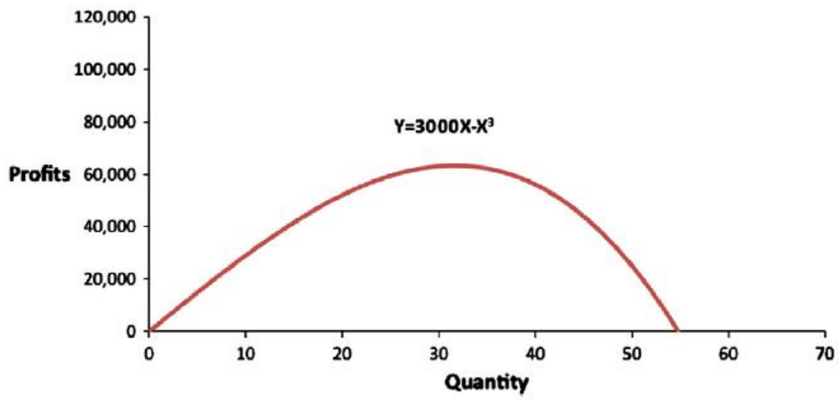
[1] Friedman, Milton. September 13, 1970. "The Social Responsibility of Business is to Increase its Profits," *The New York Times.*

[2] Stern, Nicholas. 2006. *Stern Review on the Economics of Climate Change.* HM Treasury, London.

shift in paradigm is called for. Fatemi and Fooladi propose a sustainable value creation framework, within which all social and environmental costs and benefits are to be explicitly accounted for.

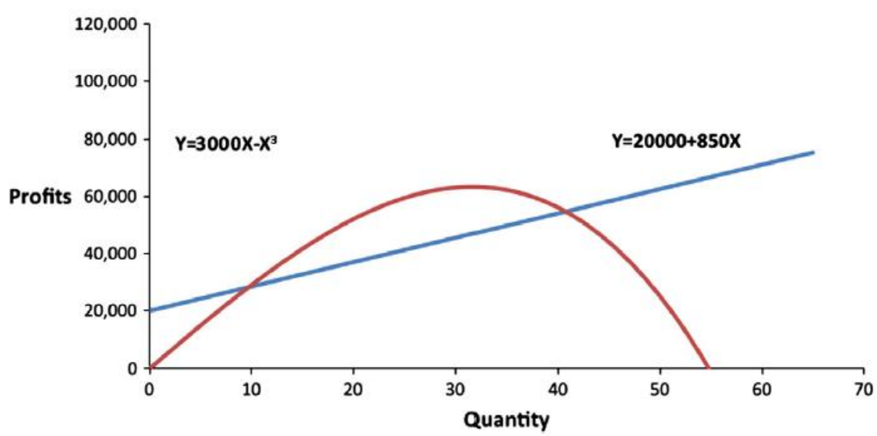
An illustration of their framework is as follows: first, consider a conventional firm. This firm's only responsibility is to its shareholders, and its code of 'responsibility' does not call for dealing with social and environmental issues, so that a rational economic agent would produce enough goods or services to achieve maximum profit. This is a simple non-constrained profit maximization model shown in Figure 2.

Figure 2. Traditional profit maximization model



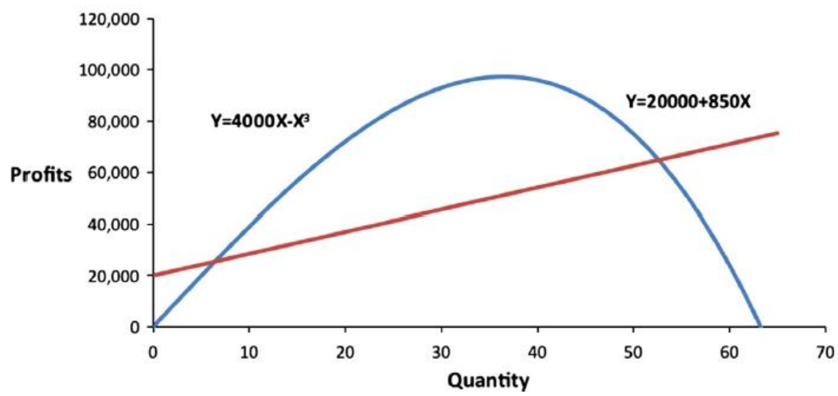
If we now impose a constraint requiring the agent to take remedial action that would compensate for its social and environmental impact (associated with its production of goods and services), the simple profit maximization model will turn into a constrained maximization problem. Absent a shift in the demand curve, the new maximum will be inferior to the old, as portrayed in Figure 3.

Figure 3. Traditional profit maximization in the presence of a constraint



However, as portrayed in Figure 4, a decision to introduce social and environmental constraints has the potential to shift the demand curve such that the new achievable maximum would dominate the old.

Figure 4. Constrained profit maximization with a rightward shift in the demand curve



The authors invoke examples of real-life firms such as Patagonia, Revolution Foods and Waste Concern, and explained the underlying reasons for the shift in demand. They stipulate that an increased global awareness of the “full impact” of a firm's decisions, coupled with an ever-increasing availability of information across the globe, will guarantee that the early adopters of social and environmental responsibility will experience a favorable demand shift for their products and services. More importantly, it can be argued that non-adopting firms (i.e., those still following the traditional profit maximization model) will experience a negative demand shift as the detrimental effects of inattention to social and environmental issues become more broadly recognized. Therefore, they conclude that a failure to duly and fully recognize all costs of doing business will lead to value destruction rather than value creation.

Only an explicit recognition of social and the environmental impacts of the firm's decisions will ensure sustainability of the value created in this process. It should, however, be noted that doing so does not call for the Net-Present-Value (NPV) approach to be discarded. Rather, it calls for full consideration of all incremental, incidental, and opportunity costs (including what economists term “negative externalities,” i.e. costs that are not borne by the incurring firm), as well as the benefits.

$$\text{Value}_0 = \sum_t \text{Cash Flows}_t / (1 + \text{Cost of Capital})^t$$

In addition to considering the usual set of cash flows, the sustainable value creation approach calls for the explicit recognition of incremental cash flows attributable to the firm's sustainability efforts. Examples include enhanced brand value, increased customer loyalty, improved ability to recruit and retain talent, ability to attract new customers (including those demanding social and environmental results) and the option value of entering markets that are restricted to firms with good reputation of sustainability efforts. It also calls for the explicit recognition of reduced costs due to lower resource usage, such as water and energy, as well as lower costs of waste management, employee healthcare, legal compliance, labor actions, legal liability, and litigation. Further, given that socially responsible firms do a better job of managing their risks (both as a matter of definition and as supported by empirical evidence), their lower cost of capital should also be accounted for in the estimate of firm value.

Porter and Kramer (2011) argue that the existing profit-maximization paradigm of value creation is outdated. In their terminology, “creating shared value” (CSV) is the right way of thinking about value creation in a way that both the firm and the community and society at large benefit from the firm's activities. They propose that companies competing in the 21st century will be able to acquire and maintain competitive advantage only by creating shared value. Janicke and Jaco (2012) hypothesize that the shift in focus to sustainability will amount to the “Third Industrial Revolution.” Today’s “new realities” call for modifications to the traditional valuation framework in a manner that takes into account all social and environmental impact of a firm's activities.

Double- and Triple-Bottom Line

While traditional businesses are concerned mainly with their financial profit or loss as a bottom line, during the past two decades the notion of sustainability has been developed and incorporated into business decisions as ‘Double Bottom Line’ (DBL) or ‘Triple Bottom Line’ (TBL) concept.[3] In the DBL concept, traditional business accounting broadens their performance measurement to include the accounting of net social impact, both positive and negative. In the TBL concept, business organizations seek to measure their business performance in three dimensions: economic or financial, social, and environmental. Today, triple bottom line dimensions are commonly called the “three Ps”: people, planet and profits, and they are together referred to as the “three pillars of sustainability.”

Based on these approaches, different indicators have been developed to assess organizational sustainability, such as the Global Reporting Initiative; IRIS; United Nations Commission on Sustainable Development. The underlying objective of developing the indicators is to monitor progress toward sustainable development with either Double Bottom Line or Triple Bottom Line concept.

Despite continuous progress on the development of indicators, the search for globally acceptable set of indicators that can easily be applied across industries is still underway. It is more challenging to use such indicators for organizations in developing countries where diversity in socio-economic and environment cultures exists and lack of data is the norm rather than an exception.

Sustainability Indicators

Labuschagne, Brent and Erck (2004) reviewed several indicator frameworks that address all three dimensions of sustainability i.e. environmental, social, and economic indicators, and that have a wide focus i.e. at a national, community or company level. They found that current indicator frameworks that are available to measure overall business sustainability do not effectively address all aspects of

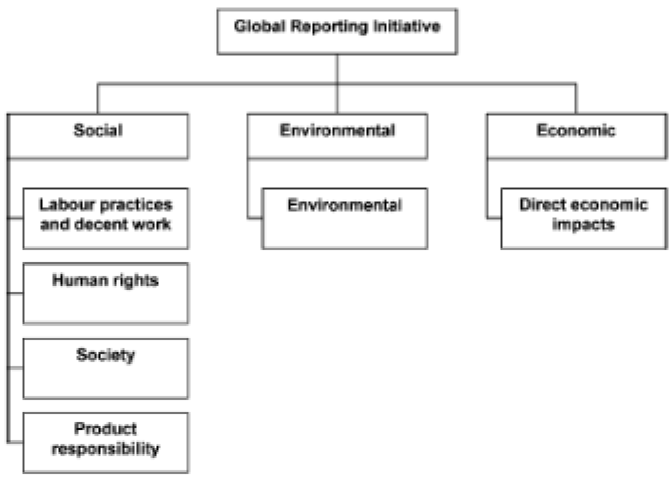
[3] "Triple Bottom Line". The Economist. November 17, 2009. Retrieved 31 October 2014.

sustainability at operational level, especially in developing countries. Social criteria, specifically, do not receive due considerations. The major frameworks that they reviewed are summarized as follows:

Global Reporting Initiative

The GRI uses a hierarchical framework in three focus areas, namely social, economic, and environmental (Figure 5). The hierarchy consists of categories, aspects, and indicators. The guideline contains more than 100 indicators. However, not all the indicators are easy to evaluate and no guidance is given on how to choose between the indicators, although it separates between "minimum" (reporting required) and "optional" indicators. The guideline does, however, indicate what should be considered at a lower level, i.e. operational or project level within the company, especially if the company reports its sustainability performance using GRI principles.

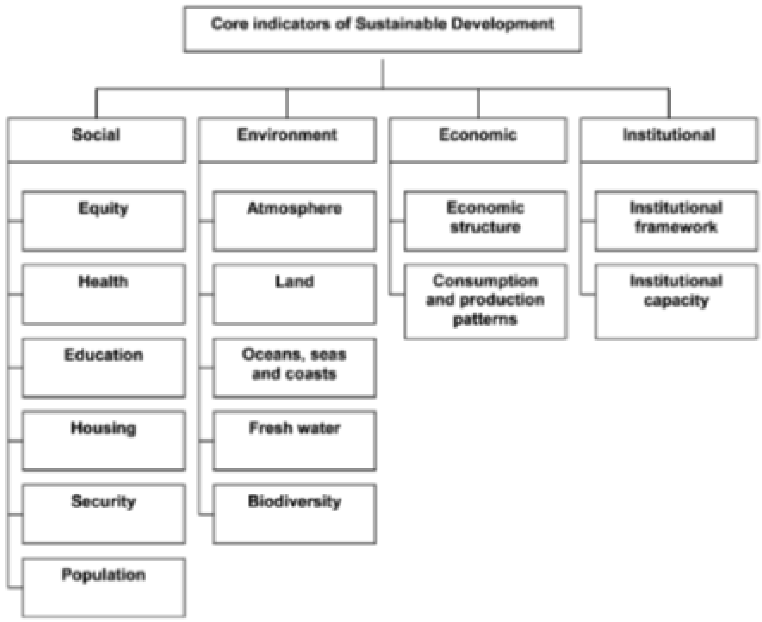
Figure 5. Hierarchical structure of Global Reporting Initiative (GRI) framework



United Nations Commission on Sustainable Development Framework

The United Nations Commission on Sustainable Development (CSD) constructed a sustainability indicator framework for the evaluation of governmental progress towards sustainable development goals. A hierarchical framework groups indicators into 38 subthemes and 15 main themes that are divided between the four aspects of sustainable development: social, environment, economic, and institutional (
Figure 6). The main difference between CSD framework and the GRI is the fact that CSD addresses institutional aspects of sustainability. The framework has been used as a basis by many developing nations. The aspects addressed by the framework are not all relevant to the business community; definitely not on an operational and project level. Nonetheless, the framework provides insight into what sustainability entails on a national level, as well as areas in which business can make a contribution.

Figure 6. The United Nations Commission on Sustainable Development (CSD) theme indicator framework



Financial performance of "sustainable firms"

Fatemi and Fooladi (2013) accumulated evidence in support of the argument that firms can "do well by doing good" as follows:

Evidence compiled by RobecoSAM and reported in its annual reports provides strong support in favor of the argument that investing in sustainability does pay off for companies. For example, in a comparison of the performance of sustainability leaders (top 20%) with laggards (bottom 20%), the company reported an outperformance of 1.48 for the former and −1.46% for the latter, with corresponding tracking errors of 3.17 and 3.22.[4]

Further, indirect support can be inferred through an examination of the rate of growth in assets under management classified as "socially responsible investment" (SRI). As reported by Social Investment Forum Foundation, SRI assets under management in the United States grew from $639 billion in 1995 to more than $3 trillion or one out of every eight dollars invested, in 2009. In comparison, European SRI under management was more than $7 trillion and nearly half of each dollar invested in 2009.

Meanwhile, empirical studies dealing with this question have also been accumulating at a rapid rate with the majority of evidence in support of the notion that corporate social responsibility does create

[4] "Sustainability Yearbook 2010." RobecoSAM. Retrieved October 30, 2014. http://www.robecosam.com/en/sustainability-insights/library/the-sustainability-yearbook.jsp

shareholder value. Utilizing a database provided by a large financial institution, Dimson, Karakas, and Li (2011) document an average 4% abnormal return for firms that successfully initiated corporate social responsibility (CSR) engagement. However, they found no market reaction when the engagement is not successful. The authors also document that when the firm's engagement is in the area of climate change or corporate governance, the market reaction is stronger. This is consistent with the findings of El Ghoul, Guedhami, Kwok, and Mishra (2011), and Plumlee, Brown, Hayes, and Marshall (2010), which show that US firms with superior CSR performance enjoy cheaper equity financing.

Earlier, Barnea and Rubin (2005) found that at low levels of CSR expenditure, the link between these expenditures and a firm's value is positive, but that the relationship becomes negative when these expenditures go beyond a certain level. This kind of non-monotonic relationship is also reported by Goss and Roberts (2011) who study the cost of borrowing and find that firms at the lower end of the CSR spectrum bear a higher cost of borrowing. Utilizing data for 2,261 firms in 43 countries over the 2002–2008 period, Hawn and Ioannou (2012) examined the differential impacts of symbolic and substantive corporate environment, social, and governance (together abbreviated “ESG”) actions on firm performance. Their results suggest that symbolic ESG actions in the presence of higher intangibles have a higher positive impact on the firm's market value. Also utilizing data from a large sample, Servaes and Tamayo (forthcoming) find that CSR activities enhance the value of the firm when they are accompanied by high public awareness (using advertising intensity as a proxy).

Evaluating the question from an investor’s perspective and comparing returns of four indices of socially responsible companies with that of the S&P 500 index, Statman (2005) finds that Socially Responsible Investment (SRI) indexes performed better than the S&P 500 during the 1990s and worse during the early 2000s. On the other hand, comparing the characteristics of mutual funds investing in responsible firms with a group of randomly selected conventional funds, Bello (2005) reports that socially responsible funds do not differ significantly from conventional funds in characteristics such as diversification and returns. Statman and Glushkov (2009) report that an investment strategy that is long with CSR leaders and short with laggards would have produced an annual excess risk-adjusted return of 6.12% for the period 1992–2007.

Using different CSR rankings and similar trading strategies, Derwall, Guenster, Bauer, and Koedijk (2005), Edmans (2010), and Kempf and Osthoff (2007) report similar findings on the presence of a significant risk-adjusted outperformance. Fatemi, Fooladi, and Wheeler (2009) compare the characteristics of firms in the Domini Social Index (DS 400) with those of similar firms not included in the index. They report that when compared to their control group over the period 1990–2005, firms in the DS 400 index produced statistically identical returns and exhibit similar market risk characteristics. However, they find that their idiosyncratic risk is significantly lower every year at the 99% confidence level. They also report that firms that are added to the DS 400 index experience a positive abnormal return upon the announcement of this news. The reverse holds for firms that have been removed from the index. Nofsinger and Varma (2012) study the performance of a sample of SRI mutual funds and their matching control groups over the 2000–2011 periods, and find that SRI funds outperform their peers during periods of financial crisis and underperform them during non-crisis periods.

Nofsinger and Varma conclude that the majority of extant empirical evidence provides robust support for the proposition that firms are rewarded for their focus on sustainability. Further, a growing body of evidence indicates that expectations of progressively better societal and environmental performance are being built into the markets' valuation of the firm over time. This evidence, combined with exponential increases in settling up costs of social and environmental damage (both the ex-post and ex-ante), suggests that sustainable value creation is the only viable way forward. Early adopter of such a framework (those that discard the traditional model that emphasizes the short term and embrace the sustainable value creation model in its place) will eventually be rewarded in the form of a premium to their market value. Firms that choose not to adopt the model will become laggards in the process of creating value for shareholders.

2.2 "Sustainable Banking" Concept

When the concept of "sustainability" is applied to commercial banks, people often misconstrue that the term refers to the level of sustainability of banking institution only. In fact, it encompasses long-term viability of both the institution and its clients within the broader framework of sustainable development, since banks play a crucial role as financial intermediary. Perhaps more than their own direct social and environmental impacts, banks contribute positively or negatively to sustainable development through financing various activities of their corporate and retail clients.

Early definitions of "sustainable finance" and "sustainable banking"

"Sustainable finance is defined as the provision of financial capital and risk management products to projects and businesses that promote, or do not harm, economic prosperity, environmental protection, and social justice." (Forum for the Future, 2002).

"Sustainable banking" can be defined as a decision by banks to provide products and services only to customers who take into consideration the environmental and social impacts of their activities." (Bouma, Jeucken, and Klinkers, 2001)

Carolyn and Chris (2013) describe the financial sector's role in protecting the planet and its people that banks are indispensable for the agenda of sustainable social and environmental development. The recent international economic crisis is thought by many to be, in part, linked to the dominant lending and investment culture of international banking and financial sector, in the context of widespread speculation and under-regulation at national and international levels. Bank financing and investments in the weaponry and mining industries, and other industries linked to climate change and environmental damage, have also come under criticism. Furthermore, the banking sector has become the object of widespread public distrust, verging on disgust, particularly at the reward and incentive systems within the sector which seem to externalize all the costs to the state and society, while internalizing all the gains to bank executives and employees. Such skewed incentive systems mean that banks are increasingly seen as major contributor to the growing international inequality that flies in contrast with the need for sustainable and equitable development. These combined forces have led to an emphasis on increased regulation of the banking and financial sector by state and international actors, and an emphasis on recuperation of public trust in banks (Donaldson and Dunfee, 2002; Hausman, 2002; Rose-Ackerman, 2002; Renneboog et al.,2008; Derwall et al.,2011).

In this climate, it comes as no surprise that the years following the latest financial crisis have seen an increasing number of industry-led "sustainable banking" initiatives. SWIFT, the world's largest member-owned cooperative that provides the communications platform, products and services to connect more than 10,000 banking organizations, proposed an ambitious idea called "Banks for a Better World" (shortened to B4BW). The initiative is led by SWIFT's innovation team, and the stated purpose is to encourage banks to contribute to sustainable development in the following ways:

- Bridging traditional and social finance, a kind of ''fair trade'' but for financial products and services.
- Connecting the unbanked—the people who are not part of the financial system because they do not have any bank relationship or account. In many developing countries, the unbanked form the majority of the population.
- Establishing a community, or movement, to influence the governments and global companies for more transparency in the way they invest.

"Fair trade" in this context means developing financial products that support small- and medium-sized enterprises (SMEs) and supporting "social enterprises" that impart no negative social and environmental impact. This initiative is run in partnership with Ashoka Foundation, one of the world's largest support organizations for social entrepreneurs.

In 2007, the International Finance Corporation (IFC), an arm of the World Bank that finances the private sector, issued "Banking for Sustainability Report" which defines sustainable banking as encompassing four dimensions:

1. Financial stability of the financial institution and its clients, so that they continue to make a long term contribution to development;
2. Economic sustainability of projects and companies the financial institution finances;
3. Environmental sustainability through protection of natural resources; and
4. Social sustainability through welfare of communities.

These four dimensions of sustainability set the stage for evaluating development projects financed by banks, and each is considered equally important.

An ongoing research by Dr. Katrin Kaeufer[5] at Massachusetts Institute of Technology (MIT) defines five levels of socially responsible and green banking as follows:

[5] Kaeufer, Katrin. "Banking as a Vehicle for Socio-economic Development and Change: Case Studies of Socially Responsible and Green Banks" (forthcoming). 2010. Retrieved on October 31, 2014. http://www.gabv.org/wp-content/uploads/SocialBanking.pdf

Level 1: Unfocused corporate activities.
At this level, banks sponsor “green” events and undertake public relations activities that are not related to the core business of the company (“greenwashing”). Most mainstream banks have been at this level of green for a long time.

Level 2: Isolated business projects or business practices.
Banks develop isolated products or activities that they add to their conventional banking portfolio. These account for only a small percentage of total business activities. Such token products and activities may be a reaction to changes in public opinion, and they are enacted in isolated areas of the bank, not as part of a company-wide application of socially responsible and green business principles and practices. Examples here are added “green products” to a conventional portfolio.

Level 3: Systemic business practices.
At this level, social and green principles and practices underlie most of the banks’ products and processes. The focus on positive social and green impact is a core dimension of every business activity. The organization is designed to support this impact on four levels: people/place, processes, principles, and purpose.

Level 4: Strategic ecosystem innovation.
Social, environmental, and financial sustainability does not end at the boundaries of the individual transaction. The success of social and green transformation requires participation from the larger system a bank and its clients operate in. Strategic ecosystem innovation broadens the focus of the bank’s activities from its own direct client interaction to include the larger system or eco-system. Examples of this engagement are networks, alliances, and public conversations that broaden the movement of conscious investors and regulatory changes that redefine the banking industry.

Level 5: Intentional (purpose-driven) eco-system innovation.
The difference between strategic (level 4) and intentional (level 5) eco-system innovation is that level 4 is driven by a strategic response to external challenges, while level 5 is driven by the primacy of purpose (social and green impact). At level 5, a socially responsible and green bank is a “hybrid” company whose purpose is not “avoiding a negative scenario” but addressing the core challenges of our time by innovating at the level of the whole eco-system.

Bouma et al (2001) argue that banks should explicitly incorporate environmental and social assessments into financial analysis or developing products.

Srivastava (2007) argues that banks should consider social and environments even in their analysis of project financing as (i) management of social and environmental risks in strategic decision making and lending will increase financial stability through decreasing non-performing loans, and (ii) it will create opportunities for development of financial products and services with social and environmental benefits. All these help banks better compete. Accordingly, the banking business is moving away from the so called ‘conservative banking’ with risk-aversion approach, to ‘sustainable banking’ with growth approach. Moreover, the integration of sustainability with management system will result in tangible benefits: the horizon of market will be enhanced because new area of lending sources will be identified, and the reputation and overall goodwill of the bank will increase manifold.

The IFC's "Banking for Sustainability" report in 2007 concludes that sustainability for banks has two components. "The first is managing environmental and social risks in strategic decision-making and lending… The second component is identifying opportunities for innovative product development in new areas related to sustainability. This entails creating financial products and services that support commercial development of products or activities with social and environmental benefits. A growing cluster of these opportunities have evolved and includes renewable energy, energy efficiency, cleaner production processes and technologies, biodiversity conservation, microfinance, financial services targeted to women, and low-income housing. Business models that address these dimensions are yielding new clients and markets. They are also helping financial institutions differentiate themselves from competitors, improve their reputation among key customers and stakeholders, attract new capital, and generate goodwill and support from stakeholders."

"Shared value" in banking

(Bockstette, Pfitzer, Smith, Bhavaraju, Priestley, & Bhat, Banking on Shared Value : How Banks Profit by Rethinking Their Purpose)

FSG, in collaboration with Shared Value Initiative, published the paper "Banking on Shared Value – How Banks Profit by Rethinking Their Purpose". This paper articulates a new role for banks in society using the lens of shared value. It is intended to help banks' leaders, their partners, and industry regulators seize opportunities to create financial value while addressing unmet social and environmental needs at scale.

This paper proposed that banks can no longer focus on short-term return optimization to benefit an increasingly small, elite segment of the global population. Rather, banks must choose new path. They need to recognize that the health of their businesses is inextricably linked to the long-term prosperity of their clients and communities and to sustained local and global economic growth. They have to turn their tremendous capability for innovation to financing consumer, social, and environmental solutions that benefit society while increasingly representing good investment opportunities for private capital. Doing so is the only way to preserve their legitimacy and their competitiveness

This new path centers on creating shared value—addressing relevant societal and environmental problems with a business model generating measurable returns. Importantly, shared value must be approached through the lens of business strategy, not as a matter of public relations. In addition, this paradigm shift is not only about what banks should do, but more importantly how banks can *embed shared value* within their day-to-day operations.

Shared value is rooted in a company's strategy and competitive positioning in three ways:

- Reconceiving products and markets. Banks create shared value by extending their reach to new markets, finding new ways to improve the financial health of their clients, and developing new products and services that support social and environmental progress.

- Redefining productivity in the value chain. Reconfiguring a bank's internal operations and processes is essential to innovating around new financial products, business models, and/or delivery mechanisms that meet bank hurdle rates while effectively meeting social needs.
- Creating an enabling environment. Proactively growing markets and strengthening key players and institutions in the market ecosystem are essential for banks to move beyond small-scale projects to pursue shared value markets profitably and at scale.

The authors estimated that the value of global business opportunities in social and environmental markets is projected to be upwards of $3 trillion annually by 2050; the estimated financing gap for small and medium-sized business (SMEs) totals $2.1 trillion; and 2.5 billion people around the world still need access to quality banking services.

These markets thus represent opportunities for banks to create shared value—to grow profits and regain their standing in society by creating social and environmental value. Shared value opportunities for banks exist at three levels

- Furthering client prosperity by improving the financial health of individual and business clients and extending banking services to the financially excluded.

  This opportunity is most relevant for retail and commercial banks. Banks could address client prosperity through core bank processes and customer relationships, rather than through CSR programs.

  Major barriers for this opportunity are the lack of cost-effective delivery channels for customers in remote areas and/or with small account sizes, the inability to accurately assess credit risk outside of traditional models that require collateral and documentation, and the insufficient understanding of customer needs.

- Fueling the growth of regional economies by moving beyond individual transactions to proactively finance and strengthen entire ecosystems of players within an industry or community.

  This opportunity is most relevant for commercial banks. Banks could develop strategy to grow supply chains and/or local economies beyond individual clients or transactions.

  Major barriers for this opportunity are the inability to move beyond individual clients and transactions, the lack of local relationships beyond existing clients, and the longer time horizon for returns.

- Financing solutions to global challenges by working with socially or environmentally beneficial client segments and by structuring, placing, and/or investing in impact investments.

  This opportunity is most relevant for investment and private banking /wealth management. Bank could move beyond one-off efforts to make significant, material investments to grow and serve these markets.

Major barriers for this opportunity are the perception of insufficient deal size and flow, the aversion to risk posed by unproven model in nascent markets, and the tendency to address market outside of core business with philanthropic capital only.

A few leading banks have embraced a new paradigm. They are making shared value a critical part of their core business strategies and maintaining an edge in the face of growing competition, client demand, and regulation. The banks that have achieved this have overcome three common challenges:

- They bypass the prevalent trade-off mentality between social good and business success by proactively pursuing profits from purpose—by identifying links between core business performance and societal needs and developing intentional and smart business strategies to pursue them.
- They avoid the trap of low return expectations by innovating for ROI—finding the internal space and ability to create new products and services that generate competitive returns from social and environmental markets.
- They realize long-term growth by making markets—working proactively to grow and strengthen supply and demand conditions, often leveraging corporate philanthropy in new ways and working in close collaboration with external partners, including NGOs.

This paper also explored three myths that act as barriers to creating shared value

- A profit vs. purpose trade-off mentality. Most banks deal with social and environmental considerations only through a corporate foundation, CSR (“corporate social responsibility”), or sustainability department. Moreover, many banks (and members of the public at large) believe that profiting from social good is somehow wrong. This deliberate isolation of profits from purpose restricts banks’ ability to recognize and capitalize on shared value opportunities, which exist at the intersection of profits and purpose.
- Low ROI expectations. Even when the opportunities are clear, banks fail to pursue them. Too often, banks evaluate the potential return on investment (ROI) of shared value efforts based on existing business models instead of thinking creatively about new solutions. As a result, they overestimate costs and risks while underestimating potential returns. Retail banks, for example, focus on the high costs of reaching underserved markets, commercial banks only see the risks associated with SME lending, and investment banks anticipate little return from broad participation in emerging social and environmental investment opportunities. Presuming a low ROI, banks do not reconfigure internal processes or redefine their value chains to enable shared value innovation.
- Insufficient scale. An important part of the ROI calculation is the scale of the opportunity, and many shared value markets seem too small to justify large-scale bank engagement. Banks focus on the lack of deal flow in nascent markets, such as pay-for-success investments and energy efficiency financing. Opportunities in impact investing or increasing access to finance appear subscale, and regulatory and compliance restrictions seem insurmountable. Banks too often fail to pursue shared value opportunities because they look at the immediate market for their specific products rather than the potential market. As a result, banks ignore a key approach to expand shared value opportunities—creating an enabling environment.

2.3 Major sustainable banking partnerships, standards, and awards

1. UNEP FI (the United Nations Environment Programme Finance Initiative) (UNEP Finance Initiative)

UNEP FI is a global partnership between UNEP and the financial sector. Over 200 institutions, including banks, insurers and fund managers, work with UNEP to understand the impacts of environmental and social considerations on financial performance.

Content

In 2011, The UNEP Finance Initiative finalized the principals of sustainable finance*, "UNEP Statement of Commitment by Financial Institutions (FI) on sustainable development"* (UNEP FI, 2011), for which financial institutions members have to commit. UNEP FI statement consists of 1) Commitment to Sustainable Development, 2) Sustainability Management, and 3) Public Awareness and Communication (see details in Table 1).

Table 1. UNEP Statement of Commitment by Financial Institutions (FI) on sustainable development

1. Commitment to Sustainable Development

1.1 We regard sustainable development - defined as development that meets the needs of the present without compromising the ability of future generations to meet their own needs - as a fundamental aspect of sound business management.

1.2 We believe that sustainable development is best achieved by allowing markets to work within an appropriate framework of cost efficient regulations and economic instruments. Governments have a leadership role in establishing and enforcing long-term priorities and values.

1.3 We regard financial institutions to be important contributors to sustainable development, through their interaction with other economic sectors and consumers and through their own financing, investment and trading activities.

1.4 We recognize that sustainable development is an institutional commitment and an integral part of our pursuit of both good corporate citizenship and the fundamentals of sound business practices.

1.5 We recognize that the sustainable development agenda is becoming increasingly inter-linked with humanitarian and social issues as the global environment agenda broadens and as climate change brings greater developmental and security challenges.

2. Sustainability Management

2.1 We support a precautionary approach to environmental and social issues, which strives to anticipate and prevent potential negative impacts on the environment and society.

2.2 We will comply with all applicable local, national and international regulations on environmental and social issues. Beyond compliance, we will work towards integrating environmental and social considerations into our operations and business decisions in all markets.

2.3 We recognize that identifying and quantifying environmental and social risks should be part of the normal process of risk assessment and management, both in domestic and international operations.

2.4. We will endeavor to pursue the best practice in environmental management, including energy and water efficiency, recycling and waste reduction. We will seek to form business relations with customers, partners, suppliers and subcontractors who follow similarly high environmental standards.

2.5 We intend to update our practices periodically to incorporate relevant developments in sustainability management. We encourage the industry to undertake research accordingly.

2.6 We recognize the need to conduct regular internal reviews and to measure our progress against our sustainability goals.
2.7 We recognize the need for the financial services sector to adapt and develop products and services which will promote the principles of sustainable development.

3. Public Awareness and Communication

3.1 We recommend that financial institutions develop and publish a statement of their sustainability policy and periodically report on the steps they have taken to promote the integration of environmental and social considerations into their operations.
3.2 We are committed to share relevant information with customers, as appropriate, so that they may strengthen their own capacity to reduce environmental and social risk and promote sustainable development.
3.3 We will foster openness and dialogue relating to sustainability matters with relevant stakeholders, including shareholders, employees, customers, regulators, policy-makers and the public.
3.4 We will work with the United Nations Environment Programme (UNEP) to further the principles and goals of this Statement, and seek UNEP's active support in providing relevant information relating to sustainable development.
3.5 We will encourage other financial institutions to support this Statement. We are committed to share with them our experiences and knowledge in order to extend best practices.
3.6 We recognize the importance of other initiatives by the financial services sector in forwarding the aims and objectives of sustainable finance and will seek to assist such initiatives in an appropriate manner.
3.7 We will work with UNEP periodically to review the success in implementing this Statement and expect all Signatories to make real progress.

UNEP FI's members are financial institutions from the global banking, insurance and investment sectors and work together via several sectorial, thematic and regional groups, seeking to understand and address the most current and important sustainable finance issues.

There are currently over 200 institutions, among them two members from Thailand: Bangkok Insurance Public Company Limited, and TISCO Financial Group Public Company Limited.

UNEP FI also collaborates with Global Reporting Initiative (GRI) and International Corporate Governance Network (ICGN).

Criticisms of UNEP FI and banks' sustainability reports

In 2012, as financial turmoil engulfed the Eurozone and other parts of the world, and such infamous scandal in banking sector as LIBOR rigging was revealed, the question of bank culture, and how to correct it, became urgent for any financial market center that values its reputation. Roger McCormick (2012) analyzed the notion of sustainability in the specific context of banks and financial markets. He summarized that "in the specific case of banks, an honest recognition of losses is key, as well as the search for clear and publicly available information on balance sheets. This latter would help understand to which extent banks have changed their "bad habits"."

In McCormick's analysis, he criticized The United Nations Environment Programme Finance Initiative (UNEP FI), which is based on the UNEP Statement of Commitment by Financial Institutions on

Sustainable Development, that the "commitments" include a number of statements of belief and opinion rather than undertakings to do (or not do) anything in particular.

McCormick also criticized sustainability reports of major banks. According to Financial Sector Supplement (FSS) of the GRI, sustainability reporting is "…the practice of measuring, disclosing, and *being accountable to internal and external stakeholders* for organizational performance towards the goal of sustainable development." But McCormick argued that in practice, sustainability reports of banks are far from consistent about how the latter part of that phrase should be interpreted. This lack of consistency makes analysis of the reports, and the comparison of one bank with another, difficult.

All in all, McCormick proposed the following ways to improve bank sustainability report:
1. Reducing the amount of material that relates to what the bank would have to do to comply with the law anyway or that is simply good customer relations (e.g. reducing queues in branches).
2. Presenting information that, as far as possible, enables verification and/or is accompanied by a statement from a third party that is confirmatory in nature.
3. Presenting information in a way that reflects a consensus (which, admittedly, may still need to be established) as to which are the more important issues and which are relatively peripheral.
4. Increasing the amount of material that is related to the bank's own business model, culture, and sustainability.
5. Increasing the amount of material on the bank's disciplinary record.
6. Presenting material in a way, as far as possible, that (i) makes comparison with previous years and with other banks easy and (ii) clearly distinguishes between facts and subjective commentary.
7. Improving the navigability of internet based documents so that, for example, (i) the indices of the Global Reporting Initiative are (where relevant) easily found and (ii) one can easily follow a link to any cross-referenced item (either in the same document or elsewhere, such as the Annual Report) with appropriate page and paragraph references.
8. Ensuring, as far as possible, that all banks present the same kind of information under the same headings (bearing in mind the widespread use of imprecise terminology such as "engagement") and omit information and "PR material" that is not relevant to those headings.

<u>2. Equator Principles</u> (EQUATOR PRINCIPLE, 2014)

The Equator Principles (EPs) is a risk management framework, adopted by financial institutions, for determining, assessing and managing environmental and social risk in projects and is primarily intended to provide a minimum standard for due diligence to support responsible risk decision-making.

The EPs apply globally, to all industry sectors and to four financial products 1) Project Finance Advisory Services 2) Project Finance 3) Project-Related Corporate Loans and 4) Bridge Loans.

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The Equator Principles have recently been revised – third version was launched on 4 June 2013. The latest principles consist of 1) Review and Categorization, 2) Environmental and Social Assessment, 3) Applicable Environmental and Social Standards, 4) Environmental and Social Management System and Equator Principles Action Plan, 5) Stakeholder Engagement, 6) Grievance Mechanism, 7) Independent Review, 8) Covenants, 9) Independent Monitoring and Reporting, 10) Reporting and Transparency.

Table 1 : Summary of Equator Principles (Mizuho Financial Group, 2014)

Scope	- Location: Global - Sectors: All Sectors - Business Type: A new project, and expansion or upgrade of an existing facility with potential significant environmental or social impacts - Method: (1) Project Finance (PF) (as defined by Basel II), (2) Project Finance Advisory Services (FA), (3) Project-Related Corporate Loan (PRCL), (4) Bridge Loan(BL) - Business Scale: (1) PF - Total project cost of US$10 million or more (2) FA - Same as above (3) PRCL - Total aggregate loan amount is at least US$100 million; the Equator Bank's individual commitment (before syndication or sell down) is at least US$50 million. (4) BL - Same as PF/PRCL thresholds
Pre-Financing	Clients are expected to meet requirements in response to Project classification of A, B or C based on the degree of impact on environment.

Category	Impact	Requirements for Client (e.g.)
A	Projects with potential significant adverse environmental and social risks and/or impacts that are diverse, irreversible or unprecedented.	a. Prepare an environmental and social impact assessment report (ESIA); b. Prepare an Action Plan (AP); c. Establish an environmental management system; d. Conduct consultations with the project-affected communities; e. Disclose summary of ESIA report online; f. Disclose the GHG emissions quantification (for projects emitting more than 100,000tons of CO2 equivalent); g. Establish a grievance mechanism; h. Require an independent expert to prepare an assessment report on the above items a, b, c, d and g; i. Require an independent expert to conduct monitoring after the project funding is executed;
B	Projects with potential limited adverse	a. Prepare an ESIA report;

		environmental and social risks and/or impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures.	b. Prepare an AP; c. Establish an environmental management system; (Following are required, as applicable) d. Conduct consultations with the project-affected communities; e. Disclose summary of ESIA report online; f. Disclose the GHG emissions quantification (for projects emitting more than 100,000tons of CO2 equivalent); g. Establish a grievance mechanism; h. Require an independent expert to prepare an assessment report on the above items a, b, c, d and g; i. Require an independent expert to conduct monitoring after the project funding is executed;
	C	Projects with minimal or no adverse environmental and social risks and/or impacts.	- none

ESIA report describes:
- Potential risk and impacts related to the issues illustrated in Exhibit II of Equator Principles
- Compliance with relevant host country laws, regulations and permits
- Compliance with the IFC Performance Standards and IFC EHS (Environmental, Health, and Safety) Guidelines

AP contains:
- Action plans needed to implement mitigation measures, corrective actions and monitoring measures and their priority.

Covenants	For all projects, the client will add the following covenant in financing documentation: a) To comply with all relevant host country social and environmental laws, regulations and permits in all material respects For Category A and B projects, the client will add the following covenants in financing documentation: a) To comply with the AP (where applicable) during the construction and operation of the project in all material respects b) To provide periodic reports prepared by in-house staff or third party experts, that document compliance with the AP and the host country's laws and regulations. c) To decommission the facilities in accordance with an agreed decommissioning plan.
Post-Financing	(1) Equator Bank may require appointment of an independent environmental consultant to conduct further monitoring, if applicable. (2) Where a client is not in compliance with its social and environmental covenants, Equator Banks will work with the client to bring it back into compliance.

	(3) If the client fails to re-establish compliance with the covenants, the loan goes into default.
Disclosure	- The client will disclose (i) ESIA online and (ii) GHG emission level (depends on the category of the project) - Each Equator Bank reports publicly, at least annually, about its Equator Principles implementation processes, including the number of transactions screened and their categorization

Members

As of 31 December 2014, 80 Equator Principles Financial Institutions (EPFIs) in 35 countries have officially adopted the EPs, covering over 85 percent of international Project Finance debt in emerging markets. None of the signatories is from Thailand.

They have also promoted convergence around common environmental and social standards. Multilateral development banks, including the *European Bank for Reconstruction & Development* , and export credit agencies through *the OECD Common Approaches* are increasingly drawing on the same standards as the EPs.

The EPs have also helped spur the development of other responsible environmental and social management practices in the financial sector and banking industry (for example, *Carbon Principles in the US*, *Climate Principles worldwide*) and have provided a platform for engagement with a broad range of interested stakeholders, including non-governmental organizations (NGOs), clients and industry bodies.

For more information, case studies, and criticisms of the EPs, see Chapter 3: Responsible Wholesale Lending section of this report.

3. GABV (Global Alliance for Banking on Values) (Global Alliance for Banking on Values, 20014)

Founded in 2009, The Global Alliance for Banking on Values is an independent network of banks using finance to deliver sustainable development for underserved populations, communities, and the environment.

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The Global Alliance for Banking on Values (GABV) principles of sustainable finance and sustainable banking are designed to champion six “fundamental pillars” of sustainable banking:
1. Triple bottom line approach at the heart of the business model
2. Grounded in communities, serving the real economy and enabling new business models to meet the needs of both
3. Long-term relationships with clients and a direct understanding of their economic activities and the risks involved
4. Long-term, self-sustaining, and resilient to outside disruptions
5. Transparent and inclusive governance

6. All of these five principles are embedded in the culture of the bank

The network's members have to meet three criteria:

- they are independent and licensed banks with a focus on retail customers;
- with a minimum balance sheet of $50 million;
- most significantly, they should be committed to social banking and the concept of "triple bottom line," i.e. people, planet and profit.

<u>Members</u>

There are currently 25 members in the GABV, made up of the world's leading sustainable banks, from Asia, Africa, Australia, Latin America to North America and Europe. Members include microfinance banks in emerging markets, credit unions, community banks, and sustainable banks which focus on financing social, environmental and cultural enterprises.

Figure 7 Members of Global Alliance for Banking on Values (GABV)

The Global Alliance for Banking on Values works with key partners to further its work, such as, FMO, the development bank of the Netherlands. It has also partnered with organization such as the Rockefeller Foundation, which co-funded early stages of its financial capital and impact metrics action track, and Georgetown University, which hosted a talk event with GABV on the future of banking in 2013.

4. FT /IFC Sustainable finance awards (Financial Times & IFC)

Every year, Financial Times and IFC, a member of the World Bank Group, sponsor the FT/IFC Sustainable Finance Awards. The awards recognize banks and other financial institutions that have shown leadership and innovation in integrating social, environmental and corporate governance considerations into their operations.

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In their eighth year as of 2014, the awards also highlight partnerships between financial and non-financial companies such as technology firms and infrastructure groups that are finding innovative and commercially viable solutions to some of the world's most pressing sustainability challenges. The 2012 programme attracted 161 entries from 145 financial institutions and 36 non-financial groups in 67 countries.

A new thematic category for 2013 is "Achievement in Inclusive Business," which highlights ground-breaking initiatives by companies and financial partners that incorporate people at the Base of the Pyramid into their value chain as suppliers, distributors, retailers or customers.

The FT/IFC Sustainable Finance Awards this year will reward leadership and innovation on an institutional and transactional basis across five categories.

- Sustainable Bank of the Year
- Sustainable Investor of the Year
- Sustainable Investment of the Year
- Technology in Sustainable Finance
- Achievement in Inclusive Business

The first category is open to banks; the remaining categories are open to all financial institutions. Non-financial companies may apply for the Sustainable Investment, Technology and Inclusive Business awards. In the case of Sustainable Investment, applications by non-financial companies should highlight a partnership with a financial institution.

As part of the overall Sustainable Bank of the Year category, Regional Awards will be offered for achievements in Africa/Middle East, Americas, Asia-Pacific and Europe, and a Global Sustainable Bank of the Year prize will be open to institutions with assets of more than US$500bn, substantial operations on at least two continents, and more than 20 percent of revenue earned outside the country of incorporation.

Table 2. Criteria of FT Sustainable Bank of the Year 2013 (Financial Times & IFC)

Note: L = Level, with L4 being the most advanced

Strategic Approach	L4 Mainstreamed	L3 Operationalizing Sustainability	L2 Reputational Risk Management	L1 Financial Risk Management
Sustainability Strategy: What is the current top management approach to sustainability?	Sustainability mainstreamed as a core driver of long term performance.	Assess and effectively manage ESG risks in transactions. Selective transactions into ESG beneficial sectors.	Reputational risk management. Screen out high-risk transactions.	Minimum focus on sustainability as a nonbusiness related issue.
Financial Indicators: What is the FI's overall financial performance?	Financial outperformance	Strong financial performance	Inconsistent financial performance	Financial underperformance
Sustainability Indicators: How does the FI assess sustainability performance?	Sustainability measured systematically as a core driver of transaction performance	Consistent indicators around risk/policy compliance	Indicators around risk/policy compliance	No systematic sustainability indicators
Communications Strategy	**L4 Mainstreamed**	**L3 Operationalizing Sustainability**	**L2 Reputational Risk Management**	**L1 Financial Risk Management**
Internal Communications: How well does the FI align the internal team with its high level sustainability approach?	Training and resources applied to ensure sustainability capability and commitment across key business leaders and transaction teams.	Consistent internal communications around compliance with sustainability policies. Selective training/resources allocated.	Internal communications around compliance with sustainability policies. Limited training/ resources.	Absence of sustainability communications and training provided to the internal client.
External Client and Stakeholders: How well does the FI align its sustainability approach with external stakeholders?	Agenda-setting engagement and communications (report, practice groups). Ongoing stakeholder consultation/influencing of policy agenda.	Active participation in industry best practice initiatives and research on sustainability.	Participation in industry best practices initiatives and research on sustainability.	Absence of engagement on sustainability issues.
Sustainability Reporting:	Integrated reporting of sustainability results,	Summary review of ESG performance of	Highlights of ESG performance of operations.	Absence of reporting of ESG

How comprehensively does the institution report on sustainability performance?	including full review of ESG performance of operations.	operations. Disclosure of non-compliance.		performance of operations.
Opportunities	**L4 Mainstreamed**	**L3 Operationalizing Sustainability**	**L2 Reputational Risk Management**	**L1 Financial Risk Management**
Product/Sectors: Which phrase best describes the FI's transactions?	Sustainability policies applied across all transactions. Primary focus on ESG beneficial sectors. Track record of pioneering sustainability transactions.	Sustainability policies applied across all transactions. Significant investments in ESG beneficial sectors.	Sustainability recognized as a factor in transactions strategy. Negative screening/exclusion list criteria required for all transaction/operation managers.	No formal process of integrating sustainability into operations.
Business Results: Which phrase best describes the business results of the FI's sustainability strategy?	Track record of pioneering sustainable transactions, combining strong ESG returns	Track record of sustainable transactions with financial and ESG returns.	Limited results from sustainable transactions.	No track record of successful transactions into sustainability.
Risk Management	**L4 Mainstreamed**	**L3 Operationalizing Sustainability**	**L2 Reputational Risk Management**	**L1 Financial Risk Management**
Business Principles and Policies: What type of policies and standards are employed?	Specific industry best practice standards for all transactions plus internal policies (e.g. on tar sands, forestry, defense, etc.) forged in consultation with stakeholders.	Specific industry good practice standards for all transactions.	Commitment to operate according to accepted business lines (OECD guidelines, etc.).	Sustainability not explicitly part of the institution's policy framework.
E&S Risk Management: How is sustainability integrated into the FI's day-to-day activities?	Transaction/investment and sustainability teams jointly responsible for identifying sustainability opportunities and managing risks.	Sustainability risk management formal part of process, with sustainability team working to provide sustainability solutions.	Risk management formal part of process, with negative screening criteria implemented by all transaction/investment/operation managers.	Sustainability not formally incorporated within procedure/asset allocation strategy.
Monitoring: How is sustainability performance	Ongoing identification of clients' sustainability driven business risks/	Monitoring and ongoing reporting by transaction/investment managers of	Monitoring of problem transactions. Requirement for transaction/investment managers	Lack of systematic monitoring of sustainability performance.

monitored?	opportunities, as a basis for active engagement/delivery of sustainability value.	performance on ESG issues. Reactive engagement on problem transactions.	to disclose potential noncompliance.	

5. beyondBanking Award

Founded in 2010, the “beyondBanking” award is given by the Inter-American Development Bank (IDB) to recognize social, environmental and corporate governance practices among financial intermediaries in Latin America and the Caribbean that fits with the vision of “Bank of the Future” – a financial business model that combines financial profitability with social and environmental returns; values principles of transparency, responsibility and integrity; seeks to reach more people through more channels; and respects the environment and community in which it operates.

In 2014, the awardees were chosen from over one hundred proposals across seven categories. A Committee of Experts selected the best twenty-one proposals, three per category. Finally, the winner was selected by the public through an online vote.[6]

6. Natural Capital Declaration

Now, more "land wisdom" is shining as the concept of ecosystem services has a new and very welcome chapter, thanks to the Natural Capital Declaration (NCD), a commitment by CEOs from the finance sector to integrate natural capital criteria into financial products and services.

"[A]ll companies are dependent on ecosystem services, either through their supply chains, around their operating sites or via their customers," said Cameron Clyne, CEO of National Australia Bank.

The declaration was officially launched at Rio+20. It states:

“Today, we the undersigned financial institutions wish to acknowledge and re-affirm the importance of Natural Capital in maintaining a sustainable global economy. This declaration calls upon the private and public sectors to work together to create the conditions necessary to maintain and enhance Natural Capital as a critical economic, ecological and social asset. We present this declaration to the world community at Rio +20, as a private sector finance response to the conference theme of working towards a green economy.”[7]

[6] “IDB announces the winners of the fourth annual beyondBanking Awards” March 27, 2014. Retrieved on October 31, 2014. http://www.iadb.org/en/news/news-releases/2014-03-27/beyondbanking-awards,10778.html
[7] Natural Capital Declaration, http://www.naturalcapitaldeclaration.org/wp-content/uploads/2012/04/NaturalCapitalDeclaration.pdf. Accessed 31 January, 2015.

The linkage between biodiversity and sustainable finance

Facilitated by a secretariat comprising the United Nations Environment Programme Finance Initiative (UNEP FI), the Global Canopy Programme (GCP) and the Center for Sustainability Studies (GVces) of the Business Administration School of the Getulio Vargas Foundation in Rio de Janeiro, Brazil, the NCD was "born out of the insight that financial institutions could benefit from greater guidance to embed specific aspects of environmental, social, and governance (ESG) factors in their risk management, due diligence, loans, investments, and insurance activities." More specifically, it developed as part of UNEP FI's research into the linkages between biodiversity and sustainable finance.

Integrating natural capital into financial vehicles is not only smart business, but necessary. As the scientific community has for the most part agreed that we are on track for widespread environmental collapse, and considering the austerity measures that have hampered governments' climate change spending around the globe (Ernst & Young expects a $45 billion gap in climate change funding due to austerity measures in the euro zone)[6], it is critical that the private sector step into the breach to support investments in biodiversity and the support of healthy ecosystems.

As of the end of 2014, the NCD has been endorsed by the CEOs of 20 financial institutions: Rabobank Group, National Australia Bank, UniCredit, Sovereign, International Finance Corporation, Standard Chartered, Caledonia Wealth Management, Robeco, Zevin Asset Management, PaxWorld Management, Mutualista Pichincha, Oppenheim, Banco Pichincha, FIRA-Banco de Mexio, Althelia Ecosphere, Cyrte, Vision Banco, ASN Bank, Shenzhen Development Bank and CI Banco. It's a good start, but all banks and financial institutions should get on board, in particular the big ones.

"Over the next decades, it will be necessary for market capitalism to undergo a Sustainability Revolution equal in significance to the Industrial Revolution that ushered in the modern period," said Joe Keefe, president and CEO of PaxWorld Management. "For this to happen, our financial system must dramatically change."

2.4 Financial performance of "sustainable banks"

Empirical results of research on the relationship between a bank's financial performance and its social and environmental performance parallel that of other businesses. Some researchers find a significant relationship between a bank's financial performance and its CSR activities, and find that CSR is negatively correlated with non-performing loans. (Wu & Shen, 2013). Others find that the largest banks appear to be rewarded for their social responsibility, as both size adjusted ROA and ROE are positively and significantly related to CSR scores (Cornett, Erhemjamts, & Tehranian, 2014).

In 2013, the Global Alliance for Banking on Values (GABV) published the results of research that compares sustainable banks (members of the GABV as of March, 2013) and Global Systemically Important Financial Institutions (GSIFIs) in response to the following key questions:

- What support does a bank provide to the real economy?
- How resilient is a bank in the face of economic challenges?
- What returns does a bank provide to society, clients and investors?
- What growth does a bank achieve to expand its impact?

The research examined results for 2003 to 2007 (pre-crisis), 2008 to 2012 (post-crisis), and over a ten-year cycle, i.e. between 2003 and 2012. With the collapse of Lehman Brothers in 2008, signaling the 'tipping point' of the most recent financial crisis, these time periods essentially capture two very different eras of the banking system. The degree to which a bank finances the real economy is measured from the portion of assets on its balance sheet that are devoted to lending. They found that loan to total assets ratio of sustainable banks is nearly double that of the GSIFIs, and it remains core to their activity.

Loans to Total Assets	Post-crisis - 2008 to 2012	Pre-Crisis - 2003 to 2007	Over the Cycle - 2003 to 2012
Sustainable Banks	77.4%	74.5%	75.9%
GSFIs	39.3%	41.0%	40.1%

In addition, sustainable banks rely much more on client deposits to fund their balance sheet compared with GSIFIs. This focus on deposit taking is not only another example of a focus on the real economy, but also reduces the liquidity risk of their funding strategies.

Deposits to Total Assets	Post-crisis - 2008 to 2012	Pre-Crisis - 2003 to 2007	Over the Cycle - 2003 to 2012
Sustainable Banks	75.3%	74.5%	73.1%
GSFI's	42.8%	43.0%	42.9%

Sustainable banks also had strong capital positions, relative to the GSIFIs, especially as measured by the equity/total assets ratio. At the same time, high levels of capital did not reduce their appetite to lend, challenging claims by some larger financial institutions that higher capital requirements lead to less lending.

The sustainable banks did not show substantially higher levels of capital than the GSIFIs relative to risk-based capital measures. However, the ratios for the GSIFIs were significantly affected by the relatively low level of Risk Weighted Assets (RWA) compared to total assets, as calculated by their risk models.

Capital Comparisons	Post-crisis - 2008 to 2012	Pre-Crisis - 2003 to 2007	Over the Cycle - 2003 to 2012
Sustainable Banks			
Equity/Total Assets	7.8%	6.7%	7.2%
Tier 1 Ratios	12.1%	n/m[9]	n/m
RWAs/Total Assets	61.9%	n/m	n/m
GSIFIs			
Equity/Total Assets	5.9%	5.2%	5.5%
Tier 1 Ratios	11.8%	n/m	n/m
RWAs/Total Assets	39.4%	n/m	n/m

Comparing financial returns of sustainable banks with GSIFIs provides a more complex picture. The sustainable banks have historically stable return on assets, although at levels below those reported by GSIFIs prior to the crisis. However, sustainable banks provide resilient financial returns over the period with lower levels of volatility. This result is somewhat surprising, given the prevailing assumption that sustainable banks would deliver lower returns than bigger banks that focus on maximizing financial returns.

With regards to returns on equity, the GSIFIs perform better, on average, over the period. However, again there is more volatility and post-crisis returns are lower for the GSIFIs. In addition, the lower level of equity/assets for the GSIFIs means that a portion of these higher returns come from greater leverage, implying greater risk. Investors and others should therefore expect higher returns on their equity investments in GSIFIs, given both higher degree of leverage and greater volatility of the returns.

Financial Ratios			
	Post-crisis - 2008 to 2012	Pre-Crisis - 2003 to 2007	Over the Cycle - 2003 to 2012
Sustainable Banks			
Return on Assets	0.53%	0.59%	0.56%
Standard Deviation	0.16%	0.17%	0.21%
GSFIs			
Return on Assets	0.37%	0.78%	0.57%
Standard Deviation	0.37%	0.29%	0.36%
Sustainable Banks			
Return on Equity	7.5%	8.8%	8.2%
Standard Deviation	2.1%	1.9%	2.7%
GSFIs			
Return on Equity	5.2%	17.7%	11.5%
Standard Deviation	10.0%	10.6%	10.2%

The issue of growth demonstrates further marked differences between the two groups. Sustainable banks had much higher growth in loans, deposits, and total income compared to GSIFIs over the period. Prior to the start of the financial crisis, GSIFIs showed strong growth, but their growth slowed substantially post-crisis. As a result, sustainable banks show a much more consistent growth pattern over the full period reviewed.

Growth	Post-crisis - 2008 to 2012	Pre-Crisis - 2003 to 2007	Over the Cycle - 2003 to 2012
Sustainable Banks			
Loans	12.5%	13.6%	12.6%
Deposits	13.9%	13.1%	12.3%
Total Income	8.0%	12.8%	10.4%
GSFIs			
Loans	3.8%	17.7%	8.4%
Deposits	6.5%	16.6%	9.5%
Total Income	2.0%	15.8%	6.1%

Given the above data, the report's authors concluded that over the long term, the business case for banking models, based on these principles, offers a compelling route to a more stable and sustainable banking industry. They suggest that the growing sustainable banking sector will help create:

- Greater focus on the real economy;
- More resiliency in the banking system;
- More profitable and less risky financial returns; and
- Sustainable growth for banks.

Global trends that are strengthening business case for sustainable banking

The following global trends and factors are strengthening the case for sustainable banking as a means of differentiating banks in increasingly competitive markets:

- The private sector is using innovation to play a role in addressing global concerns. Significant environmental threats and growing demand for action on social issues are causing both the industrial and the financial sector to seek new ways of doing business. Notable examples include extreme pollution in China, energy efficiency crisis in Central and Eastern Europe, and the HIV/AIDS epidemic in Sub-Saharan Africa. Supported by governments and international organizations, many companies are producing innovative products, services and business models to respond to such challenges. As traditional financial intermediaries, banks have an increasing role to play to facilitate their clients in these markets.
- Market-based mechanisms are gaining more power to stimulate investments in sustainability. International agreements such as the Kyoto Protocol, which came into force in 2005, as well as new regulatory initiatives to combat climate change such as carbon tax, are boosting

commercial value of energy efficiency and renewable energy initiatives. Consumer demand for more sustainable products and services, as well as tighter restrictions on imports by developed markets, such as the European Union (EU), are driving improvements in the technologies and business models used by producers in the developing world.

- Concerned non-governmental organizations (NGOs) are turning more attention to banks. Rather than simply criticize, NGOs are increasingly seeking to collaborate and advocate change in banks' social and environmental policies and practices. For example, over 100 advocacy groups signed the Colleveccio Declaration at the World Economic Forum in 2003, calling on financial institutions to implement more socially and environmentally responsible lending policies. (See more details of NGOs' scrutiny of banks in Chapter 3. Responsible Wholesale Lending)
- Leading international financial institutions are setting higher standards. IFC was one of the first multilateral finance institutions to commit to high standards for managing social and environmental risk in its private sector investments. IFC's standards, updated in 2006, have in turn been used as the basis for the Equator Principles. In April 2006, leading institutional investors from 16 countries, and representing more than $2 trillion in assets, signed up to the Principles for Responsible Investment, an initiative of the United Nations Environment Programme Finance Initiative (UNEP FI) and the UN Global Compact (see http://www.unpri.org).

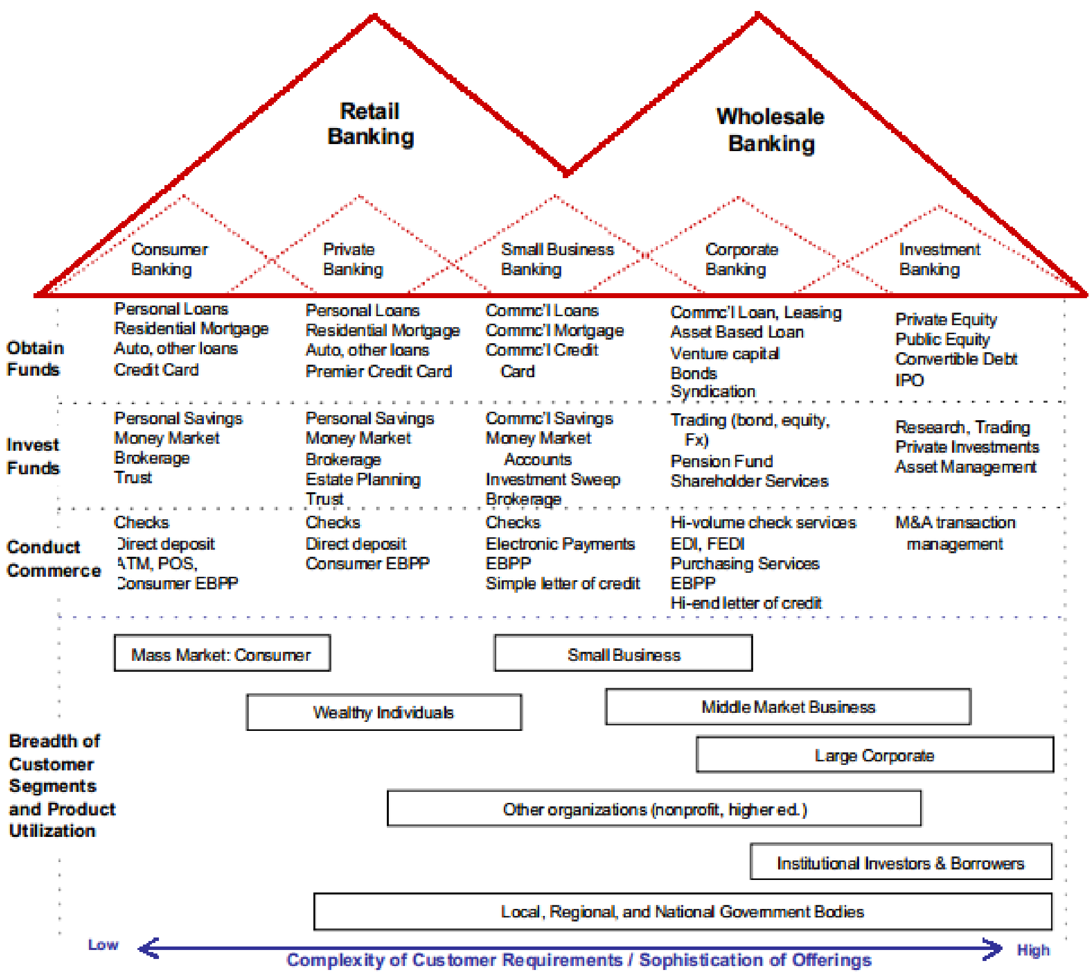
SAL FOREST

Chapter 3. Responsible Wholesale Lending

3.1 Project finance structure and risks

Wholesale banking or corporate banking means the delivery of financial services to wholesale clients, namely corporates, other financial institutions, governments, organizations, institutional investors, and public entities. Wholesale banking products range from the simplest traditional banking services such as deposits, loans, e-banking, to more complex activities such as international trade transactions, investment banking, insurance, advisory services, structured finance, and project finance (GartnerGroup, 2000; BankTrack, n.d.).

Figure 8. Services offered by retail and wholesale banking and the customers of each segment



Source: GartnerGroup, 2000

Project Finance

Of all wholesale banking services, the type of service that has the most potential to cause adverse impact is project finance, especially the financing of large-scale infrastructure projects such as hydropower dams, mines, and electricity plants. The concept of project finance – one of wholesale lending services – has existed long before the concept of corporate finance. It can be dated back to 1299 when Italian bankers lent money to the English Crown to finance the Devon silver mining and were repaid by the output from the mines. Ship voyages until 17th century also used this concept of project finance to attract funds from investors to finance trading expeditions; when the ships returned, the cargos and the ships would be liquidated to repay the investors (Comer, 1996).

Nowadays, project finance is used to developed infrastructure or construction projects such as dams, power plants, gas pipelines or telecommunication infrastructures which require a very large amount of up-front capital, typically 60-80% of total project cost). Since this amount is too large for any one single bank to undertake, so a lead bank will typically syndicate the loan with other banks to diversify risks (Comer, 1996; Chan-Fishel, 2003; Schepers, 2011).

According to Michelle Chan Fishel (2003), project finance is "a method of funding project in which repayment of debt (such as loans or bonds) is based on the revenue generated by that project". Although the definition of project finance is not limited to any one single definition, many academics and bankers have defined it similarly; for example, David Gardner and James Wright define it as "the raising of finance on a Limited Recourse basis, for the purposes of developing a large capital-intensive infrastructure project, where the borrower is a special purpose vehicle and repayment of the financing by the borrower will be dependent on the internally generated cash flows of the project".

In the article "The Equator Principles: a promise in progress?" in *Corporate Governance*, Schepers (2011) refers to project finance as a strategy to diversify risks when a bank decides to finance a capital-intensive project with long repayment period. However, the definition that many refer to is the following definition from the Basel Committee on Bank Supervision in International Convergence of Capital Measurement and Capital Standards: A Revised Framework Comprehensive Version (Basel II) in 2006:

> Project finance
>
> 1. Project finance (PF) is a method of funding in which the lender looks primarily to the revenues generated by a single project, both as the source of repayment and as security for the exposure. This type of financing is usually for large, complex and expensive installations that might include, for example, power plants, chemical processing plants, mines, transportation infrastructure, environment, and telecommunications infrastructure. Project finance may take the form of financing of the construction of a new capital installation, or refinancing of an existing installation, with or without improvements.

2. In such transactions, the lender is usually paid solely or almost exclusively out of the money generated by the contracts for the facility's output, such as the electricity sold by a power plant. The borrower is usually a Special-Purpose Entity (SPE) that is not permitted to perform any function other than developing, owning, and operating the installation. The consequence is that repayment depends primarily on the project's cash flow and on the collateral value of the project's assets. In contrast, if repayment of the exposure depends primarily on a well-established, diversified, credit-worthy, contractually obligated end user for repayment, it is considered a secured exposure to that end-user (BIS, 2006).

In other words, project-financed loans are primarily "unsecured" exposure. In the event of financial distress, lenders have recourse to the assets of the project company, but no recourse to the assets of the parent firms (Vaaler, James, and Aguilera 2008). Investors and sponsors have strong incentives to get projects built and operating on time. They may have weaker incentives to consider negative external effects (Lawrence 2009).

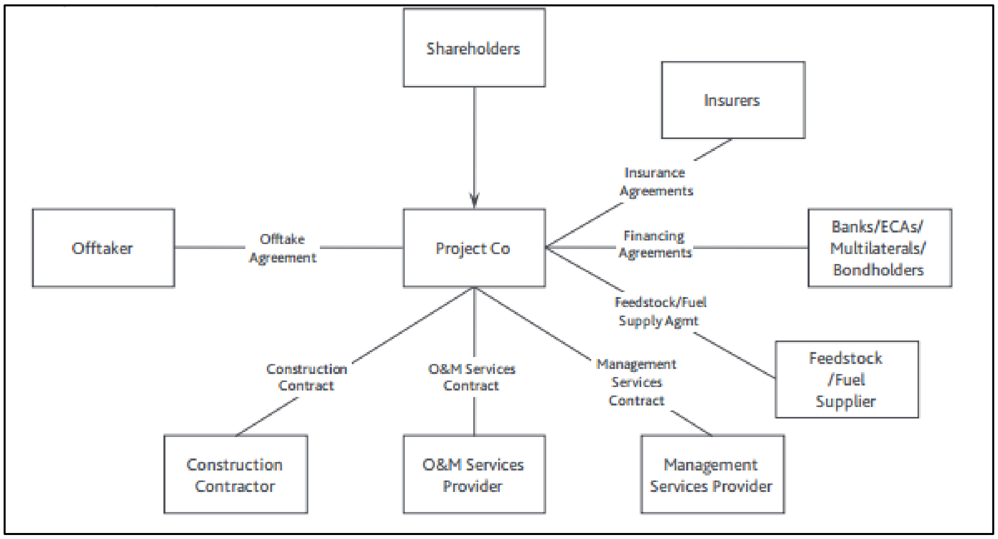
In summary, major characteristics of project finance are as follows (Comer, 1996; Gatti, 2008):

- Limited- or non-recourse
- High up-front costs
- Highly leveraged
- Long-term payout with fixed dividend policy
- Special-purpose vehicle with a finite life
- Many participants
- Allocated risk
- High cost of capital

Project Finance Structure

As stated in the previous section, one characteristic of project finance is that it involves many participants. These participants or "project stakeholders" will be allocated risks best suited to them to control and manage (Gardner & Wright). Although the complexity of project finance may vary project by project, the basic structure typically remains the same (Comer, 1996).

Figure 9. Simplified project finance structure



Source: Moody's Investors Service, 2013

Major stakeholders in project finance

- **Project sponsors or project owners** - a project sponsor or project owner is a single or a consortium of parties who owns or invests in equity of a project company. The equity of the project sponsor is usually about 20-40% of the project cost.
- **Project company** - a project company is a specific entity or special-purpose vehicle (SPV, sometimes called special-purpose entity or SPE) set up by the project sponsors only for running a specific business of the project within the period and scope identified in contractual arrangements with other parties. A project company is controlled by project sponsors, and it is the focal point of the project through contractual arrangements with other parties or stakeholders of the project as shown in

- Figure 9.
- **Government** - the role of the government is usually the most influential as it is responsible for many undertakings to create an environment to support the project including approval of the project, awarding concession contracts, legal system e.g. tax regime, operating and environmental permits.
- **Lenders** - lenders are often commercial banks, bilateral/multilateral institutions, export credit agencies, development finance institutions, and bond holders forming a syndicate to raise the needed funds. They are major sources of loans for the project financing (usually 60-80% of the project cost).
- **Contractor** - the role of a contractor is to manage engineering procurement and construction of the project. The main contractor will usually sub-contract with local companies.
- **Operator** - operator is usually an engineering company responsible for operating, maintaining and managing the project e.g. power plants, hydropower dams, pipeline.
- **Suppliers or feedstock providers** – suppliers are contracted to provide key inputs or raw materials to the project.
- **Customer or off-taker** – a customer is a party who is contracted to purchase the output or product of the project (e.g. electricity, minerals) through long-term off-take agreements. (Comer, 1996; Gatti, 2008; Nnadika; Schepers, 2011; Gardner & Wright, n.d)

It is notable that "project stakeholders" in the mainstream project finance structure, as mentioned above, do not include groups that are not parties to project agreements, but are directly or indirectly affected by the project, particularly local communities in the construction area and the environment.

The omission of these stakeholder groups from the syndicate banks' purview is usually based on the assumption that any impacts on these groups should and would already be addressed by related laws and regulations that the project company must comply with. In addition, banks as 'mere lenders' cannot be held 'responsible' for the project's impacts. This perspective and attendant project finance structure is one of the main 'shortcomings' of traditional project finance that gave rise to many problematic infrastructure projects which prompted the subsequent development of standards such as Equator Principles, as will be explained further in this chapter.

Risks of Project Finance

Since project finance is limited- or non-recourse finance whereby the lenders and investors will be repaid only after the project is completed and starts generating income, risks associated with the project are very important because they can hinder construction or operation of the project. Such hindrance will consequently affect the project company's ability to generate cash flows to service debts and pay dividends to shareholders (Gatti, 2008). Project finance risks can occur in either the construction or operation phase; some risks can occur in both phases. Various project finance advisors are responsible for identifying, mitigating, and allocating each risk to a counterparty that is best suited to control and manage the risk and bear its cost (Comer, 1996; Gatti, 2008; Gardner & Wright, n.d.). Common risks in project finance are summarized in Table 3.

Table 3. Type of common risks in project finance by project phase

Project phase	Risks
Construction phase	• Activity risk (planning risk) • Technological risk • Construction risk (cost overrun, delayed completion, force majeure, etc.)
Operation phase	• Supply risks • Operational risk (performance risk) • Market risk (demand risk)
Both phases	• Interest rate risk • Exchange risk • Inflation risk • Environmental risk (linked to political risk) • Regulatory risk • Legal risk • Political risk and country risk • Credit or counterparty risk

Source: Gatti, 2008

Risks mitigation

Since risks are very critical to the ability to service debts of project finance, project sponsors and lenders employ many ways to mitigate them. There are three ways that the special-purpose vehicle (SPV) may use to manage risks: 1) manage risks by themselves 2) allocate risks to counterparties, and 3) insure the SPV against certain risks.

Among all three, the second way is the most important strategy used in project finance. Legal advisors of project owners and lenders will identify the counterparty that is best suited to manage and control risks, and will then allocate such risks to that counterparty through contractual agreements as shown in Figure 9. The SPV will retain the risk when it is considered too expensive to shift the risk to the counterparty, and the impact of the risk is lower than the cost of insurance premium. The third strategy, i.e. insuring the SPV, is used for risks that are difficult to address (Gatti, 2008).

Environmental and social risk management

Common risks in project finance as summarized in Table 3 show that banks still largely perceive environmental and social risks of project finance mainly through the lens of “regulatory risk” or “political risk,” i.e. the risk that the project company or project sponsors may not be able to receive prerequisite permits, or fined or persecuted by the authorities for causing social or environmental damages. Such a scenario may leave the project company unable to service debt, therefore such risks are also financial risks from the lenders' perspective.

Today, many banks use different techniques and methods for incorporating environmental and social factors into their risk assessment process. The most widely used approach within the industry is to adopt the Equator Principles (EPs) which are based on the International Finance Corporation (IFC) Performance Standards on Social and Environmental Sustainability, and on the Environmental, Health and Safety Guidelines issued by the World Bank. These principles provide a credit risk management framework for determining, assessing, and managing environmental and social risk in project finance transactions. The EPs commit participating institutions to not providing loans to projects where the borrower will not or is unable to comply with their respective social and environmental policies and procedures.

Some banks have also developed their own set of sustainability guidelines for assessing projects on environmental and social grounds and established environmental risk management teams or working groups to implement such guidelines. Some examples of environmental and social risk management methodologies are shown in Table 4.

Table 4. Environmental and social risk management examples

	Existing Practice Examples	Example Bank
Environmental and social risk management methodologies	Use and integration of Equator Principles for project financing assessment and loan approval process	Standard Bank/KfW/ Barclays/HSBC/ Standard Chartered/ Bank of America, etc.
	Use binding sustainability guidelines for assessing the environmental and social impacts of projects	KfW/HSBC
	Use of Environmental Risk Management team to develop and communicate policies and guidance for lending managers, to ensure indirect environmental and social risks are identified and mitigated	Barclays
	Apply an Environmental and Social Impact Assessment Policy to potential projects for financing	Barclays
	Take carbon costs into account in lending decisions	Barclays
	Working Group established to monitor	Royal Bank of Scotland (RBS)

	Existing Practice Examples	Example Bank
	environmental risk	

3.2 The Equator Principles: responsible wholesale lending framework

What is the Equator Principles?

The Equator Principles (EPs) is usually referred to as a voluntary framework, standard or benchmark in the financial industry to help the signatory banks (“Equator Banks” or “Equator Principles Financial Institutions” – EPFI for short) manage social and environmental risks associated with project financing (Morimoto, 2012; Lance, 2013; World Growth, 2013; weber & Acheta, 2014). The Equator Principles website (www.equator-principles.com), defines this framework as follows:

> *The Equator Principles (EPs) is a risk management framework, adopted by financial institutions, for determining, assessing and managing environmental and social risk in projects and is primarily intended to provide a minimum standard for due diligence to support responsible risk decision-making (Equator Principles, 2014).*

History and evolution of the Equator Principles

Before the EPs were launched in June, 2003 with founding members of ten global banks (see Table 5), there was already mounting pressure from civil society organizations, calling for banks to be responsible for social and environmental impacts of the projects they financed, instead of viewing them as responsibility of the authorities to effectively implement laws.[8] This call culminated in the “Collevecchio Declaration” in April, 2003, in which 101 NGOs asked financial institutions to commit to Six Principles of sustainable banking: 1) Sustainability 2) Do No Harm 3) Responsibility 4) Accountability 5) Transparency and 6) Sustainable Markets and Governance (BankTrack, n.d; Macve & Chen, 2010; Weber & Acheta, 2014).

The EPs were based on the IFC[9] Environmental and Social Safeguard Policies which categorize projects into three tiers according to their social and environmental risks (A high, B medium, and C low) before considering whether or not to finance the project. The IFC safeguard policies were guidelines for crucial issues in different industries and sectors that can be applied to processes, technologies, and issues (Scholtens & Dam, 2007).

Table 5. Ten Founding Equator Banks

[8] Examples of growing pressure from NGOs that banks face are the cases of Citigroup being the target of a global campaign in 2000 by the Rainforest Action Network for financing projects that had high environmental impacts on the ecosystem (Baron & Yurday, 2004; Schepers, 2011); and in late 1990s, ABN Amro was attacked by Friends of the Earth for financing a mining project in Papua New Guinea (Morimoto, 2012).

[9] International Finance Corporation (IFC) is a member of World Bank Group (WBG) that lends to businesses in private sectors in developing countries (Morimoto, 2012).

Equator Banks	Country
1. ABN AMRO	The Netherlands
2. Barclays	United Kingdom
3. Citigroup	United States of America
4. WestLB	Germany
5. Credit Lyonnais (CaLyon)	France
6. Credit Suisse	Switzerland
7. Hypo Vereinsbank (Unicredit)	Germany
8. Rabobank	The Netherlands
9. The Royal Bank of Scotland	United Kingdom
10. Westpac	Australia

Source: O'Sullivan & O'Dwyer, 2009 cited in Weber & Acheta, 2014

The scope of the first EPs covered only project finance with a total investment of 50 million USD, and since they were based on the IFC safeguard policies, when the IFC safeguard policies were updated to be Performance Standards on Environmental and Social Sustainability in February, 2006, the EPs were also revised to be the EP II in July, 2006. The second version was revised as follows:

- Scope was expanded to cover project finance advisory service.
- An investment criterion was reduced to 10 million USD in total (from 50 million USD).
- Independent consultation, monitoring, reporting, and grievance mechanism were added.
- The assessment includes social elements (not just environmental assessment).
- The borrower had to prepare an Action Plan (AP) and a Social and Environmental Management System (not just Environmental Management Plan).
- Project monitoring is mandatory (not just "as necessary").
- Free, prior and informed consultation is provided to affected communities.
- Disclosure is required early in the Assessment process before the project construction starts for projects with adverse social or environmental impacts.
- Independent social or environmental expert's review on the assessment, action plan, and consultation process documentation is mandatory for all Category A project (not merely "as necessary") (BankTrack, 2004; Equator Principles, 2006; Morimoto, 2014)

In June, 2013, the third version (EP III) was launched. The revision of the third version is as follows:

- The scope of the EP III has been expanded to cover four financial products, namely: project finance, project finance advisory, project-related-corporate loan[10], and bridge loan[11].
- Minimum requirements for EP Association member public reporting was expanded to cover project names for project finance deals (subject to client consent), details of projects closed including sector, region, and if they were reviewed independently, and details of training for new EPFIs in the first year.

[10] Project-related corporate loans are "“corporate loans, made to business entities…related to a single Project…where the Known Use of Proceeds is related to a single Project" through: the lender using the revenues of the project to repay the loan; the security for the loan being in the form of a corporate or parent company guarantee; or documentation for the loan revealing that the majority of the loan is going to a single project". (Lance, 2013 p.190)

[11] Bridge loans are short-terms loans (up to one year) provided to businesses while they are waiting for funding, asset sales, or bond/stock offerings etc. (Zimmerman, Carniol & Pergola, 2001; Standard&Poor's, 2011).

- Information on EP implementation process was specified to cover roles and responsibilities, staffing, policies and procedures.
- Client public reporting for projects with GHG emission levels over 100,000 tons was added.
- Online summary of Environmental and Social Impact Assessment reports (ESIA) was added as a suggested option for EPFIs.
- Human rights was included in social due diligence.
- Free prior informed consultation was changed to free prior informed consent.
- Formalized approach for information sharing was included.
- A glossary of terms was added.
- Implementation notes were included under development – implementation notes for climate change, reporting requirements, and question and answer. (BankTrack, 2014)

Figure 10. Modifications of the EPs from the first (EP I) to the third version (EP III)

Topics	Version I	Version II	Version III
	Changes reflecting priorities and recommendations from the EP strategic review		
Scope	Lending	Lending, project finance advisory	Project finance, advisory, project-related corporate loans, bridge loans
Reporting	No format required	High-level reporting: number of transactions screened and closed	Minimum requirements: number of projects closed, including categorization, sector, region and whether an independent review has taken place. Project names for project finance deals (subject to client consent) Online summary of environmental and social impact assessment
	Changes to align with updated IFC standards		
Sustainability Issues	Environmental assessment (no social risks, climate change not mandatory)	Social risks due diligence, free prior informed consultation. Climate change as part of World Bank guidelines and general due diligence	Social and relevant human rights due diligence Free prior informed consent. Addressing human rights Guiding principles on Business and human rights and UN Protect Respect and Remedy Framework Climate change: Attention in due diligence for high emitting projects
	Changes to address consistency and support implementation		
Information Sharing		Informally	Formalized approach to share information related to environmental and social matters with other mandated financial institutions
Country Designation	Assessment in high-income OECD countries equivalent to IFC standards	Assessment in high-income OECD countries a substitute for IFC standards	Assessment process in designated countries (EP list) equivalent to IFC standards
Glossary of Terms			Glossary of terms for loan documentation
Implementation Notes	*Best practice	For loan documentation	For loan documentation. Under development — implementation notes for climate change reporting requirements, and questions and answers on scope.

Source: Weber & Acheta, 2014

*As per each EPFI's internal procedures and policy.

The EPs are new to the Mekong region. No domestic banks based in the region had adopted them, although international banks who have adopted the EPs would apply such standards to projects financed in the Mekong Region. Equator banks such as Mizuho, Citigroup, ANZ, ING Group, and Fortis operate in the region and finance hydropower. In China, the Ministry of Environmental Protection has been working with IFC and bank regulators on a state-sponsored policy called the Green Credit Policy, which aims to improve compliance with environmental regulations by restricting access to commercial credit for Chinese companies that bypass environmental assessments or fail pollution checks. This collaboration also promotes the Equator Principles, and in mid-2008 a number of Chinese banks began preparing to adopt the EPs. But of October 2014, Industrial Bank is the only bank from China that has actually adopted the Principles.

> Today, the Equator Principles have become the passport to successful participation in project finance transactions. . . . Mizuho Corporate Bank adopted the Equator Principles to ensure that the projects we finance through project financing are developed in a socially responsible manner reflecting sound environmental management practice. By doing so, we make sure that negative impacts on project-affected ecosystems and communities are avoided where possible, and if such impacts are unavoidable, they are reduced, mitigated or compensated for appropriately.
>
> - Osamu Odawara, Mizuho Corporate Bank (2008)

3.2.1 Applying the Equator Principles

Table 6 summarizes key responsibilities under the Equator Principles. These Principles are meant to be attained by a client (a project sponsor or developer who borrows money) as a *pre-condition* of financing, and subsequently complied with. A key part of the EP involves doing assessments and monitoring, both pre- and post-financing.

Assessments are meant to be objective, rigorous documents that identify impacts, risks, and mitigation options throughout the key stages of the project cycle. In non-OECD and low-income OECD countries, they are meant to be conducted in accordance with the Performance Standards and Environmental Health and Safety (EHS) Guidelines of the International Finance Corporation (IFC). IFC Standard 1 – Social and Environmental Assessment and Management Systems – is broad in scope and fundamentals. It includes project impact assessment, project mitigation action plans, and consultation with local communities (IFC 2006; 2007a). The level of detail in an Assessment varies depending on the project's risks and impacts. Projects with significant adverse impacts may require additional assessment beyond the project level, for example, sectoral or strategic assessment (IFC 2006). IFC's other Performance Standards cover such areas as community health and safety, biodiversity, labor standards, involuntary resettlement standards, and standards related to the treatment of indigenous peoples (IFC 2006).

<u>Key Issues</u>

Conflicts of interest – Conflicts of interest are an unavoidable feature of self-regulation. In a self-regulation framework, actors who have private interests make certain promises to act in the wider public interest. For example, under the Equator Principles they promise to conduct an objective and rigorous Social and Environmental Assessment. In developing countries the government's review and enforcement capacity is often limited. In analyzing self-regulation it is necessary to look for problematic gaps in oversight.

Both the borrower (client) and the lender (EPFI Signatory) have a financial interest in a project. Both have a strong interest in seeing a hydropower project completed and generating revenue on time. Consequently, the client will give first priority to completing civil and engineering works without delay. As well, the client has a strong interest in reducing project expenses. If state regulation is weak, huge responsibility falls on the EPFI Signatory to make sure the client is not under-investing in social and environmental programs. Under-investment – the failure to allocate a minimum threshold of financial capital or ingenuity to meet a project's stated goals, such as to restore livelihoods – may shift risks and impacts onto vulnerable people and host governments in ways that are deeply unjust.

Table 6 shows that the borrower takes a lead role in implementing four of the ten principles (Principles 2, 4, 6, 8), and shares responsibility for three principles (3, 5 and 9). The lender takes a lead role in two principles (Principles 1 and 10), and shares responsibility for three principles (3, 5 and 9). When responsibility is shared it is most often between the borrower and the lender.

Much responsibility for implementing the EP with credibility and legitimacy thus rests with the borrower and the lender. "Independent" experts share important responsibilities. For example, the lender may hire consultants to review assessments, action plans, and to monitor project compliance (Principles 3, 7, 9). A consultant's typical approach is to "solve" all social and environmental issues within a particular timeframe. However, issues such as land-for-land compensation, "downstream" aquatic impacts, livelihood restoration, and genuine benefit sharing are extraordinarily complex (see Lawrence 2009 for the case of Nam Theun 2). They are issues in which wider society has an explicit interest.

Therefore, in order to judge how well the Equator Principles have been implemented in a specific case, it is necessary for the state and civil society – parties representing the public interest – to also get involved. To date, however, wider participation has been limited, as we discuss below.

Stakeholder identification and consultation – For projects with high levels of adverse impact, Equator Principle 5 requires free, prior, informed consultation with affected communities. In theory, the IFC Standards also recognize other stakeholders. According to the IFC, stakeholder identification, for the Social and Environmental Assessment, "broadly involves the determination of the various individuals or groups who may have an interest in the project or who may affect or be affected by the project" (IFC 2007a: 7-8).

In practice, IFC views stakeholder identification primarily as a matter of "community engagement." "Community" is regarded as communities located in the impact zones of a project (IFC 2007a: 7-8). When conducting the Social and Environmental Assessment, consultation with interested parties at the national scale is not a priority of the IFC or Equator Banks. However, consultation which is narrowly focused on affected communities may result in projects whose features have been unexamined by wider society, and open to further criticism.

Technical credibility and public acceptance – Applying the Equator Principles requires a series of important decisions. For example, a decision must be made about the scope (resources) and scale (boundaries, level of detail) of the Social and Environmental Assessment conducted as part of Principle 2 (see Table 6).

Under the Equator Principles, these decisions are the responsibility and privilege first of the client (borrower), and second that of the EPFI Signatory (lender). Review by independent experts occurs later (see Equator Principle 7). In some countries, laws may require a borrower to consult with project affected communities and other stakeholders at appropriate intervals. If so, this is one opportunity for civil society to get involved prior to engagement by an EPFI. If not, however, by the time civil society groups get involved, it is possible that a project has been designed, assessed and presented as amenable to mitigation.

Large projects however are inherently complex and uncertain. Sponsors, civil society groups, and governments will disagree about impacts, risks, and appropriate responses (BankTrack 2008; Stickler and Almeida 2008). Ideally, the delineation of risks and impacts would be done by developers with early participation from civil society stakeholders (WCD 2000; Stickler and Almeida 2008). Doing so would increase the credibility of assessments, and the wider legitimacy of a project.

Discretion – When assessing the same project, different Equator banks have made different decisions. For instance, in 2006 the Texas electric utility TXU proposed to build 11 new coal-fired power stations. In late 2006 environmental groups and local governments opposing new coal power stations launched a "bitter and public" campaign against TXU, contributing to a sharp decline in the utility's stock price (Sorkin 2007). In early 2007 certain Lenders, including Citigroup, Merrill Lynch and Morgan Stanley, agreed to finance TXU's power station expansion plan. But three other Equator banks – Rabobank (Netherlands), Finance for Development (Netherlands) and Bank of Montreal – reviewed the TXU proposal and declined.

Citigroup and other Lenders justified their willingness to finance the plan based on TXU having passed various regulatory tests, both legal and those Citigroup commissioned privately (Donnelly 2007). Pressure from opponents contributed to the plan being revised from eleven power stations down to three (Sorkin 2007). In the spring of 2008, Citigroup, JPMorganChase and Morgan Stanley announced adoption of the “Carbon Principles” – a voluntary due diligence framework for banks and their U.S. power clients to evaluate and address carbon risks in the financing of electric power projects (see discussion below).

Disclosure – Disclosure is a key issue on which the EP will be assessed by wider society. Under Principle 10, Equator banks are not required to report the internal details of projects they have reviewed or financed. The Equator Principles steering committee however suggests that signatories go beyond the minimum requirements of Principle 10, and produce non-confidential case studies of their internal review processes, including review of complex and challenging projects.

Signatories are currently not required to publicly report the external reviews of specific projects required under Principle 7. Although the latest version, EP III, urges EPFI to post an online summary of environmental and social impact assessments (ESIA) of projects for which EPs were applied, this is optional. In the future, public disclosure of such reviews, especially entire ESIA reports, would improve public understanding of particular projects.

Table 6. Equator Principles: a summary of topics, roles and responsibilities

Principle	Who is responsible	Does what	Notes
1. Risk screening	EPFI Signatory (Lender)	Screens the project and classifies its level of adverse environmental and social impact	Three ratings: A, B, or C (in descending order of impact)
2. Assessment	Client (Borrower)	Prepares a Social and Environmental Assessment; proposes appropriate mitigation and management measures	For category A and B projects. Assessments can cover a wide range of environmental and social impacts.
3. Compliance with IFC Performance Standards & EHS guidelines	Client	Prepares an Assessment which refers to the IFC Performance Standards, and IFC environmental health and safety (EHS) guidelines.	Eight IFC Standards exist. IFC Standard 1 – Social and Environmental Assessment and Management Systems – is fundamental.
	EPFI Signatory	Reviews the Assessment for compliance (or justified deviation) from the IFC Standards; Approves Assessment when satisfied.	Each IFC Standard has a detailed Guidance Note to assist reviewers and implementers. EPFI Signatory may hire consultants to conduct the review.
4. Action Plan & Management System	Client	Prepares an Action Plan, based on conclusions of the Assessment, which prioritizes actions needed to mitigate negative aspects of the project Prepares a Management System (management program)	The 'Action Plan' is part of the client's management system: the purpose is to make sure the Project manages the impacts and risks which have been identified; complies with applicable IFC standards; and complies with host country laws. For A and B projects: Action Plans must be disclosed to affected communities.
5. Consultation and Disclosure	Government, Client, or Third party expert	Consults with project-affected communities in a structured and culturally appropriate manner. Free, prior, informed consultation and participation required if project may have significant adverse impact on people.	EPFI Signatory may require preparation of a formal Public Consultation and Disclosure Plan
6. Grievance Mechanism	Client	Establish a Grievance Mechanism to receive and resolve concerns and grievances from project-affected communities	Client ensures that the mechanism is fair to all segments of affected communities

Principle	Who is responsible	Does what	Notes
7. Independent Review	Independent expert	Review the Assessment, Action Plan, and consultation process documentation. Assess compliance with the Equator Principles.	The independent expert may be asked to review plans as they evolve, or to monitor the project after financial close.
8. Covenants	Client	Signs a legal contract to comply with relevant host country laws, and with the Action Plan. Also agrees to report regularly to the EPFI, and to decommission the project.	Legal remedies exist for non-compliance
9. Independent Monitoring	EPFI Signatory	EPFI / Lenders appoint an independent environmental and/or social expert. Expert is to ensure monitoring and reporting over the life of the loan	A Terms of Reference for the monitoring during the construction and operational phases, including the frequency of site visits and reporting requirements, is agreed between the client and EPFIs prior to financial close. Life of project usually exceeds life of loan
10. Public reporting	EPFI Signatory	Report publicly at least once per year on experiencing implementing the Equator Principles	Minimal reporting requirements include number of proposals screened, level of risk assigned, and information regarding how the EPFI Signatory implements the EP in its operating procedures. EPIII urges online summary of environmental and social impact assessments (ESIA) of approved projects.

Sources: Equator Principles (2013). Note: Table summarizes process applicable to non-OECD and low-income OECD countries.

Role of wider society – At present, under the EP, wider society is formally given a very late-stage role, as the audience for public reporting (Principle 10). In cases where there is no legal mandate for broader participation, IFC's Good Practice Handbook for stakeholder engagement suggests that a developer identify with actors with an interest in the project, e.g., critical NGOs, and engage with them directly (IFC 2007b). The EPFIs often refer to documents produced by the IFC as sources of good practice (C. Lowrance, pers. communication, 16 June 2009).
Civil society networks such as BankTrack have offered important reviews and criticisms of the Equator Principles, for example, that stronger disclosure will lead to better outcomes (Mori 2007). Similarly, in the U.S., conflicts over coal-fired power plants led to a 2007–08 collaboration between banks, utilities, and NGOs leading to the announcement of the **Carbon Principles**, an additional voluntary framework for the financial industry.

Ethical standards – The Equator Principles will work best when the borrower has a basic commitment to act responsibly and the lender is willing to rigorously review all assessments and management plans, and decline investments that do not meet the minimum agreed standards (see Table 6). The capacity, diligence, and professional integrity of various experts working for the borrower, the lender and any other stakeholder are also very important.

3.2.2 Motivations to adopt the Equator Principles

As of October 2014, the Equator Principles had been formally adopted by 80 financial institutions ("Equator Principles Financial Institutions" or EPFIs), which together supply about 85% of project finance in developing countries.

The Equator Principles are a voluntary benchmark (i.e., set of standards) designed to help financial organizations determine, assess, and manage social and environmental risk in project financing. They apply to project financings with capital costs above USD 10 million. The World Bank Group is not responsible for any actions resulting from adoption of the Equator Principles (Equator Principles 2006).

Guidelines such as the EP may help identify controversial issues early in project design, reduce the impacts of large projects on locally affected communities and environments, and share project benefits. Supporters argue that a common framework for environmental and social due diligence can improve risk management of financial institutions, and doing so is central to their business model (Wright and Rwabizambuga 2006; Odawara 2008).

Adopting international practices can also reduce reputational risk – the risk that a financier's public image will be tarnished by its involvement in projects with unresolved impacts to society. As well, such standards can reduce political and regulatory risk, for example the risk that a dispute leads to delay in construction or adds additional costs.

The Equator Principles are promoted as offering the same level of environmental and social performance as a project led by IFC. However, in a loan led or financed by an Equator Bank, the Equator bank determines if an action is IFC compliant, not the IFC. In any case, the Equator Principles do contain sanctions. Principle 8 requires that a client (borrower) signs a legal contract to comply with an Action Plan it has prepared as part of its program to mitigate environmental and social impacts (see Table 6).

Reasons that the EPFIs adopted the principles are various – from for the sake of their own benefits to mere public relations purposes. For those EPFIs that adopted the EPs for their operational benefits, the EPs can improve non-financial (political, social, environmental) risk management, protect their reputations, enhance the assessing/financing project process, create a level of a playing field in the sector by putting pressure on the other banks to play at the same level, and/or help forge a relationship with other EPFIs (as they need to syndicate loans).

However, some EPFIs may adopt the principles mainly for public relations benefits, i.e. wanting to appear 'responsible' in the eyes of stakeholders. Finally, some EPFIs adopted the EPs because their top-level managements have high commitment or they believe that the EPs are good corporate governance while others may think that the EP adoption will create a "virtuous circle" of project finance. They hope that the adoption will encourage project sponsors and non-EPFIs will bring better projects to them (Watchman, Delfino & Addison, 2007; Macve & Chen, 2010; Conley & Williams, 2011).

3.2.3. Response to the Equator Principles

Since the launch of the EPs in 2003, the principles have been reviewed, commented, and updated many times from the EP I to the EP III. The following sections will review literatures that study, review, comment or criticize the Equator Principles starting from the first version EPI to the latest one, i.e. EPIII.

The EP I (2003-2006)

After the ten founding banks of the EPs launched the principles in 2003, the EPs were monitored and checked if they had improved social responsibilities in the global financial sector as many NGOs had initially expected. It soon became clear that the EPs did not create the impacts as they had expected (Lance, 2013). Even though there was some progress – more banks gave more information – this was very minor achievement when considering that about 80 percent of banks disclosed limited information or none at all. Also, the Principles as implemented exposed some critical flaws, including the lack of transparency, and the lack of accountability (BankTrack, 2005).

The absence of transparency makes it very difficult for NGOs and stakeholders to assess if the EPFIs have actually implemented or complied with the EPs or not (BankTrack, 2003). This creates an opportunity for free riders – those formally adopt the EPs but fail to comply – especially when the EPs did not have a body to monitor implementation of the EPFIs (Amalric, 2005). In June, 2005 – two years after the EPs were launched, BankTrack[12] released a report called "Unproven Principles; The Equator Principles at Year Two" which assessed implementation of EPs to actual projects. The report shows that only 6 out of 26 EPFIs (at the time) provided sound EP-related reporting such as the description of actual implementation steps and quantitative performance data. Among all EPFIs, only 12 gave limited information i.e. listing many green projects that the banks financed but no information about whether or not the EPs were implemented, and 8 had no disclosure at all.

Another shortcoming of the EPs is the lack of accountability mechanism or grievance mechanism for the affected people to report their problems to the project lenders (BankTrack, 2005; Lance, 2013). The EPs did not have a formal mechanism; they only observed in co-financing transactions how the EPs were

[12] BankTrack is " international NGO network monitoring sustainability commitments and business activities of large banks" (BankTrack, 2012, p.2).

implemented. However, observation alone was insufficient for accountability, so BankTrack proposed that the EPs should develop an accountability mechanism to ensure that EPs will be implemented, using individual accountability mechanism, joint independent accountability mechanism, or existing internal mechanism or process (BankTrack, 2004).

Although NGOs seemed to be impatient with the slow progress in the EP implementation with limited or no disclosure, what really spurred outrage was that in April, 2004, 11 EPFIs sent a letter to the World Bank President to oppose the adoption of more stringent extractive industry policies. To BankTrack and many other NGOs, this action showed that these EPFIs did not adopt the EPs to use better standards, but use them as an excuse not to do so instead (BankTrack, 2004).

With all these shortfalls and criticisms, EP I was criticized by critics that adopting the EPs was just a public relation stunt of the adopting banks (Lance, 2013).

The EP II (2006-2013)

The first revision of the EPs that took place three years after their first launch was more a result of IFC policy update than the desire to improve the principles. Even so, many issues were improved including scope of coverage, grievance mechanism, and reporting requirement. Nonetheless, many shortcomings remained unresolved, and many NGOs complained that the improvements were insufficient. For example, although the scope was expanded to cover project finance advisory services, the scope was still narrow (Lance, 2013). In 2010, over 100 NGOs led by BankTrack published the paper "Bold Steps Forward; Towards Equator Principles that deliver to people and the planet" to urge the EP organizing body to improve the Principles in four areas, namely: transparency, accountability, scope of the principles, and climate change (BankTrack, 2010, n.d.). These calls for progress were voiced again in the paper "the Outside Job; Turning the Equator Principles towards people and planet." This time, BankTrack asked the EPs to address human rights issue as well, since human right violations were observed in many large-scale infrastructure projects in the developing world (BankTrack, 2011).

The problem with transparency of the EPs was also mentioned by academics. Macve and Chen (2010), for example, summarize their findings that it is hard to evaluate positive impacts of the EPs on the environment, since there is neither a detailed project-level disclosure nor a standardization of measuring process. Schepers (2011) points out that the gaps of the principles lie in the fact that many components of the EPs i.e. governance structure, content, and processes are "left to each bank, with little mandated transparency or accountability", especially at the project level.

Despite the shortfalls mentioned above, many academics regard the EPs as "successful," judging from the fact that the number of EPFIs increased from 10 in June 2003 to 45 in July 2007 and 80 by October 2014. EPFIs represented 85% of the total value of project financing loans in emerging markets worldwide, making the EPs *de facto* social and environmental standards of the project finance sector (Watchman et al., 2007; Conley & Williams, 2011; Lance, 2013). Furthermore, the EPs help raise awareness of social and environmental issues for banks and their clients (Macve & Chen, 2010; Lance, 2013), as explained in the report "Global Banks as Global Sustainability Regulators?: The Equator Principles" that "the biggest impact of the EPs is spreading knowledge" so that "project sponsors know what to expect" (Conley & Williams, 2011, p.563)."

The EP III (2013 – present)

The EP III was officially launched on June 4, 2013, following the August 2012 draft which was released for consultation and comments. On October 10, 2012, BankTrack released its comments on the draft titled "Tiny Steps Forward on the Outside Job". The paper restates five key issues written in BankTrack's paper "the Outside Job" which have not been resolved by the draft EP III, namely: transparency, accountability, scope, climate change, and human rights. The paper also analyses the improvement of EP III by comparing the draft with the recommendations BankTrack has proposed to the EP. The findings show that the EP III has improved very little (that is why the paper is called "Tiny Steps Forward"). For instance, the transparency of banks will not be much improved by listing only the number and categories of project finance transactions without giving other information regarding their natures or potential impacts. Also, climate change problems will not be reduced only by asking borrowers to evaluate and consider other options (BankTrack, 2012).

Other papers that reviewed the EP III also show that the EP III has improved, but shortcomings still remain. For example, Lance (2013) mentions that the EP III requires borrowers to consult with stakeholders, and the process has to be free from intimidation or coercion. However, the EPs have not mentioned what process or steps should be taken if the affected communities do not give consent. From the beginning, the EP is a voluntary code of conduct, so the Principles do not incur legal rights or liability to the EPFIs or the borrowers. They do not mandate the EPFIs to withdraw funding from non-compliance projects, nor will the EPFIs be 'delisted' if they fail to comply. Without enforcing mechanism, the EPFIs can decide freely to implement the EP in any projects they want. Weber and Acheta (2014) conclude that "[t]he EPs' revisions erased inconsistencies, advanced the transparency and improved the applicability of the principles. NGO demands for compliance mechanisms in cases of non-compliance of EPFIs with the EPs, however, have not been addressed yet."

Despite all these shortcomings, many EPFIs, NGOs, and outside observers view the EPs as a success, or at least a slow but positive "evolution in the financial world" because may NGOs thought that banks would only care about the bottom line, and the EP adoption and implementation of banks has raised awareness regarding social and environmental impacts of projects that EPFIs finance (Lance, 2013).

While the literatures reviewed above shows that the EPs help contribute to sustainable development in the financial community in spite of all the remaining gaps, one paper, however, argues that the EPs have hindered economic growth. In February, 2013, World Growth[13] released a paper "Revising the Equator Principles: Why banks should not become the sustainability regulators of Emerging Markets" criticizing that the EP III has changed the role of banks from financiers to sustainability 'regulators' in the emerging markets. They charged that by implementing the EPs, both EPFIs and borrowers have to allocate resources to do so, causing project delays, higher transaction costs, as well as hampering economic growth. Instead of investing capital based on expected yields, EPFIs have to allocate funds based on social and environmental impacts, and this prevents banks from investing for the highest returns (World Growth, 2013).

World Growth also argues that there is no economic justification for the EP adoption as there is no "sound business case" that reputation gains from the adoption will outweigh the costs. They cited Les

[13] "World Growth is a non-governmental organization established with an educational and charitable mission to expand the education, information and other resources available to populations in developing countries to improve their health and economic welfare." (World Growth, 2013)

Coleman paper "Sustainability May Cost the Earth: Examining the Strategic and Financial Consequences of Banks' Sustainable Corporate Strategy." In this paper, Les Coleman claims that "the economic justification for exceeding mandated requirements in relation to environmental protection, social responsibility, sustainability and so on has proven weak at best." (Coleman, 2008, p.26 cited in World Growth, 2013, p.9)

On the other hand, World Growth has been called out as a 'front' that lobbies and downplays environmental impact on behalf of multinational logging and palm oil companies. The objectivity of their studies was pointedly questioned by 12 prominent scientists in 2007, with the publication of an open letter. Citing academic research, the scientists call out World Growth for misrepresenting drivers of deforestation in Indonesia, understating the impact of forest conversion on biodiversity and climate, and ignoring the social costs of large-scale plantation agriculture.[14]

Continuous criticisms and shortcomings notwithstanding, the Equator Principles remain *de facto* sustainability standard for wholesale banking, and the growing number of signatories and continuous improvements of the Principles show the increasing awareness of the banking sector to the potential impacts of environmental and social risks of their clients on their reputation and the bottom line. As "risk management tool," Equator Principles will likely to become more and more relevant in the coming years.

[14] Butler A., Rhett. "Scientists blast greenwashing by front groups," *Mongabay.com.* Retrieved on October 31, 2014. http://news.mongabay.com/2010/1027-group_of_12_scientists_vs_oxley.html

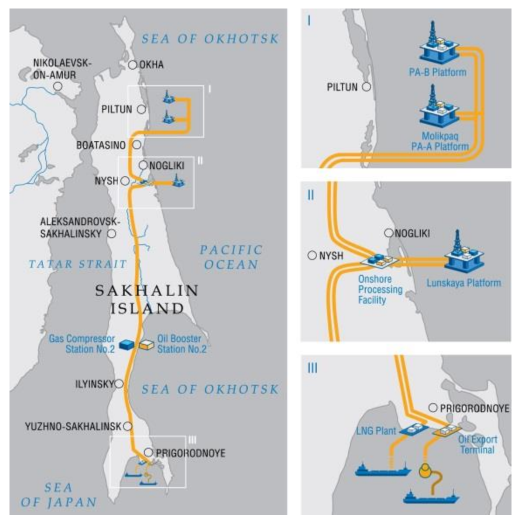
3.2.4 EP Case Study #1. Sakhalin II Project

Map of the Sakhalin region
Source: WWF

<u>Background</u>

Sakhalin II Project is "one of the world's largest integrated, export-oriented oil and gas projects" led by Sakhalin Energy Investment Company (SEIC)- a consortium of Gazprom 50%, Shell 27.5%, Mitsui 12.5%, and Mitsubishi 10% (Shell, n.d.). The project is on Sakhalin Island – a Far East island of Russia – about 450 km north of Hokkaido, Japan (Hisamori, 2002).

Under the seafloors of Sakhalin's waters and the island itself contains a tremendous amount of oil and gas (Guroff, 2007). The waters of Sakhalin are feeding grounds of about 130 nearly extinct Western Pacific gray whales that were believed to be extinct in 1970, and they are habitats of other 25 marine mammal species, 11 of which are endangered species. Also, they have the best salmon fishery in Russia (ECA Watch, n.d.).



Map of Sakhalin II project
Source: Gazprom, 2013

<u>Sakhalin II Project</u>

Sakhalin II project is claimed to be "the largest single integrated oil and gas project ever undertaken" (Platform, 2004, p.6). Over its lifetime, the project will produce about 1 billion barrels of oil and 17.3 trillion cubic feet (or about 500 billion cubic meters) of natural gas. It is estimated to cost about 20 billion USD (Minio-Paluello, 2007).

The construction consists of two phases. The first phase was finished in 1999, and production has started since then. The project includes an offshore oil production platform, 2-km submerged pipeline, single anchor leg mooring, and floating storage and offloading unit. Phase 2 was launched in 2003 and is now under development. It involves 2 offshore oil and gas production platforms, onshore processing facility, 800-km onshore pipelines, Liquefied Natural Gas (LNG) plant, and LNG jetty and oil export terminal (Gazprom, 2014).

The project was financed 45% by debt and 55% by equity (Platform, 2004) in two rounds of financing. In April 2007, Gazprom received a 2-billion-USD loan from an international banking syndicate, of which ABN AMRO [now part of Royal Bank of Scotland (RBS) and Société Générale] was the lead arranger. And in June 2008, SEIC secured a 5.3-billion-USD project financing loan, of which 3.7 billion USD was provided solely by Japan Bank for International Cooperation (JBIC). The other 1.6 billion USD was financed by a consortium of banks (Willem van Gelder, Denie & Scheire, 2009; BankTrack, 2014). The full list of financial institutions involved in this project can be found in Table 7.

Table 7. Financial institutions that financed Sakhalin II project

Name	Amount of Loan	Month/Year of Finance	EPFI	Month/Year of Adoption
Bank of Tokyo Mitsubishi UFJ	$ 358 million	June 2008	Yes	December 2005
Barclays	part of $ 2 billion	April 2007	Yes	June 2003
BNP Paribas	$ 125 million	June 2008	Yes	October 2008
Credit Suisse Group	$ 100 million	June 2008	Yes	June 2003
Mizuho	$ 358 million	June 2008	Yes	October 2003
Royal Bank of Scotland	$ 5.45 billion part of $ 2 billion	March 2007 April 2007	Yes	June 2003
Société Générale	part of $ 2 billion	April 2007	Yes	September 2007
Standard Chartered	$ 300 million	June 2008	Yes	October 2003
Sumitomo Mitsui Banking Corporation	$ 358 million	June 2008	Yes	September 2007
Japan Bank for International Cooperation	$ 3.7 billion	June 2008	No	-

Source: BankTrack, 2014; Equator Principle, 2014

Challenges of Sakhalin II Project

Sakhalin II project is highly controversial and ignited a global debate mainly for two reasons. First, many environmental NGOs fear that the project may cause significant environmental impacts to the ecosystems of Sakhalin Island and nearby seas. Second, as signatories to the Equator Principles, RBS, Barclays and other Equator Banks listed in Table 7 must ask the project to follow the guidelines of the EPs in order to be financed. However, many NGOs such as BankTrack, Rainforest Action Network, Friends of the Earth, WWF, criticize the project for obviously failing to comply with the EPs (Platform, 2004).

Environmental Impacts of the Project

Two offshore platforms that have been built in phase 2 are very close to the feeding ground of the endangered Western Pacific gray whales, whose number at around 130 is already very small. Drilling rigs and building a subsea pipeline will create noise, sediment disturbance, and risk that the whales will be collided. This can push them to extinction. In addition, the whales will be exposed to a risk of an oil spill from a tanker accident or ruptured pipelines as oil will be transported from the offshore platforms to the onshore processing facility through a seismic zone, and as the sea in this area is covered by ice for six months, it will be difficult for SEIC to fix or respond to an oil spill.

Moreover, NGOs charged that SEIC recklessly built over 1,000 pipeline river crossings, cutting right through the forests and damaging salmon spawning rivers as the construction makes the rivers muddy. Also, SEIC dredged the Aniva Bay so that tankers can get closer to the LNG plant that was constructed on the Aniva Bay in the South of the Sakhalin Island, and dumped the dredged debris in the middle of the bay which disturbed the bay ecosystem and fisheries of locals, as well as damaging shellfish beds. The indigenous people who live on the subsistent basis e.g. fishing, hunting, reindeer herding or wild plant picking complained that they are affected by the project but were not properly consulted or told about the project details (Platform, 2004; 2005; Minio – Paluello, 2007; BankTrack, 2005; 2014).

Non-Compliance to Equator Principles

Since the Equator Principles require a project requesting a loan from a bank adopting the EP to comply with the principles, the Equator Banks that funded the Sakhalin II project have been criticized since the project clearly violates the EPs. To begin with, the project's environmental assessment did not include crucial baseline data needed to assess impacts of the project regarding endangered species, mitigation measures, and assessment of project's conflicts with Russian environmental laws and legal challenges to the project (Breach of EP 3a, 3b and 3d). Some of provided data conflicts with reports of experts. Additionally, while environmental protection status of Aniva bay was obscure (Breach of EP 3b), the project did not give enough information to stakeholders during the consultation processes (Breach of EP 5) (Platform, 2004).

With all the negative environmental impacts of the project and non-compliance of the Equator Banks funding the project, the project has face a lot of criticisms from NGOs. This includes a full-page ad run in Financial Times and a protest in front of Credit Suisse office in Zurich, as well as a gigantic gray whale installation in front of ABN Amro office in Amsterdam, not to mention numerous articles and papers about the environmental impacts and non-compliance of the project (BankTrack, n.d.). Heavily criticisms from NGOs have made many banks avoid participating in the project. Some socially responsible funds such as Investec Henderson Crosthwaite and Morley Fund sold all of their Shell shares (BankTrack, 2005; Hardenbrook, 2007).

Conclusion

With huge controversy and criticisms of its environmental impacts on the endangered gray whales but yet being funded by the Equator banks, the Sakhalin II project is a showcase of how the Equator Principles fail to enforce compliance among adopting banks, as well as a lack of accountability of the Principles. Even so, the EPs helped open a ground for NGOs and concerning people to comment, criticize, and assess the project's environmental impact assessment, which ultimately made banks and project sponsors more aware of environmental and social impacts that their project might have caused. In December 2008, Sakhalin Energy won the Environmental Project of the Year award from the Natural Resources Ministry in Russia, thanks to the company's protection of the gray whale population.[15]

[15] Cited in Wikipedia. Retrieved on October 31, 2014. http://en.wikipedia.org/wiki/Sakhalin-II

SAL FOREST

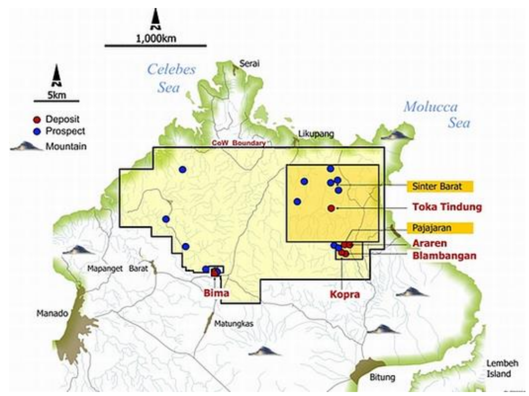
3.2.5 EP Case Study #2: Tako Tindung Project

<u>Background</u>

Tako Tindung is a gold mining project in the northern region of Sulawesi, Indonesia – 35 km northeast of Manado which is the capital of North Sulawesi. The project consists of 6 open-pit gold mines with 8 years of the expect mine life. The project area covers 400 km^2, and it is expected to mine 1.1 million oz. of gold from the total of 1.75 million oz. with yearly average production of 160,000 ounces for the first 6 years. The total project cost is 30 million USD (Archipelago Resources, 2011).

Map of Indonesia
Source: Archipelago Resources, 2011

The project is owned by Australia-based Archipelago Resources (AR) [95%] and Rajawali Corporation [5%] (Archipelago Resources, 2011). AR used to be listed on the London Stock Exchange – AIM, but it was delisted in 2013 as Rajawali Corporation – the biggest major shareholder of AR with 77.84% stake at the time – decided to de-list AR from AIM (Steward-Smith, 2013).



Map of Tako Tindung Gold Mines Project
Source: Archipelago Resources, 2011

AR took over the concession from Aurora Gold Ltd. in 2002. At first, AR tried to use the old environmental impact assessment (EIA) report of Aurora Gold which was dated in 1998. This EIA detailed a plan to dump tailings in the sea which caused considerable resistance from local communities. However, the Ministry of Environment did not allow AR to use the old EIA, stating that it was outdated and no longer valid, and asked the company to stop its construction in Toka Tindung site until all legal issues were resolved. Afterwards, AR submitted a new EIA with a better tailing disposal plan (BankTrack, 2014).

<u>Controversy</u>

This project became controversial and received heavy criticisms and resistance from local communities for many reasons.

First, the approval of EIA of this project by the Environmental Minister violated two Indonesian laws and was suspected by NGOs to be the result of bribery and corruption. After AR's attempt to embark on the old EIA had failed, it changed the plan from dumping tailings in the sea to build a Tailings Storage Facility (TSF) on land instead. However, the governor of North Sulawesi rejected the EIA; one of reasons he gave was that a gold mine was not in accordance with the regional planning schemes. It was also stated in a letter issued by the Ministry of Environment in 2005 that "if activities are not in accordance with the regional planning schemes, the EIA can't be processed". In December 2007, the provincial parliament and the Governor of North Sulawesi also denied this project.

When the central government in Jakarta rejected the original land usage plan in North Sulawesi submitted by the provincial government of North Sulawesi in 2008 which marked the region as “agriculture and tourism development zones”, and changed the North Minahasa and Bitung into mining zones after Rajawali Corporation, of which the founder is an Indonesian tycoon – Peter Sondakh, bought shared of AR and became the biggest major shareholder, the change was suspected to be made to allow Toka Tindung gold mine to be able to receive EIA approval and operate in the region. This is because the Ministry of Energy and Mineral Resources (ESDM) then issued the mining permit without a valid EIA. In October 2009, the Minister of Environment issued EIA during his last five days in office, three days after a new regulation relating to environmental management and conservation had been passed. This approval violated two laws: 1) it is the provincial governor’s authority to approve EIA, not the Minister’s, and 2) the minister signed the EIA approval on the basis of the cancelled regulation. In December 2009, AMMALTA, coastal people’s alliance, failed a lawsuit against the Minister of Environment for signing the EIA.

Second, Toka Tindung uses cyanide lye to extract gold, and the mining areas are adjacent to Tangkoko and Dua Saudara natural reserves which are habitats of many mammal, bird and reptile species, so the concern was that the toxin will infiltrate into these habitats and contaminate groundwater. Also, the tailings storage facility is located in the area prone to earthquake and volcanic activities; therefore, there is a risk that toxic waste can leak into the ecosystem.

Third, the Toka Tindung project imposes economic risks to local people as the three main industries of North Sulawesi are fishery, agriculture, and tourism which can be disrupted by the gold mine activities.

Fourth, in July 2006, it was reported that the company’s security guards attacked local people who just went back from peaceful protest against the Toka Tindung project. The attack caused a seven-month pregnant woman to miscarry and many people severely injured (Mines and Communities, 2010; BankTrack et al, 2010; BankTrack, 2014).

<u>Project Financing</u>

AR tried to secure funds to finance the construction of Toka Tindung project via several options including share issuance and project finance. When it was still listed on the AIM, AR raised funds via share issuances many times, and NGOs had tried to convince responsible investors not to buy shares. However, NGOs seemed to focus their efforts more on project financing, especially those from Equator Banks. That was probably why many project financing syndicates from international banks were announced but never successfully closed for this project.

For example, in March 2006, the company secured a 38.5-million-USD loan from a syndicate of 4 banks, namely ANZ, N M Rothschild & Son, Société Générale, and WestLB. However, in December 2007, WestLB withdrew from the syndicate, followed by other banks in the middle of 2008. In July 2008, AR announced that Credit Suisse agreed to provide a condition loan of 48 million USD, and the company was in the process of finalizing legal and other arrangements. However, after Credit Suisse received a letter in August 2008 from the Governor of North Sulawesi stating that he had not approved the project, the bank announced that the bank had not approved the project yet, and the bank would finance the project only if the project received all the permits. Table 8 shows the list of international financial institutions that were involved in various stages of the project (BankTrack et al., 2010; Mines and Communities, 2010; van Gelder & van Ojik, 2010; BankTrack, 2014).

Table 8 .Details of international financial institutions involved in the Tako Tindung project

Name	Amount of Loan	Month/Year of Finance	EPFI	Month/Year of Adoption	Note
ANZ	part of $ 60 million*	Jan 2010	Yes	Dec 2006	Mandate expired Feb 2010
BNP Paribas	part of $ 60 million*	Jan 2010	Yes	Oct 2008	Mandate expired Feb 2010
Credit Suisse	$ 48 million	Jul 2008	Yes	June 2003	Not closed
Investec	part of $ 38.5 million	Mar 2006	No	-	Pulled out mid 2008
Rand Merchand Bank	N/A	Mar 2007	No	-	Pulled out mid 2008
Société Générale	part of $ 38.5 million	Mar 2006	Yes	Sep 2007	Pulled out mid 2008
Standard Bank	part of $ 60 million*	Jan 2010	Yes	Feb 2009	Mandate expired Feb 2010
WestLB AG	part of $ 38.5 million	Mar 2006	No	-	Pulled out Dec 2007

Source: BankTrack, 2014; Equator Principle, 2014
** The figure in BankTrack document is 60 million USD, but in a research paper prepared for BankTrack "The Financing of Archipelago Resources" written by Jan Willem van Gelder and Anna van Ojik, the figure is 70 million USD.*

After unsuccessful closing of project financing deal with international banks, AR issued 70 million shares to raise 28 million GBP, and finally secured a 55-million-USD loan from an Indonesian bank (Australian Business Journal, 2014).

<u>Conclusion</u>
Toka Tindung gold mine project has imposed risks to North Sulawesi ecosystem and the livelihoods of local communities, causing strong resistance from local people; regardless, many Equator Banks had tried to finance the project although they eventually either withdrew or did not participate in the deal. The project was finally able to secure funds via both share issuance and a loan agreement with a local bank, apparently because a local bank is subject to less stringent banking standards and regulations compared to global banks. There seems to always be banks that are willing to finance unsustainable or questionable projects in pursuit of short-term financial profits.

3.3. Situation in Thailand

By and large, commercial banks in Thailand still view environmental and social risks of wholesale lending through the lens of compliance. In other words, they see it as the borrower's sole responsibility to comply with all laws and regulations. If there were any environmental or social concerns, the relevant authorities would have already mandated regulations for the borrower to follow. It is not the bank's responsibility, and any linkages between the borrower's environmental and social risks and repayment risks are normally sufficiently handled by various loan covenants and normal risk management procedures (interview, 2014).

3.3.1 Legal basis for environment and health protection

The Bank of Thailand, which regulates commercial banks, does not mandate banks specifically to manage social and environmental risks. Project finance borrowers are expected to comply with relevant laws and regulations regarding sustainability. The right of local community to public hearing and legal requirement of environmental impact assessment for project that has potentially large impacts are both protected in Thailand's Constitution and related regulations, for example:

- The 2007 Constitution of the Kingdom of Thailand: Section 67, Paragraph 2

  "*Any project or activity which may seriously affect the community with respect to the quality of the environment, natural resources and health shall not be permitted, unless, prior to the operation thereof, its impacts on the quality of the environment and on public health have been studied and assessed and a public hearing process has been conducted for consulting the public as well as interested persons and there have been obtained opinions of an independent organization, consisting of representatives from private organizations in the field of the environment and health and from higher education institutions providing studies in the field of the environment, natural resources or health."*

- Notification of Natural Resources and Environmental Ministry, August 2010

  "The regulation of types, specifications, and practices of projects or businesses, which may seriously affect the community with respect to quality of the environment, natural resources and health, of Public Services, State or Private Enterprises that require an environmental impact assessment (EIA)"

Despite the fact that the aforementioned Section 67, Paragraph 2 had been in place since the 2007 Constitution, conflicts between industrial project owners and communities regarding environmental and health risks or problems still often flared because there was as yet no law to codify and implement the principles outlined in the Constitution – until the Mab Ta Phut court case.

Changes after Mab Ta Phut

Fearing the possibility of another leak of toxic chemicals after having endured such leaks for years, villagers around the Mab Ta Phut Industrial Estate, Thailand's largest and most important industrial complex in Rayong, finally decided that enough was enough. They joined forces with environmental NGOs in early 2009 and sued the government of Thailand for failing to address pollution in the area.

Later in March that same yar, the Administrative Court ruled that Mab Ta Phut must be declared a "pollution control zone" that obliged the "authorities to measure soil and water quality regularly and to come up with a plan to reduce pollution if [found to be] too high."[16] In order to hold accountable those who violate the environmental law, the villagers and the People's Eastern Network filed another lawsuit before the Administrative Court to stop the expansion of the industries. The court decided in September 2009 to suspend the construction of seventy-six projects due to absence of health impact assessment required under Article 67 of the 2007 Constitution. The decision was appealed to the Supreme Administrative Court that decided on 2 December 2009 to maintain the suspension of sixty-five projects, but allowed eleven projects, which were deemed "not hazardous" such as clean energy, air pollution control improvements, etc., to proceed.

The court ruling shocked the business community in Thailand. The Ministry of Industry of Thailand estimated the losses that might have arisen from the suspension of the projects at a little over nineteen billion US dollars.[17]

The Thai government appealed the ruling and got the court in 2010 to allow seventy-four projects to proceed, while revoking the operating licenses of two projects that were included in a government list of "seriously harmful activities." The government also ordered a study of the environmental problem, through the appointment of the Committee of Problem Solving in Relation to Constitution Section 67, headed by former Prime Minister Anand Panyarachun. The Committee proposed 18 types of industrial projects that are deemed harmful to the environment and subject to environmental and health impact assessments in accordance with Section 67 of the Constitution. But eventually, National Committee of Environment who took charge of this issue decreed only 11 types of projects, which are as follows:

No.	Type of Projects or Businesses	Capacity	Principle, Procedure, Practice
1	Man-made land projects	0.48 square kilometers or more	Submit in the procedure of applying for the projects
2	Mining according to the Minerals Act		
	2.1 Underground Mining Projects	All sizes	Submit during the procedure of applying for permit
	2.2 Lead, zinc or other metal mining that use cyanide, mercury or lead nitrate in production process, or other metal mining that use	All sizes	Submit during the procedure of applying for permit

[16] Fuller, Thomas. "In Industrial Thailand, Health and BusinessConcerns Collide," *New York Times*, December 18, 2009. Retrieved October 31, 2014. http://www.nytimes.com/2009/12/19/world/asia/19thai.html?_r=2&emc=eta1
[17] Suttinee Yuvejwattana and Supunnabul Suwannakij, "Thai Court Lifts Ban on Industrial Projects Halted on Environment Grounds," *Bloomberg*, September 2, 2010. Retrieved October 31, 2014. http://www.bloomberg.com/news/2010-09-02/thai-court-lifts-ban-on-industrial-projects-halted-on-environment-grounds.html.

	arsenopyrite as associated mineral 2.3 Coal mining which transport coal outside mining area by car 2.4 Mining in the sea	Exceeding 200,000 tons/month or 2,400,000 tons/year All sizes	Submit during the procedure of applying for permit Submit during the procedure of applying for permit
3	Industrial enterprises which are related to Petrochemical industry according to 4. or Mining industry according to 5.1 or 5.2 that have more than one factory	All sizes	Submit in the procedure of applying for new project
4	Petrochemical industry 4.1 Upstream petrochemical industry 4.2 Intermediate petrochemical industry 4.2.1 Intermediate petrochemical industry that produce chemical substances or use raw materials which are categorized as carcinogen type I 4.2.2 Intermediate petrochemical industry that produce chemical substances or use raw materials which are categorized as carcinogen type 2A	All sizes or project that increase its production capacity more than 35 percent of existing production capacity Production capacity exceeding 100 tons/day Production capacity exceeding 700 tons/day	Submit in the procedure of applying for new project or project expansion Submit in the procedure of applying for new project or project expansion Submit in the procedure of applying for new project or project expansion
5	Mining industry 5.1 Iron industry 5.2 Iron industry which produce Coke or process Sintering 5.3 Copper, gold or zinc industry	Iron inputs in production process exceeding 5,000 tons/day All sizes Mineral input into production process exceeding 1,000 tons/day	Submit in the procedure of applying for new project or project expansion Submit in the procedure of applying for new projects Submit in the procedure of applying for new project or

			project expansion
	5.4 Lead industry	All sizes	Submit in the procedure of applying for new project
	5.5 Metal furnace industry (except iron and aluminum)	Output capacity exceeding 50 tons/day	Submit in the procedure of applying for new project or project expansion
	5.6 Lead furnace industry	Output capacity exceeding 50 tons/day	Submit in the procedure of applying for new project or project expansion
6	Produce, eliminate or modify radioactivity objects	All sizes	Submit in the procedure of applying for new project
7	Factories that recycle waste products according to the Factory Law	All sizes	Submit in the procedure of applying for new project
8	Air transportation projects	Building or expanding the length of runway exceeding 3,000 meters	Submit in the procedure of approving for new project
9	Ports	1.Berth length exceeding 300 meters or total ports area exceeding 10,000 square meters 2. Water course dredging exceeding 100,000 square meters 3. Transferring hazardous materials which are categorized as carcinogen type I exceeding 25,000 tons/month or 250,000 tons/year	Submit in the procedure of approving for new project Submit in the procedure of approving for new project Submit in the procedure of approving for new project
10	Dams	1. Volume exceeding 100 million cubic meters 2. Area exceeding 15 square kilometers	Submit in the procedure of applying for new project
11	Power plants 11.1 Coal-fired power plants	Production capacity exceeding 100 mega watts	Submit in the procedure of applying

			for new project
	11.2 Biomass power plants	Production capacity exceeding 150 mega watts	Submit in the procedure of applying for new project
	11.3 Natural gas power plants which use combined cycle or cogeneration system	Production capacity exceeding 3,000 mega watts	Submit in the procedure of applying for new project
	11.4 Nuclear power plants	All sizes	Submit in the procedure of applying for new project

The Mab Ta Phut court case suggests that the lax enforcement of environmental law and regulations in Thailand can cause severe business disruption through lawsuits, since the right of community to live without serious impacts "with respect to the quality of the environment, natural resources and health" has already been enshrined in the Constitution.

Lax enforcement of law is but one problem concerning the environment in Thailand. The next section explores related problems that the Thai lenders are still either oblivious to, or do not see their role and responsibility.

3.3.2 Problems of environmental laws and regulations in Thailand

Banks, as well as many companies, erroneously believe that the framework and content and environmental law in Thailand is sufficient to safeguard the environment. They believe that if everyone simply follows the letter of the law, then they would not face business risks relating to the environment. In reality, problems and obstacles Thailand's legal framework regarding the environment, both the content and execution, have been well documented and can be summarized as follows:

1. Many regulations are outdated and do not correspond to reality in the area. For example, different agencies can announce their own environmental benchmarks that are not unified. The law stipulates minimum pollution level for each emitting source, but has no provision for pollution quota that takes into account the carrying capacity of the entire area. This creates high likelihood of "legal pollution" that the authorities have no powers to rectify.
2. Enforcement of environmental regulations at project level is not clear; the law only stipulates broad methodology or policy.
3. There are many environmental laws with confusing statutes, and there remain many undefined basic terms such as "community rights" or "traditional community rights."
4. Thai law still cannot actualize the "polluter-pays principle." Once the project passes approval, there is no mechanism to ensure that the project operator would actually implement all the measures outlined in its environmental impact assessment (EIA) report. This obvious omission of the law means that in many cases, much environmental damage has already been done by the time affected villagers file lawsuits.

5. Penalties in environmental lawsuits are still determined based on civil law where the court focuses almost entirely on compensation for health-related costs; there is no “punitive damage” principle in Thai environmental law. In addition, limitations of the law force villagers to sue relevant regulators as opposed to the pollution emitter directly. This therefore creates no incentive for the culprit to improve operations, since the state (and ultimately taxpayers) is the one who pays for damages.
6. Local administrations are often unprepared to protect natural resources in their jurisdiction, and the law also grants them limited powers; they have to largely follow policy directives from the central government.
7. There is still no public hearing law in Thailand.

Given the problems as summarized above, it is not surprising that disputes between private sector operators and affected local communities are still commonplace. Lenders in the past have not been the focus of protests, but that is slowly changing as large Thai banks start lending to more and more complex megaprojects and expand project lending overseas in their ambition to be regional players.

The ongoing saga of Xayaburi Dam, a hydropower project in Laos that is 100-percent financed by commercial banks from Thailand, may portend changes to come. The next section summarizes this case and explains how environmental and social risks from this project translate directly to repayment risk for the banks.

3.3.3 Case study: Hidden risks from bankrolling the Xayaburi Dam

The Mekong River is one of the world's great river systems. It rises in the mountains of China's Qinghai province and winds south more than 4,800 kilometers down to the South China Sea, making it the longest river in Southeast Asia. The Lower Mekong, one of the last large untamed stretches of river in the world, supports nearly 60 million people with its rich fisheries that have a commercial value exceeding US$4 billion. The Mekong produces an estimated 2.6 million tons of fish and other aquatic products per year, making it the largest inland fishery in the world, and accounting for 19-25% of global inland catches. More than 700 species of freshwater fish ply its water, including four of the world's biggest freshwater fish species, notably the iconic and endangered Mekong giant catfish.

At the mouth of this mighty Mekong, sediment and nutrients accumulate and the delta explodes with productivity. Vietnam's part of the Mekong Delta hosts 17 million people, and contributes more than 50% of country's staple food crops. It is the source for 60% of the fish production in Vietnam, providing food for 40 million people and contributing 27% of the GDP of Vietnam. Since Vietnam is the world's second largest rice exporter, the Mekong delta also feed people over the world, far beyond the boundaries of Mekong basin.

The US$3.5-billion Xayaburi dam in northern Laos is the first lower mainstream dam to go through the Mekong River Commission's (MRC) procedure of notification, prior consultation and agreement (PNPCA). In April 2011, five international Mekong specialists carried out a critical analysis of the Xayaburi Dam Environmental Impact Assessment (EIA). The experts described the EIA as flawed and substandard. The five specialists in the fields of fisheries, livelihood restoration, consultation and water quality expressed surprise that an EIA of such poor quality was being submitted for a project with such far-reaching impacts as the first dam on the lower Mekong mainstream.

Partly as a result of experts' strong objections to the EIA, water resources ministers had agreed in 2011 to delay a decision on building the Xayaburi dam pending further studies on its environmental impacts. But this agreement was swept aside in November 2012 when Laos decided unilaterally to forge ahead with construction, and hosted a ground-breaking ceremony.

US$ 100 million design changes, US$ 100 million question

The Lao government and Ch. Karnchang, the Thai constructor, have consistently argued in unison that the potentially devastating environmental impact, mainly the blockage of sediment flows and migratory paths of river fish, can and will be mitigated via several "technological innovations" which will make Xayaburi a "transparent dam" with "state-of-the-art" fish passage.

Soon after the Xayaburi groundbreaking ceremony, Pöyry Energy AG in its capacity as Technical Consultant to the Laos government – before being 'promoted' to "Government of Lao Engineer" position – recommended several "design changes" which will cost a total of US$ 100 million. Pöyry claims that "after …design changes recommended by Pöyry, the [Xayaburi] project follows the current state-of-the-art design for run-of-river hydropower schemes."[18]

[18] Pöyry Energy AG. "Background Material on Pöyry's Assignment: Xayaburi Hydro Power Plant," November 9, 2012, p. 17. Retrieved on September 8, 2013 from www.poyry.com/sites/default/files/imce/eng_xayaburi_hpp_09112012_final.pdf

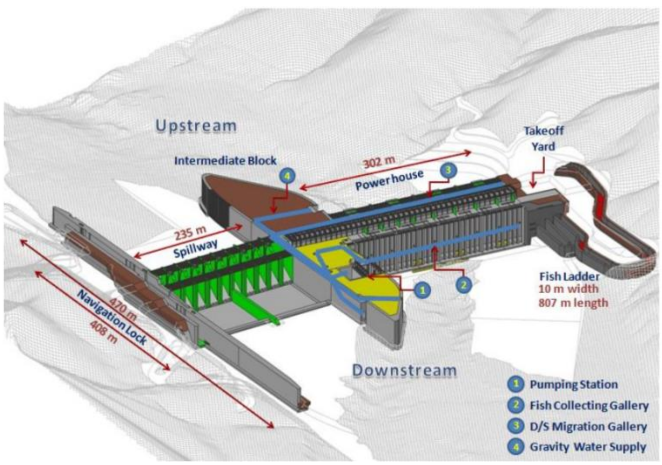
Pöyry's recommended design changes comprise the following components:

A. Sediment transportation: Provision of large capacity low level outlets, allowing passage of the sediments downstream. Pöyry claims that "baseline study for sediment quantity and quality of Mekong river in project area" can be conducted during construction.

B. Fish passage: 1. Fish passing facility in navigation lock, which allows fish passage also during construction period. 2. Adaptation of fish ladder system (step height) using the findings of baseline studies, and 3. Provision of a fish lift if baseline studies indicate the need for it. Pöyry claims that "fish survey and related studies" can be conducted during construction "for optimizing fish pass facility."

C. Navigation locks: Improvements in upstream lock approach area and changes in lock feeding system.

In the same document, Pöyry provides a graphical overview of the Xayaburi scheme post-recommendations[19]:



The US$ 100 million question is: are these "design changes" likely to work as advertised? Is Xayaburi really a "state-of-the-art run-of-river" dam? And shouldn't this case be made before construction begins?

Deconstructing myth with science

In order to answer this question, it is important to understand the current body of knowledge regarding the Mekong river ecosystem, which is as fluid and evolving as the river itself because there are still many unknowns. One thing that experts agree upon, however, is the pristine condition of its ecosystem. Walling (2009), following Kummu & Varis (2007) and others, considers that the Mekong is "one of the world's most pristine large rivers", owing to a low average population density due to the rugged

[19] Ibid, p. 21.

topography of most of the watershed. The "lack of major extractive industries and industrial development, and the limited use of the river as a transport waterway" are also suggested as reasons why the river is in near 'pristine' conditions.

Fish passes are not a realistic migration option for Mekong mainstream dams

In 2011, World Wide Fund for Nature (WWF) commissioned an expert review[20] on the fish and fisheries aspects in the EIA. This expert review found that the EIA ignored most studies and relied heavily on a very light field sampling that captured less than a third of the biodiversity in the impact area.

The review found the proposed fish passes for the dam ignore design guidelines, lack critical detail including any specification of target species and have a slope and steps which would be challenging even for strong swimming northern hemisphere salmon. The review noted other studies that concluded that fish passes are not a realistic mitigation option for Mekong mainstream dams, and "that the Mekong should never be used as a test case" for proving or improving fish passage technologies.

Since the beginning of 2012, ultrasound images underwater have been captured every six hours by a hydro-acoustic camera which has a scope of 30 meters and 30-degree angle. However, neither the detailed monitoring protocol, data nor analysis of this endeavor has been made public.

In August 2013, Knut Sierotzki, Pöyry's director for hydropower in Asia and Russia, claims that "investigations are underway to address concerns about fish migration." Fish pass design is now being modified further by Swiss company AF Colenco to "make it much flatter" according to media reports.[21]

Dr. Eric Baran, expert from the World Fish Centre, explained the issue as follows: "You can't expect fish ladders to work without understanding your target species, their swimming capabilities, and the water current that will attract these fish toward the pass entrance… Research is still needed to ensure mitigation efforts will work."[22] Fish ladders have had some success in Europe and North America, but this is where only a handful of species are migratory, and many of those are of the salmon family that are much stronger swimmers and jumpers than most Mekong migratory species.

Because Pöyry's recommended design changes still includes a "fish ladder system" and "fish lift," scientific evidence suggests that these schemes are unlikely to work given the wide variety of fish sizes and behaviors in the Mekong, no matter how many "technological innovations" are introduced. Therefore, such "innovations" can only be proven based on an in-depth study of target fish biology, which still has not been conducted as of September, 2013.

[20] World Wildlife Fund, "Substandard dam assessment opens way to fisheries destruction on Mekong," April 14, 2011. Retrieved on September 8, 2013 from http://wwf.panda.org/wwf_news/?200028/Substandard-dam-assessment-opens-way-to-fisheries-destruction-on-Mekong

[21] **"Xayaboury dam: extensive research generates reassurance,"** ***Vientiane Times,*** **August 13, 2013.** http://www.vientianetimes.org.la/Video_FileVDO/Aug13_Xayaboury.htm

[22] "Mekong Dams Threaten Extinction of Giant Catfish," *Radio Free Asia*, June 19, 2013. http://www.rfa.org/english/news/laos/dams-06192013184629.html.

Transparent dam: impossible in not-so-ideal conditions

MRC experts and many observers, particularly the downstream countries Cambodia and Vietnam, are concerned that Xayaburi will block sediment flows down the river which keeps the delta from sinking and eroding as a result of climate change and provide sand for construction as well as fertile soil for agriculture. In March 2013, Rewat Suwanakitti, Deputy Managing Director of Xayaburi Power, claimed to the press that the company "…redesigned the spillway, fish passage system, and that nearly one hundred percent of sediment can pass through the dam."[23]

The project company's claim falls apart if one looks at what it is based on. Over a year earlier, in January 2012, Laos government contracted the French consulting company, Compagnie Nationale du Rhône (CNR), to conduct an independent review of the Pöyry report and to address gaps in hydrology, navigation and, importantly, sediment transport in the Mekong river. CNR has been operating 19 run-of-river hydropower stations on the Rhone River for the last 50 years, including Rheinfelden in Switzerland and Fredenau in Australia, both of which feature effective fish passage facilities.

CNR concedes that transparent dam is only a "concept to aim to." Its report states[24], "There is a lack of data about present solid transportation along the Mekong River upstream Xayaburi dam (material size, solid discharge). Thus, data collection on sediment yield and sediment sources is necessary." More specifically, CNR suggests that the following "behavior of sediments" must be evaluated in order to "define flushing operation": first in the present natural state without Xayaburi dam with and without Lancang River dams, second in the reservoir in normal operation including floods, and lastly in the reservoir during flushing.

CNR concludes that under "ideal conditions," Xayaburi dam could be redesigned as a "transparent" dam, where all sediments are transported past the dam. In short, "transparent dam" is a concept only, and CNR's proposed solutions have never been done in a large tropical river. However, Laos government misrepresented CNR's report - Vice Minister of Energy and Mines Viraponh Viravong said "[CNR] study … confirms that if the Lao government wants to let the dam be redesigned, there will be no impact on the environment."[25] Such gross misrepresentation of the report prompted CNR to issue a press release in August 2012, clarifying that "the solutions have been proposed at the conceptual level by the CNR… These solutions need to be developed and their costs evaluated."[26]

In 2009, World Wildlife Fund (WWF) commissioned a study by Francis Fruchart, the very same sediment expert from CNR who co-wrote the CNR report on Xayaburi. The study presented gravity of the impacts if coarse sediment load (pebbles, gravel and sand) is blocked by a dam, as well as acknowledging that coarse sediment cannot be flushed through a reservoir. In addition, the report highlights that the flushing procedure comes with its own suit of serious impacts, and that its management is far from easy. Proper flushing requires not only in-depth technical knowledge, but also a robust institutional

[23] "Xayaburi dam presents no risks to environment, Lao government," *Global Times*, March 19, 2013. http://www.globaltimes.cn/content/769096.shtml#.Ui67I8bI2So
[24] Compagnie Nationale du Rhône, "Xayaburi Hydroelectric Power Project: Peer Review of the Compliance Report made by Pöyry Final Report," March 30, 2012. http://www.poweringprogress.org/download/Reports/2012/April/Final-report-V1.pdf
[25] "Xayaburi Dam Redesigned Mulled," *Radio Free Asia*, May 16, 2012. http://www.rfa.org/english/news/laos/xayaburi-05162012180613.html.
[26] CNR. "Xayaburi Dam Project: Clarification from the Compagnie Nationale du Rhône," August 2, 2012. http://www.internationalrivers.org/files/attached-files/2012_08_02_press_release_cnr_xayaburi_dam_project.pdf

framework to ensure cooperation from many parties. A case in point is the ecological catastrophe that resulted from dam flushing on the Rhône in June 2012, which was coordinated between Switzerland and CNR.

Mounting scientific evidence shows that the Xayaburi site is far from "ideal conditions." Recent research on sediment transport and discharges in the Lower Mekong points out that (a) source of coarse sediment (sand & gravel) that supports morphological and ecological stability of riverbed and delta + sand mining/construction industry in 4 Lower Mekong countries, comes from 2 sources : Mekong upstream from LPB and Nam Ou River, both of them upstream from X dam site (b)"the hydrology of the Mekong has already been altered by the Lancang dams and by dams built on tributaries. These impoundments have the potential to reduce the frequency and magnitude of small to large flow events. This reduction in the magnitude and frequency of flow events will become more pronounced as the additional Chinese dams presently planned or under construction come on line."[27]

The same research concludes that the success of sluicing as a sediment transport mitigation measure in the lower Mekong is doubtful due to the following factors:

- *The compaction of mixed sediment.*
- *The likely low frequency of the flow releases to mobilize sediments from the dam.*
- *The short duration of most flushes is unlikely to allow downstream sediment sorting as would occur in a natural river…In the Mekong, the complex morphology of the river bed with lateral bedrock landforms and vegetation on the river margin would also promote rapid sediment deposition during a flush.*
- *This alteration of sediment deposition would alter the habitat characteristics of both the banks (loss of complexity and of the specific characters of natural banks), the channel (infiltration of fines into the gravel substrate), and floodplain (reduction in frequency of inundation, change to composition of deposited sediment), which would likely affect ecological processes. It is extremely difficult to predict the longitudinal extent of such kind of environmental effect.*

The report concludes that "based on these factors, the ability to mitigate the impact of Lower Mekong mainstream dams on sediment transport in the Mekong is highly questionable."

Can an engineering miracle rise from bad science?

Construction of the Xayaburi continues to move ahead with hyperbolic what-ifs and endless design modifications without scientific evidence. Migratory fish data captured on camera, latest fish pass designs, and details of sediment flushing mechanisms have neither been substantiated nor disclosed outside the project company. In short, Laos has put faith in unproven technologies being offered by European consultants as a means to mitigate the Xayaburi's impacts to fisheries and sediment flows, ignoring many scientists' warnings that technologies that work in North America and Europe may not work in the Mekong, a river whose rich ecosystem is still not fully understood. At its own peril, Laos has neglected its own consultants' numerous caveats, reservations, and fine prints, even though the cost of failure will not be borne by those consultants, but will fall squarely on Lower Mekong countries as a whole.

[27] Bravard, Jean-Paul, and Goichot, Mark. "Knowledge of sediment transport and discharges in relation to fluvial geomorphology for assessing the impact of large-scale hydropower projects," June 2013.

Hidden risks in bankrolling the Xayaburi Dam

After a brief halt in May 2012 following Cambodia's threat to sue Laos[28], and despite unprecedented protests from hundreds of civil society organizations, the construction and loan disbursements for the Xayaburi dam project have picked up pace again. By June 2013, the project developers had resettled the first local village, built dikes in the river, dug and widened the riverbed, built access roads and set up transmission lines.

In addition to being the first Lower Mekong dam that will have significant impact, Xayaburi is also one of the largest cross-border project finance that large Thai banks have undertaken to date. The project's location notwithstanding, the dam is being constructed by a Thai construction company and financed 100% by Thai banks. The 14-year, 80 billion Baht term loan syndicate comprises six banks: Siam Commercial Bank (SCB), Bangkok Bank (BBL), Krung Thai Bank (KTB), Kasikornbank, TISCO Bank, and Export-Import Bank of Thailand (Exim Bank). SCB and BBL lead the syndicate as two of Thailand's most prominent and experienced project lenders.

Lenders' thinking revealed

Thai banks' continuing financial support for Xayaburi despite myriad risks and mounting evidence of the ineffectiveness of social and environmental risk mitigations might seem puzzling to observers. The thinking of Thai creditors is best revealed in 2013 annual shareholder meetings, when their directors fielded questions posed by a shareholder-activist regarding their involvement in Xayaburi. Their responses can be summarized as follows:

Oranuch Apisaksirikul, President and CEO of TISCO Bank : "TISCO has determined that this project is not unethical; it is an energy project that will boost Thailand's economic growth, and we are confident that it will be able to repay loans on schedule… Xayaburi is a run-off-the-river dam without large reservoir; therefore it has little sedimentary impact. It also has fish passage. As for potential impact to the society and environment, TISCO is not an expert in these fields, so the bank relied on external experts. This project employs 6 consulting firms which produced numerous reports… those reports concluded that this dam will have very little social and environmental impact, less than Chinese dams built in the Upper Mekong. For these reasons, TISCO was comfortable with joining the loan syndicate."[29]

Ms. Oranuch's remarks were strikingly similar to that of Anand Punyarachun, former Prime Minister of Thailand, who answered shareholder's query in his capacity of Chairman of the Board at Siam Commercial Bank (SCB).[30] More telling was the response of Buntoon Lamsam, CEO of Kasikornbank, one of Thailand's three largest banks (emphasis added): "Xayaburi project has almost no repayment risk. Every Thai bank [in this syndicate] jumped at the chance to support it, *because the project has already been approved by the international committee*. In addition, Electricity Generation of Thailand (EGAT)

[28] "Laos halts Xayaburi dam work", *Radio Free Asia*, May 11, 2012. http://www.atimes.com/atimes/Southeast_Asia/NE11Ae02.html

[29] "TISCO explained to its shareholders: Xayaburi loan is not unethical," *Prachatai*, 26 April 2013 (http://prachatai.com/journal/2013/04/46429).

[30] Ibid.

agrees to buy all electricity produced from the project, and *Thailand also needs this electricity*. We therefore are not concerned about repayment …. But since it is a large project, it may have some impact on the local communities. For example, some communities will be relocated away from flooded areas. It is normal for large projects to have both supporters and dissenters; therefore, it is a matter of weighing between costs and benefits."[31]

Interestingly, Kasikornbank refused to disclose the value of loans to Xayaburi when asked by the shareholder, while TISCO disclosed that its portion of the syndicate loan is roughly 3,000 million Baht. The refusal of Kasikornbank to disclose even the amount of loan facility suggests that it is at least uncomfortable with increasingly intense scrutiny and protests from civil society and villagers who reside downriver.

Post-war development mindset

A common refrain from Thai banks whenever they are confronted with the issue of social and environmental impact of Xayaburi is that such matters "lie outside their area of expertise." What this means, in effect, is that Thai lenders still view social and environmental impact as only a "compliance risk" issue. Two implicit assumptions in this viewpoint are: 1) the government does a reasonable job at monitoring and regulating social and environmental issues, and therefore 2) if the project company can demonstrate that it has received all necessary licenses and consent from government agencies, then it must mean that social and environmental risks have been "dealt with" sufficiently (otherwise the project company will not have received 'green light' from the regulators).

In other words, the main reason that Thai banks do not directly assess social and environmental risks of projects they finance is that *they believe that such risks would have already been curtailed or contained in the compliance process* before the first loan disbursement date (and in fact, the requirement that the project company must undertake that it has received all necessary licenses is a common "condition precedent" in syndicate loan agreement).

This post-war mindset is a curious anachronism, given that negative externalities of improper or inappropriate dam-building are increasing well documented, and such externalities often "spill over" into direct financial and reputation risks for the banks. Worldwide, advances in science and technology, increasing calls for better protection of human rights and the environment in the face of regulatory inadequacies, have compelled commercial banks recognize the benefits of evaluating risks associated with social and environmental impacts and their mitigation and wider sustainability issues.

In other words, the development world at large now recognizes the difference between "good" and "bad" dams (although disagreements remain as to what constitutes a "good" dam), but Thai banks do not yet seem aware of these developments. To date, no Thai bank has set up a separate social and environmental risk committee or department.

Inadequate due diligence

[31] "KBANK explained its confidence in Xayaburi; refusing to disclose loan amount," *Prachatai*, 4 April 2013 (http://prachatai.com/journal/2013/04/46429).

From the responses above, it is clear that Thai creditors are not treating Xayaburi any different from other dams that they have financed, such as Nam Ngum 2, another hydroelectric power in Laos. However, Xayaburi is different from other dams in two regards: it is the first large dam (planned installed capacity of 1,290 megawatts) being built in Laos, and, while the two previous dams are built on tributaries that already had other dams on the Mekong, so their impact is lesser and easier to ascertain. Xayaburi's sitting also makes it the first dam that is subject to the "Procedures for Notification, Prior Consultation, and Agreement" (PNPCA) of the Mekong River Commission (MRC), a regional decision-making body.

The banks' mistaken beliefs, such as "[Xayaburi] project has already been approved by the international committee" and "this dam will have very little social and environmental impact" must have partly resulted from inadequate due diligence, because such beliefs run counter to facts that should have been well-known, especially in light of the technical assessments produced under the MRC framework, which are more independent than "independent consultants" to the project. Key facts that lenders should have been aware prior to syndicate loan closing are as follows:

1. Even smaller dams such as Nam Ngum 2 had raised concerns

Before Xayaburi, Nam Ngum 2 which is much smaller than Xayaburi (615 megawatts installed capacity) was also developed by Ch Karnchang, the same Thai company which is constructing Xayaburi dam. As part of the process to study the development of Nam Ngum 3 dam, the Asian Development Bank (ADB) commission a report on the cumulative impacts of hydropower development in the Nam Ngum river basin. This report indicates that proposed dams would have serious impacts on the livelihoods of tens of thousands of Laotians.[32] The report also points out that Nam Ngum 2 dam was not well prepared, but its impact could be managed given its location just upstream from older Nam Ngum 1 dam. The report calls for better coordination amongst all hydropower projects on the Nam Ngum, and proposes the suspension of all projects on the Nam Lik, one of Nam Ngum's large tribulatories. But the government of Laos ignored the report and went ahead with all projects.

Given its sitting, the social and environmental impact of Xayaburi is certain to be much more far-reaching than Nam Ngum projects. It should be a cause for concern for Thai creditors that Xayaburi syndicate gathered no interest from non-Thai banks, particularly ADB and International Finance Corporation (IFC).

2. Under the MRC Agreement, harmed countries has the right to stop construction

According to Article 7 of the Agreement on the Cooperation for the Sustainable Development of The Mekong River Basin, signed by all MRC members including Thailand, Laos, Vietnam, and Cambodia, Cambodia and/or Vietnam clearly has the right to demand Laos to stop the construction of Xayaburi as soon as "substantial damage" from the dam becomes apparent. The full text of Article 7 reads as follows[33]:

[32] Vattenfall Power Consultant, AB. *Lao People's Democratic Republic: Preparing the Cumulative Impact Assessment for the Nam Ngum 3 Hydropower Project.* Technical Assistance Consultant's Report to the Asian Development Bank, December 2009. Accessde 31 August, 2013.
http://ifcext.ifc.org/ifcext/spiwebsite1.nsf/0/3302CBDA8520406A8525795D007A0BDB/$File/Disclosure%20-%20CIA%20Update%20Post%20Monitoring%20.pdf

[33] Mekong River Commission. Agreement on the Cooperation for the Sustainable Development of The Mekong River Basin. http://www.mrcmekong.org/assets/Publications/agreements/agreement-Apr95.pdf

Article 7. Prevention and Cessation of Harmful Effects To make every effort to avoid, minimize and mitigate harmful effects that might occur to the environment, especially the water quantity and quality, the aquatic (eco-system) conditions, and ecological balance of the river system, from the development and use of the Mekong River Basin water resources or discharge of wastes and return flows. Where one or more States is notified with proper and valid evidence that it is causing substantial damage to one or more riparians from the use of and/or discharge to water of the Mekong River, that State or States shall cease immediately the alleged cause of harm until such cause of harm is determined in accordance with Article 8.

Such provision in the MRC Agreement makes it necessary, from the bank's standpoint, to assess risks of "substantial damage" that may result from the dam more thoroughly than in a typical project finance case, because it has direct bearing on financial risks of the project (see next section).

3. Laos' decision to green-light dam construction violate MRC ruling

It is a well-known fact, mysteriously unknown perhaps only to Thai creditor banks, that the construction of Xayaburi continues without approval from the MRC, in violation of the MRC Agreement. The "Xayaburi Dam" article on public encyclopedia Wikipedia[34] summarizes thus: "On 19 April 2011, the MRC Joint Committee announced that the MRC countries could not reach a consensus on how to proceed with the project, and agreed that a decision on the prior consultation process be tabled for consideration at the ministerial level. However, in June 2011, the Laos Government gave the Thai developer Ch Karnchang the go-ahead to resume work on the Xayaburi Dam, informing the company that the Mekong River Commission's decision-making process was completed."

Given the slew of public protests, public information, and media attention surrounding this issue, creditor banks should have been well aware that they were being misled by Ch Karnchang and the Laos government.

4. Problematic Pöyry report and conflicts of interest

One of the common refrains from creditor banks involved in Xayaburi is "we are not environmental experts." This refrain is typically cited to justify the need for third-party consultants, deferring mainly to the 'expertise' of Pöyry Energy AG, which was hired by the Laos government in 2011 to evaluate Ch Karnchang's compliance with MRC standards. However, creditor banks should have been aware of both the myriad problems of the Pöyry report[35], as well as conflicts of interest of the firm.

The Pöyry report itself does identify uncertainties and weaknesses with the proposed fish passes. It even acknowledges that Xayaburi fails to comply with at least a quarter of the MRC's guidance on this, confirms the dam will block part of the sediment flow, and acknowledges that important gaps in knowledge concerning the sediment aspects remain. Nonetheless, Pöyry concludes its report that the

[34] "Xayaburi Dam," *Wikipedia*. http://en.wikipedia.org/wiki/Xayaburi_Dam
[35] Pöyry Energy AG. Compliance Report: Xayaburi Hydroelectric Power Project, August 9, 2011. http://www.internationalrivers.org/files/attached-files/poyry_xayaburi_compliance_report.pdf

project "has principally been designed in accordance with the applicable MRC Design Guidelines," despite listing over 40 major scientific and technical studies that still need to be completed.[36]

Pöyry's "guarantee" that the dam's impacts could be mitigated, while acknowledging that those impacts have not yet been fully identified, should have already raised a red flag for Thai creditors. A closer look at its status and business relationships should have raised the flag higher – Pöyry served as consultant for Nam Ngum 2 dam which was also built by Ch Karnchang, and after submitting the 2011 report, Laos government hired the company to be engineer of the project. The company therefore clearly has strong financial incentives to provide positive reviews.

Prior to loan disbursement, creditor banks should have been aware of problems of the Pöyry report, its conflicts of interest, as well as the fact that MRC's own expert team which reviewed of this report suggested "…conducting specific investigations before (rather than in parallel with) dam construction will reduce risks, including those of transboundary and cumulative impacts, and avoid "regret measures", actions that may ultimately be inappropriate and lead to expensive and/or irreversible unintended negative impacts. The MRC review team observes that collecting and analysing baseline data as well as adapting the design of the fish bypass facilities should be initiated at least two years before dam construction starts."[37] (as to be able to (a) evaluate if the dam project is viable, i.e. if its environmental and social impact management plans are feasible, (b) provide inputs to the final design of the dam, and (c) determine financial implication on the cost of construction and operation, i.e. return on investment.)

How social and environmental risks translate into financial risks

Banks worldwide have long known that large hydropower dams entail significant risks. However, outside Thailand banks are increasingly aware that major social and environmental risks can also 'translate' into financial risks that directly impact the financial return profile and capacity to repay. For example:

- The failure to address social and environmental issues can result in costly delays, as frustrated communities disrupt project construction. Unforeseen costs may also be incurred if affected communities pursue fair compensation or modification of project design through legal proceedings.
- Historical data of river flows and rainfall are no longer relevant due to climate change, with more extreme weather events expected. Drought will reduce the power production of hydropower dams, while extreme floods could damage the dam infrastructure itself or require sudden water releases causing damage downstream of the project that would require compensating.

Because of the poor quality of Pöyry report which advocates the "fix it as you go" approach despite identifying many problematic issues, we can anticipate two major channels in which social and environmental risks translate into financial risks for Xayaburi project:

1. Scientifically improbable mitigation of risks lead to cost overruns and lower financial return

[36] Ibid.
[37] Mekong River Commission Secretariat. "Observations and Comments on the Pöyry report on the Xayaburi Hydropower Project," November 25, 2011. http://www.internationalrivers.org/files/attached-files/mrcs_comments_on_poyry_report_nov_2011.pdf

As of August 2013, project developers have not disclosed plans for fish bypass facilities, despite seeking and receiving $100 million from the creditor banks to modify dam's design that supposedly will "make it more ecologically sound" according to Viraphonh Viravong, Laos' Deputy Minister of Energy and Mining.[38] This means Xayaburi has already incurred $100 million (3.7% of initial loan facility) cost overruns, for mitigations of which the ability to mitigate remains highly uncertain.

Another potential source of cost overrun is the additional operation costs of maintaining a permanent operation to remove consolidated sediment (that cannot be flushed) that will accumulate in the 60-80km-long, in-river reservoir upstream from the dam, as well as the amount of lost revenue caused by the flushing of sediment at the dam site. This flushing will reduce water available for power generation and/or requires periodically halting the turbines, thereby reducing power output and the project's return on investment. Subsequently, this affects the project's risk profile and adds to repayment risk. Additional impact from flushing on people and ecosystems downstream of the dam also increases the cost of mitigation measures as well as the risk of delays during construction. It may also disrupt dam operation after construction is finished, if downstream population or MRC member states request more frequent or less intensive flushing, or request that flushing be stopped altogether.

2. High likelihood of "substantial damage" is a significant legal risk that can halt the project

According to Article 7 of the MRC Agreement cited in the previous section, every MRC member country can stop the project if it can demonstrate "significant damage" from the dam. Since it is highly likely that some of the most significant social and environmental risks of this project, such as the sediment build-up and the collapse of fisheries, will not be sufficiently mitigated, the possibility that Cambodia and Vietnam will invoke Article 7 to halt the construction of the dam cannot be understated. This legal risk translates directly into financial risk, since halting dam construction will severely erode financial return and puts future repayment of the loan in jeopardy.

[38] Jacey Fortin. "A Dam Conundrum: Xayaburi Project Could Help Laos And Thailand, Hurt Cambodia And Vietnam," *IB Times.* November 5, 2012. http://www.ibtimes.com/dam-conundrum-xayaburi-project-could-help-laos-thailand-hurt-cambodia-vietnam-859904

Chapter 4. Responsible Retail Lending

4.1 The need for financial consumer protection

Retail banking refers to the provision of financial products and services to retail customers, both individuals and small businesses (Clark, Dick, Hirtle, Stiroh, & Williams, 2007). Banks define "small business" by annual sales or revenue volume; however, a cut-off level that separates small business customers from corporate customers is varied – it may range between $1 million and $20 million in annual sales. Larger banks are likely to have larger cut-offs. Individuals and small businesses together are considered consumers of retail banking. In some cases, both groups use exactly the same products, e.g. credit cards which are an important source of credit, and they are mainly served through the bank's branch network. Moreover, products and services they use have similar risk characteristics, generating economies of scope in risk management (Clark, Dick, Hirtle, Stiroh, & Williams, 2007).

According to the World Bank survey on consumer protection and financial literacy (2013), regulated financial institutions serve around two billion retail customers globally. As retail financial services expand, more and more people gain access to deposit, payment and credit services. Access to basic financial services is increasingly considered a fundamental component of inclusive economic systems and contributes to poverty reduction (see more details in Chapter 5. Improving Financial Access)

Financial products and services are delivered through many channels; however, branches remain the key delivery channel for most banks. This is due to their important role in attracting and retaining consumer deposits, the core retail banking product. Banks' retail activities comprise three complementary dimensions, namely i) customers served, ii) products and services offered, and iii) customers-products/services connected through the delivery channels. These dimensions are interrelated and must be viewed together in order to understand retail banking as a whole (Clark, Dick, Hirtle, Stiroh, & Williams, 2007).

The most important feature of retail banking is the stability of revenue and profit. In particular for large banks, stability from retail banking can help outweigh the volatility of other riskier businesses, for example, trading and other capital-market-related activities. Retail is considered an essential source of stable and predictable income, especially when other sources are volatile or insecure (Clark, Dick, Hirtle, Stiroh, & Williams, 2007).

According to Clark et al. (2007), there are several factors that contribute to the stability of retail-related activities. The most important one is that retail banking is fundamentally a consumer-based business. The resilience of the consumer sector has contributed to the stability of retail banking. A strong and stable consumer sector will result in a promising stable and growing retail business line. The second key factor is the fundamental feature of retail banking that servers a large number of small customers. That retail lending portfolio contains a large number of small loans means that net interest income should become less volatile over time. This is due to the diversification across customers.

Clark et al., (2007) gave example of how the continued strength of the consumer sector contributes to retail banking stability. Changes in revenue generated form two activities tend to offset one another over the interest rate cycle. This brings stability to retail banking income.

> "Deposit margins—the difference between rates paid on retail deposits and alternative market funding rates such as the federal funds rate—are an important source of income in retail banking. In periods of low interest rates, deposit margins tend to be low, reducing the implicit income earned on deposit balances. Low rates, however, spur mortgage refinancing, which boosts fee income. Many of these banks have been building large branch networks and increasing the share of retail-related positions on their balance sheets. As this article observes, retail banking is clearly an important source of revenue and profit for these firms and, given their systemic importance, it is important to understand the effect of this strategic focus not only for individual firms but for the banking system as a whole." (Clark, Dick, Hirtle, Stiroh, & Williams, 2007)

In recent years, particularly after subprime crisis in the United States in 2008 which triggered worldwide financial crisis, practices termed "Irresponsible Lending" have created negative impacts not only on individuals but also on the society. Products and practices that harm individuals' and businesses' wealth threaten the foundation of the economy. Global financial crisis has underscored the importance of consumer protection and financial literacy for the long-term stability of the financial sector. Household lending has rapidly increased over the last decade, however, this has been followed by a growing number of households facing difficulties to understand and make judgment on risks and obligations. In some cases, complex financial products were sold to those who lack financial literacy and creditworthiness. Consequently, securitization of such household credit had expanded instability to the rest of financial system (Ruthledge, Annamalai, Lester, & Symonds, 2010).

According to the World Bank (2013), over-indebtedness has four major effects when seen from a society's perspective:

- Economic: over-indebtedness limits future access to credit and shorten free cash flows for individuals as well as local businesses; hence, hinder economic growth and development.
- Social: over-indebtedness and the decrease in available cash flow widen the gaps between social groups and worsen opportunities for the poor.
- Political: the widespread and politicized over-indebtedness may reflect regulatory failure to limit over-indebtedness and can discredit financial supervisors and the political process.
- Perception of justice: in some cases, particularly predatory lending, if over-indebted clients fail to get protection in courts, predatory lender may be seen as protected from prosecution.

The need for consumer protection arises from asymmetry of information, the imbalance of power and resources between financial institutions and consumers. Financial service providers know their products while consumers are not well informed or find it difficult or costly to get sufficient information. This has placed consumers at a disadvantageous situation (Ruthledge, Annamalai, Lester, & Symonds, 2010; GlobeScan, 2011). When purchasing and using financial products, consumers should know and understand product features, otherwise they might be targeted for products that could create long-term negative aftermath, debt in particular. These products include credit cards, bank accounts with hidden fees, and mortgaged with variable rates (GlobeScan, 2011).

Increased competition among financial provides together with improvements in information technology resulted in highly complex financial products available in the market. In the meantime, rapid growth of income has not only allowed consumers to invest more but also created first-time customers. However, this emerging market lacks experience in using complex financial products (Ruthledge, Annamalai, Lester, & Symonds, 2010). The situation where the growth of available investment resources is far ahead of the growth of financial literacy had escalated probability of crisis. As a consequence, the need for consumer protection rises (Ruthledge, Annamalai, Lester, & Symonds, 2010; The World Bank, 2013). Consumer protection, in addition, helps to prevent financial service providers from seeking excess profit and taking advantage from unsophisticated consumers as they can potentially sell expensive products to those consumers with limited understanding and experience (The World Bank, 2013).

The presence of responsible lending conducts is necessary not only for low-income economy, but also high-income countries. The 2008 financial crisis in the U.S. was a case in point. Irresponsible lending had nearly led U.S. financial system to a collapse. It has started with the financial inclusion policy in an attempt to expand mortgages availability to subprime borrowers, who did not understand products features or related terms and conditions. This group of customers was eventually not able to service their debts (Ruthledge, Annamalai, Lester, & Symonds, 2010; (World Bank, 2013). This brought the U.S. consumer protection regime under criticism, until today U.S. authorities can no longer neglect the importance of consumer protection, or question the link between protecting consumers and the stability of financial system (Ruthledge, Annamalai, Lester, & Symonds, 2010).

Consumer protection and financial literacy both promote efficiency, transparency, competition and access to retail financial markets. Consumer protection attempts to redress the imbalance by reducing information asymmetries, by giving consumers clear and complete information, by prohibiting financial service providers from engaging in unfair conducts, and by providing adequate dispute resolution mechanism (Ruthledge, Annamalai, Lester, & Symonds, 2010; World Bank, 2013). To bring stability to the financial sector through responsible lending, financial consumer protection needs to be in place with effective financial education policies as well as adequate regulation of financial institutions and markets, as stated in the World Bank (2013) that

> "Policies that protect the interests of consumers of financial products and services contribute to enhanced risk management by households, more competitive financial markets, and greater financial stability. This financial crisis demonstrated the desirability of strengthening such policies and ensuring that the use (or misuse) of individual financial products do not become a source of financial instability."

The World Bank Global Survey on Financial Consumer Protection (2013) indicated that many countries had adopted consumer protection rules to secure responsible lending. Some form of responsible lending provisions is present in 80 out of 114 economies. In the same manner, there are many international efforts to identify best practices in financial consumer protection and develop international principles.

4.2 Financial consumer protection: principles and elements

Despite many efforts on developing financial consumer protection best practices, an internationally accepted standard on responsible lending has not yet been established. Countries have adopted a wide range of regulatory approaches in order to prevent over-indebtedness. In policy design, regulators should understand the whole market cycle of retail lending and must strive to ensure that the regulatory framework does not result in two potential negative effects of such regulations, namely i) making credit inaccessible to those who might benefit from using it, and ii) shifting large share of consumer lending to unregulated and unsupervised sources, which is usually associated with negative social impacts (The World Bank, 2013).

The two most recognized international principles on financial consumer protection are the following:

The World Bank Good Practices for Consumer Protection and Financial Literacy

These principles advocated by the World Bank were published in 2012, based on consumer protection and financial literacy reviews across countries. The Good Practices can be seen as the World Bank's attempt to develop an international benchmark on consumer protection and financial literacy. For this reason, the principles were established based on existing international good practices carried out in financial sector across countries (Ruthledge, Annamalai, Lester, & Symonds, 2010; The World Bank, 2013).

The G20 High-level Principles on Financial Consumer Protection

The G20 High-level Principles on Financial Consumer Protection were endorsed by the G20 Finance Ministers and Central Bank Governors in 2011. It was designed as a set of guidelines for policymakers in different countries to improve their financial consumer protection framework (Ruthledge, Annamalai, Lester, & Symonds, 2010; Organization for Economic Co-operation and Devalopment, 2011).

In addition, there is the Smart Campaign Guidance on the Client Protection Principles. The guidelines were developed specifically for microfinance and microinsurance client protection (The Smart Campaign, 2011; Hickson & Suzuki, 2013) – see more details in Chapter 5 of this report.

Those aforementioned mentioned principles were built upon the perspective that an effective consumer protection system should cover five protection areas as follow (The World Bank, 2013):

I. Institutional arrangements

Regarding institutional arrangements, the World Bank emphasized that fragmented responsibilities for consumer protection in retail financial services may lead to fraud and misuse by providers.

II. Disclosure

Responsible disclosure should provide all relevant information in understandable terms. Financial providers' disclosure should be adequate and allow consumers to compare available products to make informed decisions.

III. Business practices

Fair and reasonable selling practices should be ensured. The rules regarding business practices should identify how to verify the suitability of the loan.

IV. Consumer redress

The regulatory framework should provide an affordable and efficient redress mechanism not only for consumers to address complaints, but also for the regulator to early identify potential threats.

V. Financial capability

Financial education and awareness should be promoted so that consumers acknowledge the impact of their choices and make informed decisions. This helps prevent significant long-term adverse effects.

Consumer protection key elements

Basic information on 9 key elements of financial consumer protection is summarized in this section, building on the earlier research including 1) The G20 High-level Principles on Financial Consumer Protection, 2) The World Bank Good Practices for Consumer Protection and Financial Literacy, 3) The World Bank Global Survey on Consumer Protection and Financial Literacy, and 4) The Smart Campaign Client Protection and Principles.

1) Legal framework

Consumer protection rules regarding financial products and services should be clearly identified and integrated within the legal and regulatory framework. Regulation should reflect product features and effectively respond to new technologies and delivery channels. Furthermore, strong legal and supervisory mechanisms need to be in place to protect consumers from financial frauds, abuses and errors (Ruthledge, Annamalai, Lester, & Symonds, 2010; Organization for Economic Co-operation and Devalopment, 2011).

The World Bank survey on consumer protection (2013) found that countries in general followed two broad approaches regarding legal framework on financial products and services. The first approach is that the specific provisions of financial products and services are incorporated into the general consumer protection law. In the second approach, there is a separated law to address financial consumer protection issues. Thailand has basically adopted the second approach, although regulation is scattered across many different regulators depending on the kind of financial providers, from the Bank of Thailand, to the Ministry of Finance, to the Ministry of Agriculture and Cooperatives etc. (see more detail in Chapter 5).

As countries focus on enhancing legal frameworks for financial consumer protection, more countries issued laws explicitly dealing with the financial products and services in the past two years. Reforms to rationalize and streamline financial consumer protection are ongoing in a number of countries. There is some degree of consensus reflected in the laws across the world on a broad set of consumer rights, such as rights to be informed about the products offered, to obtain advice about the suitability of products on offer for the consumer's needs and objectives and for financial institutions to engage in responsible lending practices, to seek recourse in case of wrong doing by the provider of financial services, and restrictions on unfair and misleading practices by providers of financial services.

2) Institutional arrangements

There should be institutional arrangements, e.g. oversight bodies, responsible for financial consumer protection. That is to ensure the comprehensive and fair implementation and enforcement of all related rules (Ruthledge, Annamalai, Lester, & Symonds, 2010; Organization for Economic Co-operation and Devalopment, 2011). Consumer protection and prudential supervision can be in separate agencies or in a single organization; the main focus is on the balance between prudential supervision and consumer protection (Ruthledge, Annamalai, Lester, & Symonds, 2010).

However, there are concerns towards the need to separate financial consumer protection supervision from prudential supervision. Firstly, consumer protection may require different sets of tools and methods. Secondly, supervisors tend to pay more attention to prudential supervision. As a result, consumer protection may not receive adequate attention without a separation of two units. Lastly, mandates over consumer protection and prudential supervision may potentially cause conflicts with each other (The World Bank, 2013).

To make supervision effective regardless of institutional arrangement selected, responsibilities and appropriate governance should be clearly and objectively defined. This includes operational independence, accountability and power, resources and capabilities, transparent enforcement framework, and compatible regulatory mechanism (Organization for Economic Co-operation and Development, 2011).

3) Fair treatment and protection of consumer confidentiality

Fair treatment principle requires all consumers be treated equitably, honestly, fairly, and respectfully (Ruthledge, Annamalai, Lester, & Symonds, 2010; Organization for Economic Co-operation and Devalopment, 2011; The Smart Campaign, 2011). An act of discrimination is not acceptable. Financial service providers and all authorized agents should integrate fair treatment as a part of good governance of corporate culture (Organization for Economic Co-operation and Development, 2011). Laws and regulations should provide sufficient mechanism to protect consumer from and prohibit as well as detect unfair conducts including corruption, fraudulent sales, misleading advertising, and abusive collection practices (Ruthledge, Annamalai, Lester, & Symonds, 2010; The Smart Campaign, 2011).

Regarding the protection of consumer confidentiality, financial institutions are required to protect the confidentiality and technical security of customer data. Financial service providers are responsible to ensure the security of client data and to inform consumers of related policies. Consumer rights should be protected by the laws, this includes information sharing, accessing to personal information, and rectification of errors. In addition, rules regarding the release of client records should be clearly identified (Ruthledge, Annamalai, Lester, & Symonds, 2010; The Smart Campaign, 2011).

4) Disclosure

Financial institution and authorized agents should inform customers of full details of key product features including benefits, risks, and terms and conditions. The providers should communicate in a manner and language that is clear and understandable, so that the clients can make fully informed decisions. Financial services providers should also provide information on conflicts of interest associated with the authorized agent as well as advise consumers of their legal rights associated with purchase of the product (Organization for Economic Co-operation and Devalopment, 2011; The Smart Campaign, 2011).

Provided information should not only be accurate, honest, understandable and not misleading, but also comparable. Comparison between financial products and services of the same categories can be facilitated by using standardized disclosure practices, e.g. forms, annual percentage rate (APR), effective interest rate (EIR) (Organization for Economic Co-operation and Devalopment, 2011; The Smart

Campaign, 2011). Disclosures that make product features comparable, more transparent and easier to understand can reduce search costs and allows consumers to find the most suitable product. This will potentially improve outcomes for the consumers (The World Bank, 2013).

Regarding information disclosure, there are two aspects to be consider, namely what is disclosed and how it is disclosed. "What is disclosed" relates to the content of disclosure and aim to ensure that the consumers get all relevant information. "How it is disclosed" describes the method of disclosure, the way information is presented must be adequate and not manipulate consumers (The World Bank, 2013). Table 9 compares the "What" and "How" aspects in greater detail.

Table 9. Comparison of "What" and "How" for financial product disclosures

What is disclosed	How it is disclosed
At opening - Copy of the general terms and conditions (including cooling-off period the consumer may cancel the contract without penalty) - Key Fact Statements (show key information about the loan, such as the volume of credit, interest rate, total cost of credit, and installment payments) **On periodic basis** - Monthly statements regarding key details of financial transactions - Notification of changes in interest rates, fees and charges or other key terms and conditions	- Main concern on accuracy, simplicity, and understandability **Provided in a standardized way** - Standardization of vocabulary (use the same term instead of several terms for the same issue) - Standardization of formulas and calculations (use the same formulas and rules to compute the cost of credit) - Standardization of content and format of the disclosure documents (This allows consumers to easily make a comparison.) **Oral disclosure** - Build on written disclosure documents - Ensure consumers' attention on the most important issues - Verify consumer's understanding (well enough to make decision)

Source: Ruthledge et al., 2010 and The World Bank, 2013

5) Responsible lending and prevention of over-indebtedness

Provision of appropriate products

Financial services providers should design products for the best interest of their customers and make sure that consumers are allowed to choose the most appropriate product from a range of options. When making recommendation, financial institutions should assess all related financial capabilities as well as consumers' situation and needs before selling products or services (Ruthledge, Annamalai, Lester, & Symonds, 2010; The Smart Campaign, 2011).

The assessment of product's suitability is generally evaluated by three tests, which are 1) consumer's best interest, 2) understanding of the product, and 3) long-term affordability. In the interest of an effective and enforceable responsible lending regime, all three of these tests should be combined and the results adequately documented to allow for verification, both by the lender's internal compliance team and by the relevant supervisory agency (The World Bank, 2013).

I. Consumer's best interest

The test of best interest verifies the consumer's understanding of his/her current situation and future plan. The financial institution's obligation is to consider consumer's portfolio and understand how the loan may impact the consumer's financial stability in the long run[39]. The providers should be able to give advice on which product(s) is the most appropriate to the specific need of the consumer, although the final decision remains in consumer's hand.

II. Understanding of the product

The test of consumer's understanding assesses if the consumer understand all product features, including benefits and risks. Level of understanding is influenced by two factors: clarify of information disclosure, and explanation provided by the sales staff as the oral presentation.

III. Long-term affordability

The test of long-term affordability aims to evaluate how long-term risks may affect consumer's ability to repay the loan. To test long-term affordability, financial service providers need to make various assumptions about the customer's future, consider potential impact of general economic development on the borrower's ability to repay the loan.

Responsible pricing

Responsible pricing refers to pricing terms and conditions that are set in a way that is affordable to consumers at the same time allowing for financial institutions to be sustainable. Financial institutions should make an evaluation of product costs through a systematic costing and pricing process, where the actual cost is reflected, and set the product price with a reasonable profit margin (The Smart Campaign, 2011).

i) Interest rate

In some countries, interest rate ceiling are used to limit maximum interest rates of consumer loans to protect consumers from usurious behavior of some lenders. The primary target group comprises lenders

[39] Sometimes called "Know Your Customer (KYC) principle"

serving low-income consumer groups who are not qualified for credit from banks and mainstream non-bank lenders. This is due to their negative credit history or riskiness, such as insufficient income, other existing loans, socio-demographic profile (The World Bank, 2013).

ii) Fees and penalties

Late fees and penalties are used to penalize customers not able to repay on the agreed schedule and cover any costs occur to the lenders. On the contrary, additional feed and penalties applied may be seen as a profitable business. Without regulations on limits, or if the limits are set too high, financial service providers may intentionally create debtors to make profit, resulting in an increase of over-indebtedness. For this reason, some regulators have designed the rules to control this irresponsible conduct. Fees or penalties above the set limits are automatically invalid and lenders trying to charge these penalties may lose their right to any compensation (The World Bank, 2013).

Prevention of over-indebtedness

According to the Smart Campaign (2011), lender will take detailed credit assessment on all prospective of borrowers to determine that clients have the capability to repay without becoming over-indebted.

There are many factors that affect consumers' ability to make judgment of their capability to repay the loan, leading to over-indebtedness. Three main drivers of over-indebtedness are as follows (The World Bank, 2013):

i) Financial imprudence

Financial imprudence, in other words poor financial decisions-making, is primarily caused by an inadequate understanding of the real cost of loan repayment. This is connected to the transparency of product terms and conditions on the lender's side, as well as to financial literacy and ability to manage their personal finances on borrower's side. Psychological biases and mental shortcuts that affect consumers' decisions predictions about borrowing also influence the imprudence.

ii) The occurrence of unexpected events

Unexpected events such as an unexpected reduction in income, an unforeseen expense (e.g. expensive medical care, damage to an uninsured house in a natural disaster), increase in the cost of debt (e.g. a rise in interest rates or exchange rate in the case of foreign currency denominated loans) can lead to over-indebtedness. Unexpected changes in family structure (e.g. divorce or the birth or death of a family member) may also affect the ability to repay.

iii) Poverty

Poverty makes borrowers incapable of handling their expenses to take on loans that have little chance of being repaid. This usually happens due to information asymmetries when lenders do not have information on credit history and current financial situation. A loan also arises from over-indebtedness itself, thus allowing a vicious debt cycle to continue.

6) Dispute resolution and resource

Financial institutions should ensure that consumers have access to adequate complaints handling and redress mechanisms that are accessible, affordable, independent, fair, accountable, timely and efficient (Ruthledge, Annamalai, Lester, & Symonds, 2010; The Smart Campaign, 2011; Organization for Economic Co-operation and Devalopment, 2011). Statistics of customer complaints should be periodically compiled and published. Consumer complaints may serve as an important indicator of the emerging problems in the financial sector and can help identify issues relating to specific institutions or products (The World Bank, 2013).

The key principles of operation for efficient redress mechanisms include independence, transparency, fairness and effectiveness. Financial ombudsmen can help resolving disputes, dealing with consumer enquiries and sharing the lessons learned to help improve the financial consumer protection framework (The World Bank, 2013).

7) Financial education

Financial education and awareness should be promoted by all relevant stakeholders. Clear information on consumer protection, consumer's rights and responsibilities should be easily accessible. A broad-based program of financial education should be developed to increase the financial capability of the existing and future consumers in order to understand financial risks and opportunities, make informed decisions, know where to go for assistance, and take effective action to improve their own financial well-being (Ruthledge, Annamalai, Lester, & Symonds, 2010; Organization for Economic Co-operation and Devalopment, 2011).

8) Protection against misuse and insolvency

The law should provide relevant information, control and protection mechanisms to, with a high degree of certainty, protect consumers' deposits, savings, and other similar financial assets, against fraud, corruption, inappropriate selling practices, misappropriation or other misuses. (Organization for Economic Co-operation and Development, 2011) There should be an effective and timely payout mechanism in the event of insolvency of financial institutions (Ruthledge, Annamalai, Lester, & Symonds, 2010).

9) Competition

Competitive markets, both nationally and internationally, should be promoted in order to provide consumers with greater choice amongst financial products and services. Competitive pressure can drive providers to offer competitive products, therefore, enhance innovation and maintain high service quality. Competitive markets contribute to positive environment where consumers are able to search, compare and easily switch between products and providers at reasonable and disclosed costs. (Organization for Economic Co-operation and Development, 2011) In policy designing process, impacts of competition issues on consumer welfare should be considered. Competition authorities should conduct assessments of competition in retail financial markets and make recommendations on how competition in retail financial institutions can be optimized (Ruthledge, Annamalai, Lester, & Symonds, 2010).

Table 10 compares key components of financial consumer protection across the aforementioned three sets of principles.

Table 10. Comparison of financial consumer protection key elements across G20, World Bank, and Smart Campaign principles

Consumer protection key elements	G20 High-level Principles on financial consumer protection	The World Bank Good practices for consumer protection and financial literacy : Banking sector	The Smart Campaign Client protection principles
Legal framework	- Financial consumer protection should be an integral part of the legal, regulatory and supervisory framework	- The law provides clear consumer protection rules regarding financial products and services	-
Institutional arrangements	- There should be oversight bodies responsible for financial consumer protection - Require clear and objectively defined responsibilities and appropriate governance; operational independence; accountability for their activities; adequate powers; resources and capabilities; defined and transparent enforcement framework; clear and consistent regulatory processes	- Institutional arrangements should be in place to ensure the thorough, objective, timely and fair implementation and enforcement of all rules. - Prudential supervision and consumer protection may be placed in separate agencies or in responsibility of a single organization, there should be a balance between prudential supervision and consumer protection	-
Fair treatment and the protection of confidentiality	- All financial consumers should be treated equitably, honestly and fairly at all stages of their relationship with financial service providers - Protection of consumer data and privacy	- The law prohibits the use of fraudulent sales practices such as misleading advertising - Privacy and data protection and technical security of customer data - No financial institutions, or third parties, should employ abusive collection practices	- Treat clients fairly and respectfully not discriminate - Ensure adequate safeguards to detect and correct corruption, aggressive or abusive treatment - The privacy of individual client data will be respected

Consumer protection key elements	G20 High-level Principles on financial consumer protection	The World Bank Good practices for consumer protection and financial literacy : Banking sector	The Smart Campaign Client protection principles
Disclosure	- Provide consumers with key information that informs the consumer of the fundamental benefits, risks and terms of the product - Appropriate information should be provided at all stages of the relationship with the customer - Standardized disclosure practices (e.g. forms) should be adopted where applicable and possible to allow comparisons	- Provide consumers with key facts - Provide a cooling-off period - Prepare regular statements - Notification of changes in interest rates, fees, and charges or other key terms and conditions of their financial products or services	- Communicate clear, sufficient and timely information in a manner and language that clients can understand - The need for transparent information on pricing, terms and conditions of products is highlighted
Responsible lending (over-indebtedness)	- Financial services providers work in the best interest of customers - Assess the related financial capabilities, situation and needs of customers before agreeing to provide a product, advice or service	- Before making recommendation to a consumer regarding a specific financial product or service, gathers sufficient information from the customer to ensure product suitability	- Design appropriate products and delivery channels in such way that they do not cause clients harm - Assess clients' capacity to repay without becoming over-indebted (total loan repayments should not exceed 40% of total disposable income) - Implement and monitor internal systems to prevent over-indebtedness - Responsible pricing affordable to clients while allowing for financial institutions to be sustainable

Consumer protection key elements	G20 High-level Principles on financial consumer protection	The World Bank Good practices for consumer protection and financial literacy : Banking sector	The Smart Campaign Client protection principles
Dispute resolution and recourse	- Ensure that consumers have access to adequate complaints handling and redress mechanisms that are accessible, affordable, independent, fair, accountable, timely and efficient.	- Financial institutions should have clear procedures for handling customer complaints - Consumers should have access to an affordable and efficient mechanism for recourse, such as an independent financial ombudsman or equivalent institution with effective enforcement capacity - Statistics of customer complaints	- Provide timely and responsive mechanism for complaints and problem resolution for clients
Financial education	- Financial education and awareness should be promoted by all relevant stakeholders and clear information on consumer protection, rights and responsibilities should be easily accessible by consumers - Appropriate mechanisms should be developed to help existing and future consumers develop the knowledge, skills and confidence to appropriately understand risks, including financial risks and opportunities, make informed choices, know where to go for assistance, and take effective action to improve their own financial well-being	- A broad-based program of financial education and information should be developed to increase the financial capability of the population - The financial capability of consumers should be measured periodically through a broad-based household survey that is repeated from time to time	

Consumer protection key elements	G20 High-level Principles on financial consumer protection	The World Bank Good practices for consumer protection and financial literacy : Banking sector	The Smart Campaign Client protection principles
Protection against misuse and insolvency	- Relevant information, control and protection mechanisms should appropriately and with a high degree of certainty protect consumers' deposits, savings, and other similar financial assets, including against fraud, misappropriation or other misuses	- The law should ensure that the regulator can take prompt corrective action in the event of distress at a financial institution - There should be an effective and timely payout mechanism in the event of insolvency of a financial institution - Any liability arising from the bank's failure to exercise duty to act with skill, care and diligence in the provision of any financial service or product to the consumer	-
Competition	- Nationally and internationally competitive markets should be promoted in order to provide consumers with greater choice amongst financial services and create competitive pressure on providers to offer competitive products, enhance innovation and maintain high service quality	- Competition policy in financial services should consider the impact of competition issues on consumer welfare, and especially limits on choice - Competition authorities should conduct and publish periodic assessments of competition in retail financial institutions and make recommendations on how competition in retail financial institutions can be optimized	-

Source: Ruthledge et al., 2010; The Smart Campaign, 2011; Organization for Economic Co-operation and Devalopment, 2011; The World Bank, 2013

4.3 Financial literacy as integral part of financial service

In both the G20 and World Bank Good Practices principles of financial consumer protection, financial education is seen as an integral component. Although increasing financial literacy for the populace is widely seen as the government's responsibility, not financial institution's intrinsic role (although many banks have begun financial education programs as part of their CSR activities), research has shown that 1) financial education is an important element of responsible lending, and 2) some of the most effective financial education programs are those that integrate seamlessly into the point-of-sale, i.e. when consumers are about to decide on which financial services to buy. Several banks have already integrated financial literacy into their marketing and delivery of financial services, and are able to enjoy business benefits as a result (see case studies at the end of this Chapter).

Using two surveys from India and Indonesia, a World Bank-supported study presents evidence that financial literacy is an important predictor of financial behavior in the developing world (Cole, Sampson, & Zia, 2009). Results demonstrated that financial literacy education has no effect on the chances that participants would open a bank savings account, but the training did increase knowledge about financial concepts for households who started off with low financial literacy and education. For households who received small subsidies, they were more likely to open a savings account. With larger subsidies, more than 9% households opened a savings account. This suggests that either subsidies or reduced price of services may represent a cost-efficient approach to expanding services to the unbanked, which would be an alternative to less effective financial education programs geared for the general public.

Short-term technical assistance could greatly help financial education implementers seek solutions to the operational challenges they are encouraging. Most programs are developing training based financial education programs, but with technical assistance they could explore alternative delivery channels and produce alternative financial education toolkits that use other engaging formats such as comic books, video clips played on iPads or computers or mass media channels. Many organizations cited that building the capacities of trainers (to use training guides and tools correctly) was a major challenge, especially since some rely exclusively on volunteers. Short term technical assistance can help implementers come up with practical solutions to train trainers and facilitators how to use tools, how to teach adults, how to engage in dialogue, how to tell stories, how to ask questions, how to provide counseling services. Another area where short term technical assistance could add value is to help program implementers design monitoring and evaluation systems so they measure their success and also refine their programs.

There is growing consensus in the mobile banking industry that financial education/ consumer education is an integral part of the customer journey to increase uptake and usage of mobile banking services. FINO Tech Foundation in India is leveraging its extensive network of business correspondents called Bandhus to teach low-income clients how to make the most of the financial services linked to their biometric cards using financial education tools such as interactive flip books and posters. These business correspondents offer training on the benefits of savings and making savings plans and also how to transact using a biometric card and point of transactions (POT) machine. Importantly, FINO went to considerable lengths to customize their FE practices to their target audience.[40]

[40] Impact Insurance. "Leveraging technology-enabled banking agent distribution networks -- FINO Fintech Foundation." June 2014. Retrieved October 31, 2014. http://www.microinsurancefacility.org/projects/lessons/leveraging-technology-enabled-distribution-networks

Financial institutions can be convinced to see the value of incorporating financial education into advertising, marketing, sales and customer service tactics. More specifically, commercial banks and insurance companies that are beginning to penetrate low-income markets could be persuaded to view financial education as an integral part of the customer journey. Global examples in mobile money are showing that sales agents, retailers and merchants play a critical role in educating consumers not only on the steps necessary to transact and also in helping customers to register and try the service.

"When asked to reflect on lessons learnt while rolling out M-PESA in Tanzania, one Vodacom executive cited the important of customer education. He said that above the line marketing is not enough to get mobile money "off the blocks" and that a lot of effort must be invested to get people comfortable with the idea of transferring money using their phones. Indeed, he estimated that it takes at least 30 minutes of personal interaction (with a transactional agent, a field agent, or a friend or family with M-PESA) to get a new customer to understand how to use a mobile money service."

- Adapted from Davidson, Neil and M. Yasmina McCarthy. Driving Customer Usage of Mobile Money for the Unbanked. GSMA. 2011, Page 19.

4.4 Case study #1: "Debt Pay Down Solution" by Wells Fargo

Regarding the provision of appropriate products, it is bank's obligation to design products for the best interest of their customers and consider clients' financial situations and understanding before selling products or services (Ruthledge, Annamalai, Lester, & Symonds, 2010; The Smart Campaign, 2011). The assessment of consumers' suitability to the product helps secure long-term affordability and prevent over-indebtedness (The Smart Campaign, 2011).

Background

Wells Fargo is a U.S.-based financial services company found in 1852. It provides various products and services including banking, insurance, investment, mortgage, and consumer and commercial finance. Beside its 9,000 business units across the U.S., it operates in 36 countries globally. At the end of second quarter 2014, Wells Fargo was the fourth largest bank in the U.S. in term of assets, possessing $1.6 trillion. It is considered one of the leading financial products and services provider in the U.S. market (see Appendix1) (Wells Fargo, 2014).

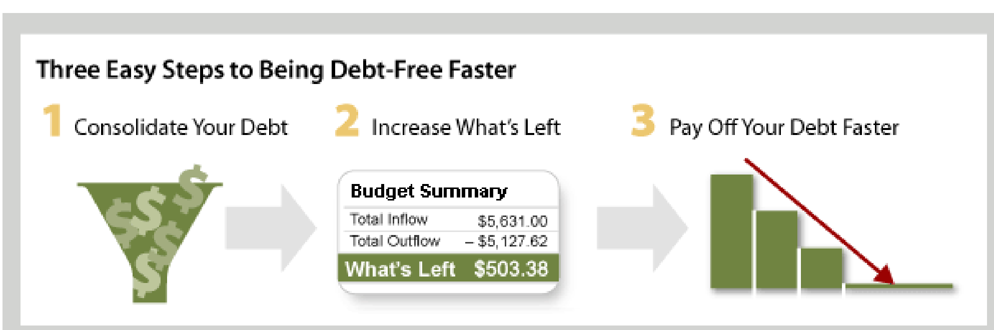
Debt Pay Down Solution

Between 2007 and 2008, Wells Fargo launched new products and tools to assist customers to manage credit, budget, and pay down debt. This new product line includes the online resource center Smarter Credit™, Wells Fargo Debt Pay Down Solution®, Wells Fargo Online®, and My Spending Report with Budget Watch (Wells Fargo, 2008).

Debt Pay Down Solution was introduced to the clients in late 2007 and has been found successful since late 2008 (Ladika, 2009). It helps debtors manage their debts and repayment through an online banking platform which allows customers to easily examine their budget and offers as well as to calculate the length of repayment period. This eventually help customers save their expense, utilize their increased saving, and become debt-free faster (Ladika, 2009).

Wells Fargo's Debt Pay Down Solution offers a disciplined way to help customers control their debt through three steps as follows (Wells Fargo, 2014):

Picture 1: 3-step Debt Pay Down Solution

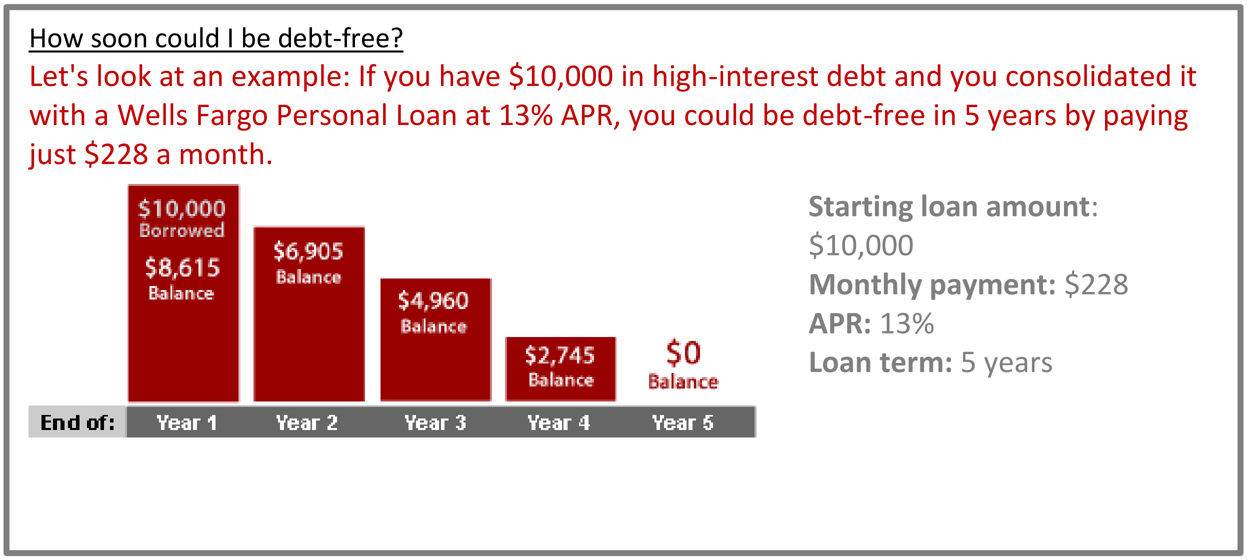


Source: Wells Fargo official website
https://www.wellsfargo.com/personal_credit/debt_consolidation/index

Step 1: Consolidate Your Debt

Debt consolidation simplifies debtors' monthly payment, instead of paying several payments on multiple bills, this service allows one monthly payment by offering a new loan to refinance existing debt. This not only helps make repayment more manageable for consumer, but can also help reduce monthly payment amount (Wells Fargo, 2014). Debt consolidation program offers terms that help customers pay down their debt, namely a lower fixed interest rate, a single fixed monthly payment, fast credit decisions, and no collateral requirement.

Picture 2: Benefit of debt consolidation



Source: Wells Fargo official website,
https://www.wellsfargo.com/personal_credit/debt_consolidation/consolidate/index

Step 2: Increase "What's Left" Each Month

"What's Left" refers to the margin between deposits and spending, that is "**Deposits - Spending = What's Left".** For the customers to better manage "What's Left", Wells Fargo provides a free online budgeting tool called "My Spending Report", which demonstrates clients' deposits and spending across categories. This helps customers understand their expenses, how much they have left, and consequently enables them to spend smarter (Wells Fargo, 2014).

Picture 3: Example of Wells Fargo's suggestions to increase "What's Left"

A little "What's Left" can go a long way

Increasing *What's Left* by even a small amount can make a big difference to paying down your debt faster. Did you know that with just $41 more of *What's Left* each month, you could pay off a $10,000 loan a whole year sooner?

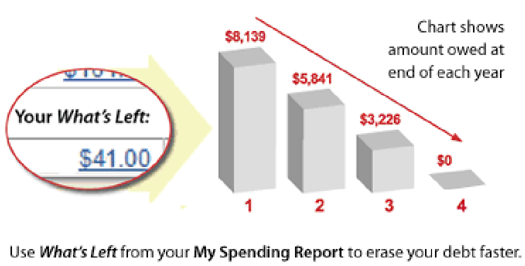
Here are some ways that you might save $41 or more a month. For example, $17 (movie savings) + $24 (coffee savings) = $41.

Replace	With	Estimated Monthly Savings
Going to the movies and buying popcorn	Renting a movie and making popcorn	$17
Daily latte or cappuccino	Making coffee at home a few days a week	$24
Driving to work and parking	Mass transit or carpooling	$25
Grocery shopping from memory	Using a list to avoid impulse buys	$25
Buying books and magazines	Using your public library	$30
Eating lunch out	Bringing lunch to work a few days a week	$12

Picture 4: How an extra payment helps customers become debt-free faster

How you can get out of debt one year faster

If you consolidated $10,000 in debt with a 13% APR, you could pay it off in 5 years with just $228 a month. But if you increase those payments by just $41 more a month, you could pay if off in just 4 years — and be debt-free a whole year sooner.



Starting Loan Amount: $10,000
Monthly Payment: $228 + $41 = $269
APR: 13%
Accelerated Payoff: 4 years

Source: Wells Fargo official website

Benefits to the bank

There is no clear evidence whether increased saving and smaller debt loads would necessary increase customers' loyalty to lenders. However, financial products designed to help consumers better manage their finances also help lenders reduce their exposure to the risks of defaults from over-indebtedness.

This undoubtedly allows financial institutions to carry on their business and continuously enjoy profit in a competitive industry (Holmes, 2009).

The financial performance of Wells Fargo between 2010-2014 shows that the bank has experienced a fairly constant growth in assets and market value of stock, while the number of customers remains stable throughout the period 2010-2014.

Table 11. Wells Fargo financial highlights, 2010-2014

Year (as of)	Mar 31, 2010	Sep 31, 2011	Sep 30, 2012	Jun 30, 2013	Jun 30,2014
Assets	$1.2 trillion	$1.3 trillion	$1.4 trillion	$1.4 trillion	$1.5 trillion
Customers	70 million				
Market value of stock	$162 billion	$127.2 billion	$182 billion	$219 billion	$276 billion

Source: Wells Fargo Quarterly Fact Sheet 1st Quarter 2010, 3rd Quarter 2011, 3rd Quarter 2012, 2nd Quarter 2013, and 2nd Quarter 2014.

Wells Fargo received many awards which reflect its success as a leading and *trustworthy* financial institution[41]. To mention a few, the company has just recently been named the world's most valuable finance brand from the Brand Finance Banking 500[42]. In the past year, its brand value has grown $4.2 billion to reach a total of over $30 billion. Due to its broad range of lending services across categories, together with recovered U.S. economy, Wells Fargo has become the world's most profitable bank, overtaking JP Morgan position in 2014 (Brand Finance , 2014).

Table 12. Wells Fargo's ranking in U.S. financial industry

Types of products and services	**Ranking (U.S. market)**
In supporting homeowners and consumers	
Retail mortgage lender (2014)	1
Home loan originator to minority and low-to moderate-income borrowers, and in low- to moderate-income neighborhoods (2012)	1
Mortgage servicer (2014)	1
Overall auto lender (June 2013- May 2014 excluding leases)	1
Used auto lender (June 2013- May 2014 excluding leases)	1
Provider of private student loans in commercial banking	1
Provider of student loans overall	2
In helping small businesses	
Small businesses lender (U.S. in dollars per 2012)	1
SBA 7(a)[43] lender in dollars (2013)	1
In wealth, brokerage and retirement	
Annuity sales (2013)	2

[41] To see Wells Fargo awards and achievements, visit https://www.wellsfargo.com/about/csr/awards/
[42] The Brand Banking 500 was conducted by Brand Finance, brand valuation consultancy. It ranked the world's biggest banks by their brand value. The result was published is The Banker magazine February 2014 edition.
[43] SBA 7(a) is a type of term loan for small business. For more information, visit https://www.wellsfargo.com/biz/loans_lines/sba/7a_term_loan/

Types of products and services	Ranking (U.S. market)
Full-service retail brokerage provider (2Q2014)	3
Wealth management provider, assets under management of accounts greater than $5 million (2013)	4
IRA[44] provider (4Q2013)	6
Institutional retirement plan record keeper (2012)	8
Family wealth provider (2012)	8 (internationally)
In commercial and residential real estate	
Bond administrator for Commercial MBS[45]	1
Winner of Global PERE Awards North American Debt Provider of the Year (2013)	1
In total commercial real estate originations in the U.S. (2013)	1
Largest servicing portfolio of commercial real estate loans in the U.S. (2013)	1
Affordable housing lender (2013)	3
In insurance	
Nation's largest crop insurance provider (2013)	1
Provider of Health Savings Accounts (HAS) in U.S. (2013)	6
In commercial banking	
Share of lead banking relationships with middle-market companies (2013)	1

Source: Wells Fargo (2014)

[44] Individual Retirement Account
[45] Mortgage-Backed Securities

4.5 Case study #2: Financial education by Itaú-Unibanco

As stated in various research on consumer protection, financial education program should be developed to increase the financial capability of consumers in order to understand financial risks and opportunities, and therefore make informed decisions, know where to go for assistance, and take effective action to improve their own financial well-being (Ruthledge, Annamalai, Lester, & Symonds, 2010) (Organization for Economic Co-operation and Development, 2011).

> "Regulation may protect customers from making bad decisions, but it cannot empower them to make good ones" (HM Treasury 2007:19 in Widdowson & Hailwood, 2007 p.44)

Improving the financial literacy of customers will eventually strengthen banks' business by supporting the long-term financial health of the clients. This will not only help their business grow but also help them avoid defaults and foreclosures. Moreover, healthy customers are likely to expand their use of products and services, including size of their accounts (Bockstette, Pfitzer, Smith, Bhavaraju, Priestley, & Bhatt, Banking on shared value, 2014).

Background

Itaú and Unibanco, two of the largest banks in Brazil, merged in 2008 and created the largest bank in Latin America. Based in Brazil, it operates in 19 countries across South America, North America, Asia and Europe with over 104,000 employees. In 2011, the bank generated total of US$40billion of revenue, gaining almost US$9 billion in net profit (Narsalay, Coffey, Sen, & Pongeluppe, 2013).

Itaú-Unibanco's outstanding business conduct is its microcredit served to the low-incomes borrowers. Unlike its competitors that expand the credit to the poor in rural areas, Itaú-Unibanco focuses on the densely populated surrounding areas of major cities including São Paulo, Rio de Janeiro and Porto Alegre. These three urban areas contribute more than 18 percent of Brazil's population. Low-income market offers huge opportunities for business expansion, however, it comes with potential risk from lack of financial capability and understanding. Therefore the Brazilian bank mitigate the negative circumstances by investing in financial education along with market expansion (Narsalay, Coffey, Sen, & Pongeluppe, 2013).

Corporate sustainability strategy and financial education initiative

Financial education is incorporated in Itaú-Unibanco's strategic focuses accompanied with Social-environmental Risks and Opportunities, and Dialog and Transparency. According to Hill (2013), financial education refers to the understanding of people's needs to offer knowledge and appropriate financial solutions, contributing for individuals and companies to have a healthy relationship with money.

In 2012, Itaú-Unibanco launched a set of initiatives to promote financial education. The campaigns comprise tools, videos, tests, tips, articles, and simulators in various channels to help customers manage their money wisely (Itaú Unibanco Holding S.A., 2012). The Conscientious Use of Money program is a core initiative consisting several components, including the Conscientious Use of Money website which got more than 3,000,000 access in 2012 (Hills, 2013).

Picture 1: Itaú-Unibanco 3 strategic foci

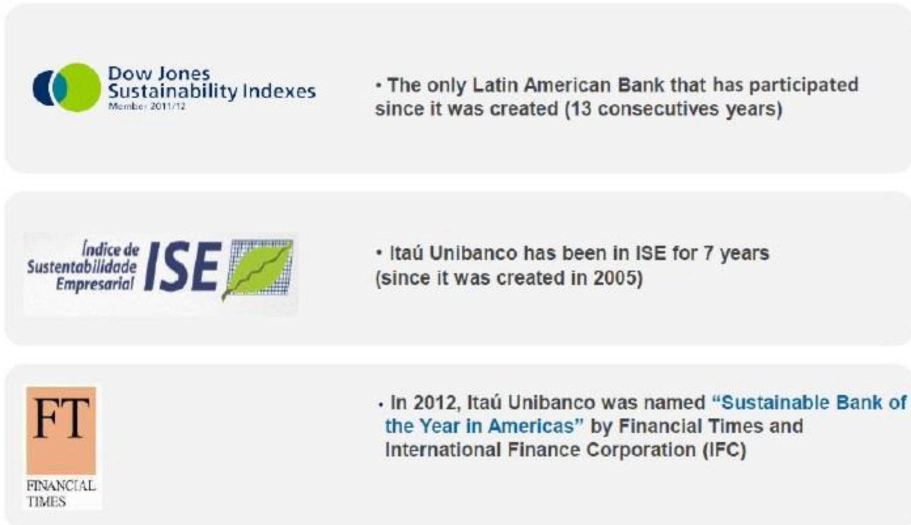
Benefits to the bank

First, financial education campaigns help Itaú-Unibanco strengthen its retail business. Results from 2010 to 2012 show a 56 percent increase in saving of those customers that participated in the program, while their retirement accounts grew 37 percent (Bockstette, Pfitzer, Smith, Bhavaraju, Priestley, & Bhatt, Banking on shared value, 2014).

According to Hill (2013), financial education campaigns have brought benefits to the bank in many ways, 1) Transforming risks into opportunities, 2) Creating synergy within different businesses (investments, credit, insurance), 3) Increasing Market Value, 4) Enable access to new capital sources, 5) Differentiating from the market, 6) Attracting talents, 7) Enhancing long-term decision making, 8) Anticipating tendencies, 9) Improving customer loyalty, and 10) Market leadership into a new economy.

Sustainable practices help strengthen organizational brand value as Itaú-Unibanco received many award at regional and global level. In 2009 and 2010, Itaú-Unibanco had won the award “Emerging Markets Sustainable Bank of the Year” and Regional Winner Latin America. It was elected Sustainable Bank of the Year in the 2011 FT/ITC Sustainable Finance Awards, presented by the British newspaper Financial Times and IFC (International Finance Corporation), the World Bank’s financial arm. The bank was also awarded Sustainable Bank of the Year – Regional Winner Americas, after defeating competitors from Argentina and Mexico. (Itaú Institutional, 2011)

Picture 2: Itaú-Unibanco track record and awards



Source: Hills (2013)

Picture 3: Itaú-Unibanco Brand value

Source: Hills (2013)

Table 13. Financial education programs at Itaú-Unibanco

Financial education programs	Details
Financial education program for clients	
Active management	Clients identified with a high potential for default level are advised to reorganize their loans and to review the use of their income, according to their payment capacity. The approach is made through electronic channels, a specialized service center, and the commercial area
Credit Advisor	Available on the Internet, suggests the type of credit that best suits the needs of customers and noncustomers. If the credit advisor is used via the checking account, it is also possible to confer about the interest rate, term, and limit conditions for the product suggested and for the credit products already contracted by the customer.
Microcredit agents	These agents are trained to provide financial education advice to customers. Using tablets, these agents help customers analyze loans and present educational videos related to conscious use of money.
Entrepreneur Notebook	It advises micro-entrepreneurs on the management of their finance, providing control and transparency for expenses, revenue, and inventory. In 2013, a total of 1,000 copies of this handbook were distributed.
Financial education of investors and potential investors	A methodology that helps in the building of retirement funds. Incorporated into the process of sales of pension fund products, this methodology simplifies the monitoring and recommendations for the building of retirement funds. Investment managers and consultants were trained through presentations, videos, and simulators. In addition, a communication and education campaign about investments and pension funds was executed.
Family Wealth Across Generations Program	Executed annually, addresses family wealth management. In effect since 2008, it has engaged more than 1,000 people among the children of customers of various nationalities (Brazilian, Chilean, Argentinean, and Uruguayans).
Investment Workshop	On a quarterly basis, discussions are held about basic investment principles such as asset management, fixed-income markets, alternative and international investments, and portfolio diversification.
Financial education initiatives for clients and non-clients	
Conscious use of money Website	Advises clients and non-clients how to make the best decisions about their money. The channel has simulators, tests, articles, tutorials, videos, and podcasts on topics such as breaking into the black, saving without giving up consumption, talking about finances with your family, and choosing the best credit, among others. Visitors can send in their questions, which are answered by specialists from the institution. In the first eight months, the website *www.itau.com.br/usoconsciente* registered approximately two million hits.
Conscious use of money Guides	Using simple and informative language, the guides offer tips on how the wise use of money contributes to meeting objectives. The guides are available at bank branches and on the website

Financial education programs	Details
	www.itau.com.br/usoconsciente. A few examples of topics are Consuming and Saving; Use Your Money Wisely; The Best Credit for You; Break Into the Black; Family and Money; and Extra Cash! What Now?
Guide on How to Talk About Money with Children	This guide stimulates parents and educators to introduce and to discuss the topic at home and in schools. In its digital version, the guide is available at the conscious spending portal.
Communication campaign and education about conscious credit	YouTube tutorials about the use of each credit product and the importance of making conscious choices. Visit *www.itau.com.br/creditoconsciente*.
Communication and education campaign about investments and pension funds	Launched on YouTube in 2011, the *Invista Channel* offers tutorials, simulators, and educational games about investments. As of the end of 2013, it had over 10 million views. The idea is to foster reflection about the importance of having a cash reserve for eventual emergencies and about how to invest money to build wealth.
Expo Money	In 2013, the bank took part in its nine editions, giving 43 lectures to approximately 3,400 people.

Source: Itaú Unibanco Holding S.A. (2013)

4.6 Situation in Thailand

4.6.1 Legal basis for consumer protection

- **The constitution of the Kingdom of Thailand, Section 61 and 84**

Consumer rights in Thailand were enshrined for the first time in Article 57 of the 1997 Constitution. In that constitution, the rights of consumers in Thailand are protected under Section 61 and 84 as follows:

> ***Section 61***
> *(1) Consumers shall have the right to receive factual information*
> *(2) Consumers shall have the right to make a complaint for remedy (redress)*
> *(3) Autonomous consumer protection organization*
>
> ***Section 84***
> *(1) The State shall regulate business activities for free and fair competition, anti-monopoly and consumer protection*

- **The Consumer Protection Act, 1979 (revised 1998)**

The broad rights of the consumer are outlined in this Act as follows:

> (1) The right to be informed of the appropriate and correct description and quality of goods or services;
> (2) The right to freely choose or seek goods or services;
> (3) The right to safe goods or services;
> (4) The right to fairness in contracts;
> (5) The right to be heard by appropriate competent authorities, as well as the right to be compensated in case where consumer experiences damages resulting from a violation of consumer's rights.

- **The Unfair Contract Terms Act, 1997**

Recognizing that consumers are generally disadvantaged in their ability to negotiate contracts with business entities, this law identifies "unfair" contract terms and provides legal consequences for businesses convicted of undertaking unfair contract terms.

The "Committee on Contracts", whose members are nominated by the Consumer Protection Board, is responsible for overseeing the fairness of contractual arrangements with consumers. This committee has control over contracts associated with; credit cards, vehicle hire purchase and the sale of condominium units. It is currently considering expanding its purview to include loans by financial institutions, mobile phone services, and sale of real estate.

Due to the high incidence of complaints with regard to credit card contracts, the Committee on Contracts has issued in the Royal Gazette guidelines to be followed in the preparation of credit card contracts. These include a list of prohibited (unfair) clauses, as well as a list of required clauses aimed at protecting the interests of users of credit cards.

- **The Financial Institution Business Act, 2008**

Section 39 empowers the Bank of Thailand (BOT) to regulate banks for consumer protection.

Section 38 and 40 require prominent disclosure of interest rates and fees, and grant BOT the right to issue the standard for the calculation of interest. In 2005, the Bank of Thailand issued a notification that established a uniform standard for commercial banks to publish their deposit interest rate, interest rates for commercial and consumer loans, together with the fees and expenses associate with credit extensions.

- **Trade Competition act, 1999**

The principal legislation governing competition law in Thailand is the Trade Competition Act of 1999 (TCA). The TCA came into effect on 30 April 1999. The enforcement agency for TTCA is the Trade Competition Commission (TCC).

- **Deposit Protection Act, 2008**

The Deposit Protection Agency (DPA) was established under the Deposit Protection Agency Act which became effective on 11 August 2008 following the Asian financial crisis. Specialized Financial Institutions (SFIs) do not pay deposit insurance premiums, although there is an implicit government guarantee on SFI deposits. Commercial banks pay a premium to the DPA which provides an insurance of 1,000,000 Baht per account per bank (until August 2015). The DPA Fund is comprised mainly of contributions by commercial banks which are calculated based on a prescribed percentage of the balance of their deposits that are protected under the DPA Act. This percentage was 0.4% of deposits until March 2012 when the contribution rate was reduced to 0.1%.

- **Credit Information Business ACT 2002**

Privacy of credit information is taken seriously in Thailand and is specifically safeguarded by the Credit Information Business Act 2002. This law governs the legal operation of Credit Information Companies such as NCB. To oversee the implementation of this act the Ministry of Finance has established a Credit Information Protection Committee (CIPC).

All SFIs, commercial banks, and regulated Non-Bank Financial Institutions (NBFIs) are required to protect personal data collected from clients and prevent leakage of this data to third party organizations. In the case of institutions reporting to the National Credit Bureau (NCB) clients are asked to sign a form providing consent for the financial institution to pass on credit history information to the NCB.

- **Regulation regarding the prevention of over-indebtedness**

There is no particular legal basis regarding the prevention of over-indebtedness in Thailand. Rather, financial authorities leave requirement of specific due diligence mechanism to be undertaken by financial institutions themselves, assuming that risk of loan losses in itself will ensure prudence on behalf of the lender.

The primary instrument used by the BOT to restrict household debt levels is to raise the base interest rate; which hopefully provides a disincentive for individuals and businesses to borrow money.

- **Regulation regarding the protection against inappropriate selling practices**

In 2012, The Bank of Thailand issued a circular regarding the selling of security and insurance products that require the commercial banks to disclose information related to product offering to customers sufficiently and appropriately, as well as to protect the consumer rights of customers.

This is due to the fact that the BOT received many complaints from consumers regarding "forced" product bundling offered by the banks. To illustrate, the commercial banks pressured customers to accept life insurance products in order to obtain loans, or in case that the banks offered such complex product as security or insurance without properly informing relevant risks to customers.

Authorities responsible for consumer protection in Thailand

The Office of Consumer Protection Board (OPCB), under the Office of the Prime Minister, has the overall responsibility for consumer protection in Thailand. With regard to financial services, OCPB has regulations on Credit cards, Hire purchase cars and motorbikes, Hire purchase electrical items, and Loans for personal use, and co-operates with each of the relevant financial authorities for the purposes of public relations and dispute resolution. OPCB oversees random investigations to ensure financial institutions are complying with regulation on loan contracts, and also undertakes investigations in responsible to complaints with regard to deceitful advertising

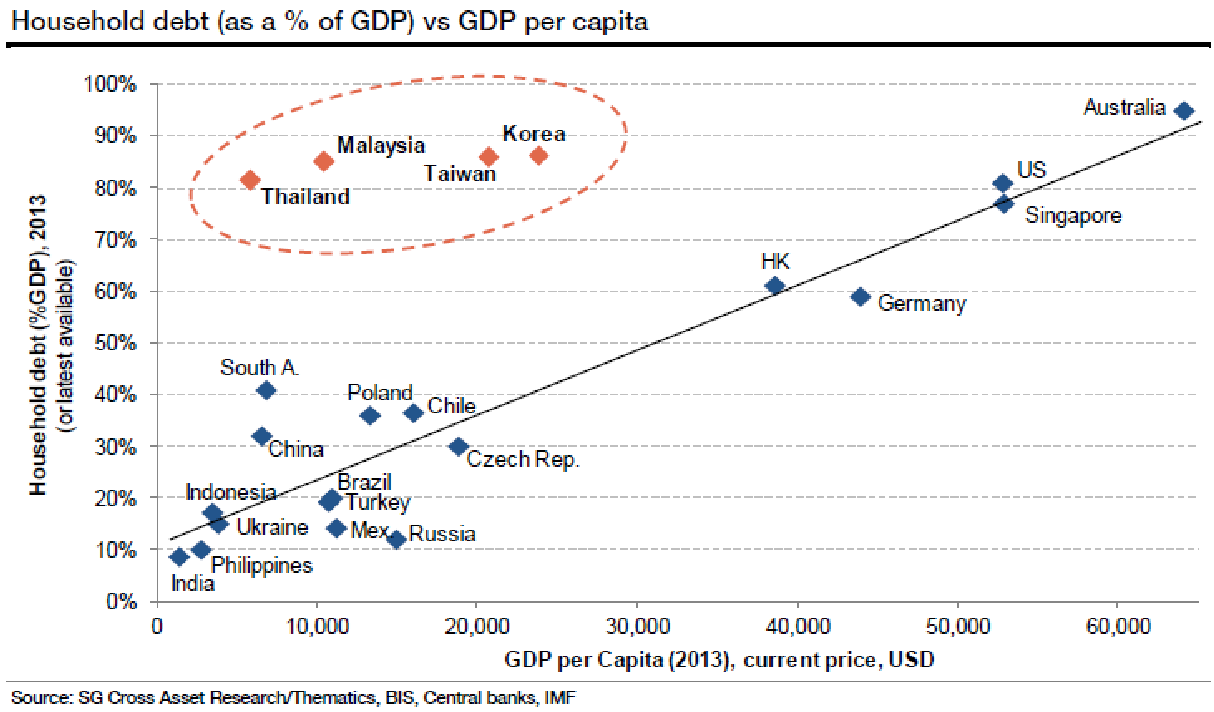
The Bank of Thailand has set up the Financial Consumer Protection Center (FCPC, hotline 1359) in January 2012 with aims to systemically enhance its financial consumer protection mandate. The FCPC was tasked with two main responsibilities: First, to serve as a one-stop service center for complaints handling and enquiries pertaining to financial products and services provided by the financial service providers under the Bank of Thailand's supervision. FCPC's services also include providing information and advices regarding the matters under the Bank of Thailand's purview such as banknotes, government bonds and debt securities as well as foreign exchange regulations. Second, to equip consumers with financial knowledge in order to raise awareness and understanding of consumer rights and responsibilities, enable informed decision making, and avoid becoming victims of fraud.

Specialized Financial Institutions are supervised by the Bureau of Financial Policy and Financial Institutions within the Ministry of Finance. The responsibility for consumer protection lies with the Bureau of Financial Inclusion Policy Development (FIPD).

4.6.2 Lending practices and household debt situation

As of 2014, household debt in Thailand had been increasing for several years, reaching 82 percent of GDP, making it among the most indebted country in Asia in terms of this data, alongside Malaysia, Taiwan, and South Korea. In a press release in April 2014, FitchRatings warned that "Systemic risks would rise if household debt growth does not slow down. These risks could become an increasing source of asset-quality problems - particularly if a worse-than-expected slowdown amidst Thailand's political turmoil results in sharp rises in unemployment and inflation. This increases the contingent liability risk the sovereign could face if support for the banking sector is required in the event a large economic shock undermines capacity for households to service debt."[46]

Figure 11. Household debt as % of GDP vs. GDP per capita



The first FinScope nationwide survey in Thailand, conducted in 2013 as part of ADB's Financial Inclusion research project conducted for the Ministry of Finance, across 6,000 adult individuals provides some interesting opportunities to analyze the nature of indebtedness in Thai households. Some key findings include:

- Of households currently with outstanding debt (44%), 38% of these believed that they were over-indebted.
- At least 12% of all borrowings are taken out in order to repay other debts.
- Among the indebted the poor are more over indebted; those with monthly income is below 3,000 Baht have debt burdens of nearly 3 times their annual income (most probably nearly all consumption debt).
- Village Funds, savings groups and moneylenders and SFIs that serve poorer households.
- Farmers (62%) are the most indebted group in Thailand followed closely by government employees (59%).
- While these government employees represent only about 4% of the population they hold about 12% of total individual debt.
- Informally employed such as farmworkers and those receiving wages from an individual (e.g. domestic workers), and those relying on remittances; are also commonly indebted but are only able to borrow small amounts through mostly informal sources.

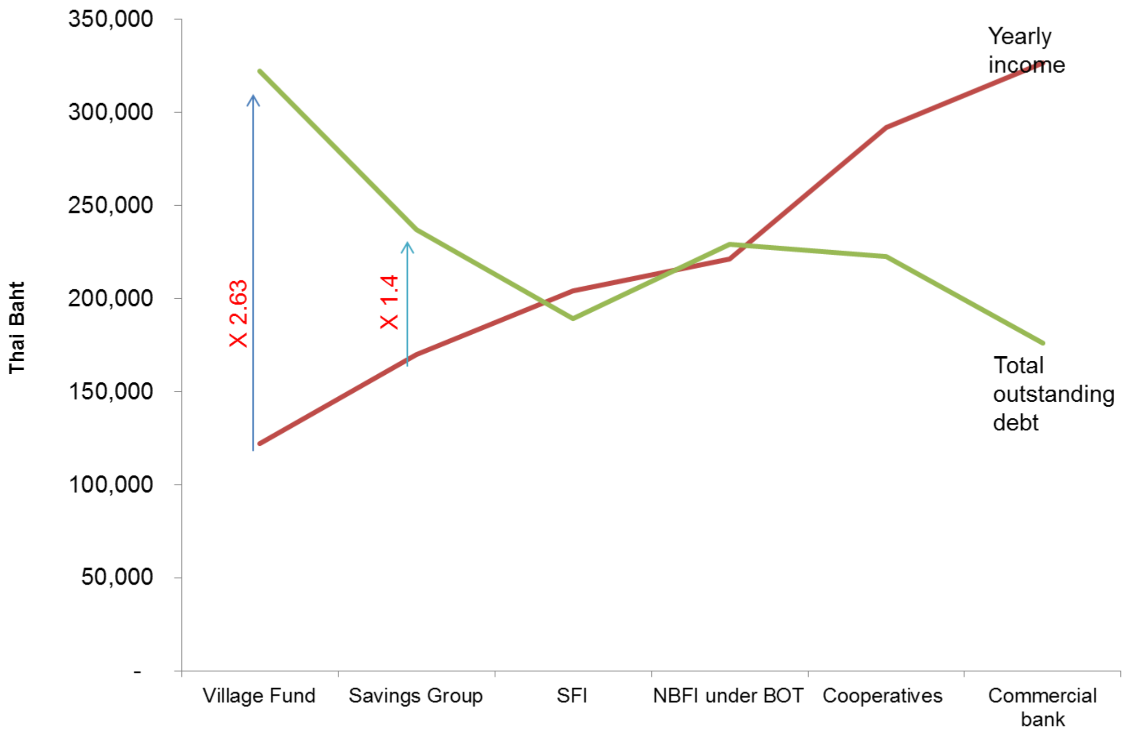
[46] Fitch Wire. "Thai Household Debt Growth Threatens Bank Asset Quality," April 1, 2014. Retrieved October 31, 2014. https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/Thai-Household-Debt?pr_id=825711

- Levels of savings in Thailand are not very high by global standards. In contrast to debt at 77.7% of GDP, in 2011, household savings were 5.3 percent of GDP, and 45 percent of households, or 9.09 million, were not capable accumulating any significant savings.
- 64% of individuals save less than 2,000 Baht per month.

Qualitative demand-side research conducted in 2013 in the same ADB project revealed a number of market conduct concerns in the provision of credit to the low-income market.

1. Exclusion from credit
2. Inappropriate timing of loan disbursement
3. Inappropriate loan repayment schedules
4. Slow loan approval procedures with excessive documentation requirements
5. Unethical debt collection practices

The 2013 FinScope Survey also reveals that borrowers of village funds and savings groups, who tend to have lower income and reside in the rural areas compared to consumers of commercial banks, have much higher debt burden relative to their income than other borrower groups. This suggests that integrating financial education as part of delivering retail products would be essential for any financial institution that aims to target low-income markets in Thailand, whether or not the bank subscribes to 'responsible lending' ethos and standards. (See more details in Chapter 6. Improving Financial Access)



Source: FinScope Thailand 2013

Debt collection practices

Debt collection practice of the commercial banks in Thailand is increasingly outsourced to debt collection agencies or legal firms. In the latter case, abusive collection practices are still fairly common judging from consumer complaints (see more details in Section 4.6.3. of this report). Many such outsourced debt collectors harass borrowers in their homes or by telephone at all hours of the day and night. In addition, debt collection staffs within some banks are also inclined to use abusive behavior due to their KPIs (key performance indicators) relating to the cost effectiveness of their debt collections.

The smaller and less reputable consumer finance companies, on the other hand, have notoriously unethical debt collection practices. Customers from Bangkok slums mentioned that the moneylenders commonly used public humiliation, contacted relatives and employers, and even threaten physical violence in order to recover loan. Moreover, respondents alleged that the police did not respond to complaints in regarding these issues and that perhaps they were paid by the moneylenders to turn a blind eye.

Many banks nowadays require borrowers to establish direct debit loan repayment amounts from the borrowers' savings account, occasionally resulting in their savings accounts becoming completely depleted, leaving nothing to cover essential daily expenses.

Fair Debt Collection Practices Act, 2015

In 2008, the Bank of Thailand issued a guideline for debt collection practices to prescribe banks and BOT supervised NBFIs in order to protect consumer against unethical debt collection behaviors. This BOT debt collection standard provides general practices regarding debt collection, hiring agency, and complaint mechanism. Despite providing this guideline, many consumers still face unethical debt collection behaviors because this guideline is merely a suggestion, lacking an enforcement power and mechanism.

The fair debt collection practices act, proposed by National Legislative Assembly in 2014 and passed by National Legislative Council in 2015, provides significant development of debt collection practices at least in two ways: Firstly, as an Act of Parliament, it has enforcement power in general, not only to banks and BOT supervised NBFIs as in the BOT guideline, and thereby obligates the court to enforce this Act. Secondly, under Section 3, it provides both administrative punishment and criminal punishment for those who not comply with the law.

This act also provides mechanism to manage unethical debt collection behaviors more systematically by founding "Debt Collection Committee". This committee has power to consider complaints and has the right to withdraw debt collection license for those who do not comply with the law.

Other interesting articles in this law are as follows:

- Article 5: debt collection agencies must officially register to the government body, and must comply with the given laws
- Article 8: debt collector must disclose their identity when contacting borrowers, and must not divulge borrower's debt information to anyone else other than his or her spouse, parents, and/or children. Debt collector must contact the borrower between 8.00 am to 8.00 pm on weekdays, and between 8.00 am to 6.00 pm on public holidays.
- Article 10: debt collector must not deceive the borrower by acting as if they are government officer, national credit bureau officer, or lawyers, and must not mislead the

borrower into thinking that the debt collector can legally confiscate assets or sue the borrower.

Privacy of client data

In Thailand, privacy of client data has not been a key element of consumer protection regime, which partly reflects the overall lack of awareness of financial consumers as to the importance of privacy protection. As at the end of 2014, Thailand does not yet have a national personal data protection law. Many complaints regarding inappropriate use of client information refer to debt collection process as explained above.

Disclosure transparency

Currently, BOT requires financial institutions under its supervision to conform to a standard publication of deposit interest rate, effective annual interest rates for commercial and consumer loans, together with the fees and expenses associate with credit extensions. However, the Thai Retail Credit Bank stated that this policy is not implemented effectively to all banks. TCRB's Mass Communication Department (MCD) receive many customer queries regarding its published "effective" interest rate, which is higher than other bank's published "flat" rates.

Furthermore, even if consumers have access to comparable interest rates, it is difficult to customers to calculate the financial impact of fixed fees on the full cost of credit. This is because there is still no regulation that mandates standardized disclosure of Annual Percentage Rate (APR) in Thailand. In the United States, the calculation and disclosure of APR is governed by the Truth in Lending Act. The APR is expressed as the periodic interest rate times the number of compounding periods in a year (also known as the nominal interest rate) and must include certain non-interest charges and fees. The APR must be disclosed to the borrower within 3 days of applying for a mortgage. This information is typically mailed to the borrower and the APR is found on the truth in lending disclosure statement, which also includes an amortization schedule.

For further information and example of retail product disclosure in Thailand, see Section 4.6.4. (the comparison of credit card application forms) in this report.

Responsible pricing

Despite the fact that BOT and MOF enforces interest rate caps (28% per annum for consumer loans under BOT regulation) for both formal and semiformal lending, some financial institutions avoid this regulation through fixed bank fees which could add a significant amount to total borrowing cost. It is difficult for authorities to monitor non-standard fees that financial institutions may impose.

In 2013, the Foundation for Consumer reported that one common consumer complaint is that some financial institutions charge 500 Baht as fee for late payment, even on small loans and even if the payment is only one day late, and even when lenders only send repayment reminder via phone messages (SMS), which costs less than 5 Baht per message.

Another approach to avoid the interest rate cap is done through cooperation between finance company and retail store, by increasing prices for goods purchased. The finance companies usually tempt buyers by offering "0% interest over a 12 month loan repayment" promotion. However, the price of goods may be as much 30 or 40% higher than the cash price, resulting in effective interest rates of 30-40%.

In case of the informal sector, there are no effective controls over the rates charged to their customers. Moneylenders are particularly known to charge from 3% per month to 3% per day (36% to 1,000% per annum).

Responsible lending and over-indebtedness

Intensely competitive market, all commercial banks are well equipped with tools and processes in order to best serve their customer. The banks commonly make sure that the customers fully understand the details and the obligations of the products for which they are signing up by providing detail fact sheets and Q&A sessions to customers. The banks also have Know Your Customer (KYC) and Customer Due Diligence (CDD) requirements and processes which are designed to deliver loan products that are appropriate to each customer. This process involves an attempt to analyze borrowers' profiles such as occupation, salary, and household or business cash flow. This process, however, is problematic for customers employed in the informal sector wherein such information is not well documented.

In Thailand, BAAC which dominates the formal microfinance market has not undertaken a systematic approach to market segmentation and adaptation of its products according to the needs of individual market segments. Lack of effective competition to BAAC has removed the imperative to continually modify its financial products in accordance to individual needs. Rather than responding directly to the needs of its clients, BAAC is required to respond to the directives of the government in terms of product policies, which unfortunately cannot be intimately aware of the needs of different market segments of BAAC clients. The Village Funds, savings groups and village moneylenders operate in the same market as BAAC yet have insufficient capital to provide substantial competition; consequently, BAAC continues to hold the dominant share of the market for microfinance.

BAAC has been the major implementing arm of the Royal Thai Government policy for reducing indebtedness to moneylenders. BAAC has, to its credit, recognized the inability of many of its clients to provide collateral for loans (e.g. land titles) and provides loans to low income households using group guarantees instead of physical security. Yet BAAC is still legally obliged to require identification documents for all its loan clients and this is a major obstacle for access by the many millions of Burmese, Laotian and Cambodian illegal migrants, some of whom are second or third generation Thai residents.

By providing loans secured by group guarantee, BAAC has provided a facility to purchase debt from informal moneylenders. As this is, by necessity, and informal process, it is difficult to know whether this has resulted in transfer of all money lender debt to BAAC's lower interest facility, or whether in fact this has simply allowed these borrowers to re-borrow from moneylenders and increase their level of indebtedness. Unfortunately there are no before-and-after studies on the level of borrowing from moneylenders.

The National Credit Bureau (NCB)

The National Credit Bureau (NCB) provides an important service to prudent lenders, allowing them to determine some of the pre-existing liabilities of loan applicants and their on-time repayment record. The NCB, however, at this stage only really provides effective credit reference information for financial institutions catering to the middle income market. Major lenders to the low income market, such as BAAC, the Village Fund, AEON and the many credit cooperatives, savings groups and informal lenders; do not report to NCB. Furthermore, these low income households often receive most or all of their income from the informal sector and have very limited documentary evidence of their income and expenditure. Consequently, lenders to the low-income market cannot rely on NCB credit information to assess existing liabilities of potential customers, or to undertake accurate cash flow assessments.

Dispute resolution and recourse

Financial institutions

All commercial banks and BOT-regulated NBFIs are required to have in place complaint facilities at each of their branches and a complaint hotline. This is also required by MOF for the SFI banks. These institutions are also required to provide facilities for customer complaints and suggestions.

Higher level of complaint resolution

For receiving complaints OCPB has a hotline (1166) and prepaid complaint lodgment forms with 7-11 stores. OCPB is also represented in every Provincial Governor's Office.

FCPC will serve as a one-stop service for complaints handling pertaining to financial services providers under the Bank of Thailand's supervision, such as banking and financial related services. It will serve as a coordinator between complainants and financial service providers under the Bank of Thailand's supervision in order to solve problems and follow up on complaints being filed. Customers can either contact FCPC via hotline 1213, or directly walk-in to FCPC head office in Bangkok and regional offices in Chiang Mai, Khon Kaen, and Songkhla. For complaint handling, the task is divided into 2 tiers. The FCPC and Regional Offices serve as tier 1 to response to non-complex enquiries. However, for complex cases, they will be forwarded to Financial Institutions Monitoring and Analysis Department for further coordinating with financial service providers in question. In order to ensure appropriate policy formation and market conduct supervision, the FCPC also sends reports to the Financial Institutions Policy Group and Supervision Group to give feedback on consumers' complaints and enquiries. Some issues gathered from consumer complaints are used as inputs in the formulation of supervisory policy.

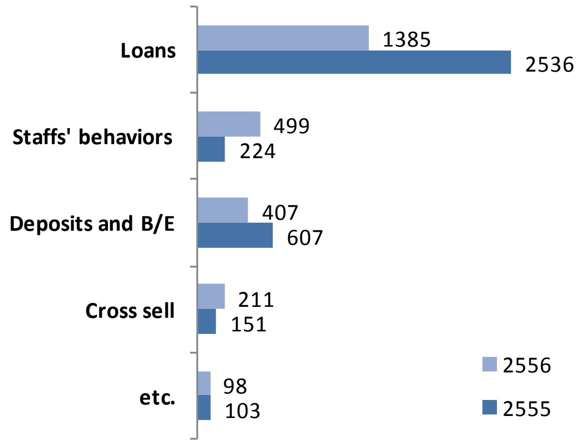
Customers of Specialized Financial Institutions SFIs are referred to the Ministry of Finance. The Ministry of Finance provides a national call center (hotline 1359) through which customers with complaints that are not able to be dealt with by individual SFIs are able to be directed through to FIPD. It appears that the availability of this facility is not well understood by the general public as relatively few calls are received.

4.6.3 Common financial consumer complaints in Thailand

There are currently three major outlets that receive complaints from financial consumers in Thailand: the Financial Consumer Protection Center (FCPC) run by the Bank of Thailand, the Foundation for Consumers, and the call center run by the Ministry of Finance which handles specifically complaints regarding SFIs and informal lenders.

Complaints statistics for the year 2013 from the FCPC and Foundation for Consumers, which encompass many complaints about commercial banks, are summarized and discussed in this section.

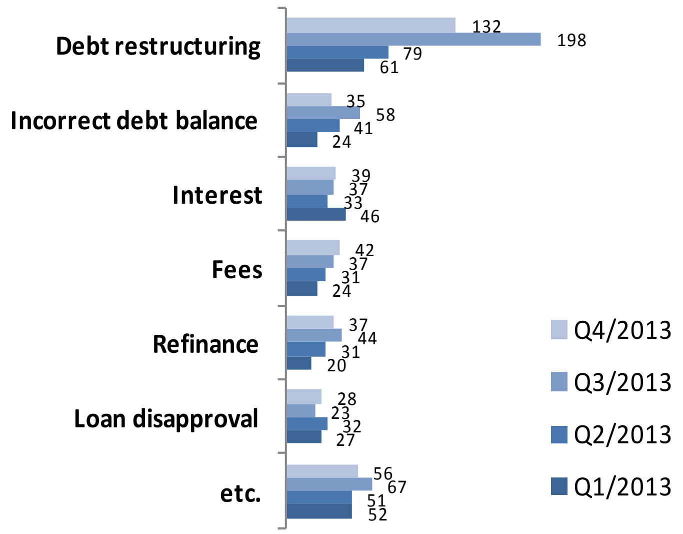
Summary of Financial Consumer Protection Center Report 2013



Between B.E. 2555 – 2556 (2012-2013 A.D), the issue that consumers complained the most is loans, specifically concerning personal debt restructuring, followed by alleged problem that financial institution reports incorrect data of deposit, withdrawal, and transfer transaction, and the third is about abusive collection practice.

Details of most complaints can be summarized as follows:

1. Loans

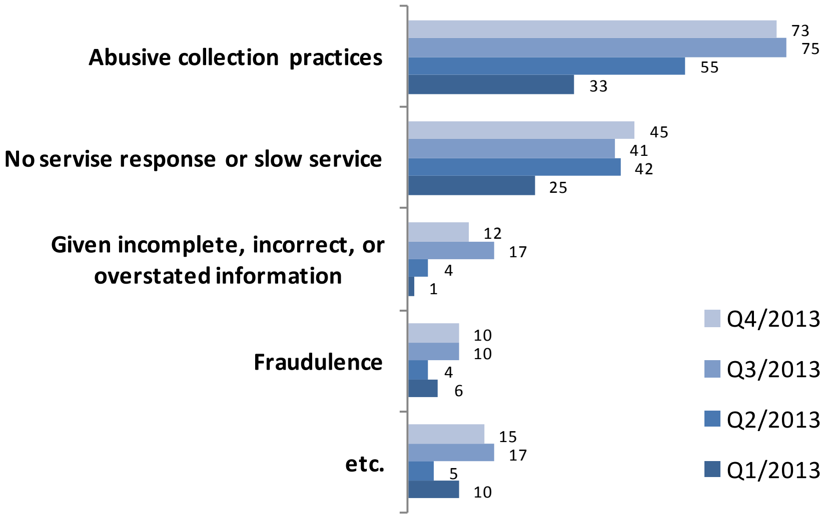


Loans product which received the highest number of complaints is credit card, followed by personal loan, commercial loan, and hire purchase respectively.

Important issues can be summarized as follows:

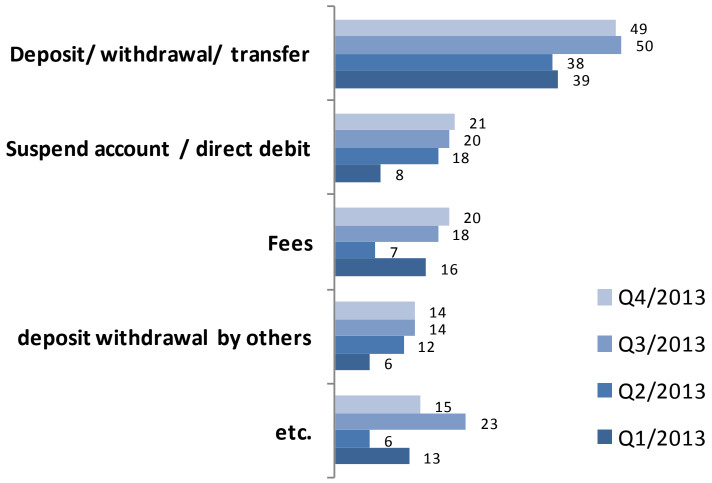
- Debt restructuring: request for assistance about debt restructuring or decreasing interest and fees, especially for credit card and personal loan.
- Incorrect debt balance: mostly on credit card or cash advance card, inquirer stated that they already requested officers to close their account, but they were still receiving card invoices and asking to pay their debt.
- Interest and fees: interest calculation is incorrect or not abiding by contract and fees for late payment is inappropriate.

2. Staff behaviors



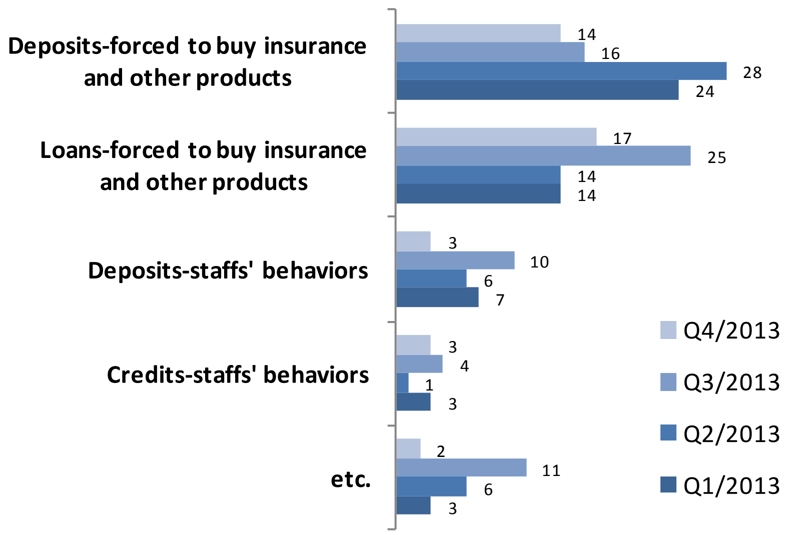
Most complaint regarding staffs' behaviors is about abusive collection practices i.e., threatening or harassing borrowers. The second-highest complaint is about no service response or slow service; for example, many consumers reported that financial institutions did not respond to calls to cancel credit card and request for debt invoice. As for the example of what is viewed as "fraudulent" sales, many consumers complained that bank officers forced them to buy insurance in order to apply for a loan. When the loan application was rejected, the customers could not cancel this insurance.

3. Deposit and Bills of Exchange (B/E)



Complaints regarding deposit and B/E are mostly about transactions via ATM and ADM. The second problem is due to suspending customer account without prior notice. The third most frequent complaint is about fees, which are collection fees in order to maintain account and transaction fees of electronic card.

4. Bundled products



Many bank employees forced customers to buy ATM or Debit card which is bundled with an insurance product by telling customers that they ran out of an ordinary card without insurance. This problem also occurred with housing loan product. Customer did not know that they already bought insurance until financial institutions deduct insurance premium from their loan repayment. Another problem is that officers always given vague information to customer, making customer misunderstand or not fully recognize whether they have bought an ordinary deposit product or a life-insurance product that is bundled with deposit.

Summary of Financial Complaints statistics by Foundation for Consumers 2011-2013

Aside from Financial Consumer Protection Center at BOT, leading consumer protection NGO called Foundation for Consumers actively engages in receiving complaints regarding financial consumer protection, and acts as an advisor to those who faced unfair practices by financial institutions.

Table 14 shows summary statistics of financial complaints to the Foundation for Consumers between 2011 and 2013:

Table 14. Types of complaints on financial services made to Foundation for Consumers, 2011-2013

	Financial compliants	2011		2012		2013	
		number of complanits	portion	number of complanits	portion	number of complanits	portion
1	Late payment	296	63.5%	195	63.7%	190	55.6%
2	Being prosecuted	34	7.3%	17	5.6%	49	14.3%
3	Abusive collection practices	62	13.3%	46	15.0%	36	10.5%
4	Contract default by Financial institutions	42	9.0%	18	5.9%	30	8.8%
5	Refinance	10	2.1%	9	2.9%	14	4.1%
6	Banks' fee	3	0.6%	5	1.6%	7	2.0%
7	Unfair fees or interest	3	0.6%	8	2.6%	5	1.5%
8	Direct debit loan repayment	3	0.6%	4	1.3%	3	0.9%
9	Document crimes	6	1.3%	0	0.0%	2	0.6%
10	ATM/Debit card	4	0.9%	1	0.3%	2	0.6%
11	National credit bureau	2	0.4%	2	0.7%	1	0.3%
12	etc.	1	0.2%	1	0.3%	3	0.9%
		466	100.0%	306	100.0%	342	100.0%

Source: Foundation for Consumers

Financial complaints data provided by Foundation for Consumers shows another distinctive consumer vulnerability which is not thoroughly included in the Financial Consumer Protection report. This vulnerability is over-indebtedness problem. A number of complaints regarding late payment, being prosecuted, refinance, and direct debit loan repayment, which indicated over-indebtedness problem, approximately account for 75% of total complaints.

Foundation for Consumers explained that many consumers have household expenses greater than their income, and have several credit cards and/or personal loans. A number of borrowers are fall into a debt vicious circle, crossing financing loan repayments from other loans. Also, many consumers complained that banks' fees and interest are too high, and that banks' fee is unfair, given that only one day late payment is as high as 200 to 450 Baht regardless of debt balance.

Contract default or misuse by financial institutions, mostly related to insurance products, is one of the main complaints. For example, many consumers complained that they did not receive the right amount of insurance payments according to the insurance policy, and many complained that they were forced to buy insurance policy as a bundle with loan product without their consent. Many of these policies list the bank as main beneficiary of insurance policy payouts, although the bank has no valid insurable interest.

The foundation for Consumers also provided this research team with financial complaints statistics by name of financial institution that is the target of complaint. The result is shown below.

Table 15. Complaints by name of financial institution, 2011-2013

	Commercial bank	2011		2012		2013	
		number of complanits	portion	number of complanits	portion	number of complanits	portion
1	Kasikorn Bank	22	11.2%	15	10.3%	27	19.4%
2	Citibank	49	24.9%	27	18.5%	25	18.0%
3	Bank of Ayudhya	12	6.1%	12	8.2%	18	12.9%
4	Siam Commercial Bank	24	12.2%	13	8.9%	14	10.1%
5	UOB	7	3.6%	10	6.8%	12	8.6%
6	Krungthai Bank	24	12.2%	26	17.8%	8	5.8%
7	TMB Bank	4	2.0%	4	2.7%	7	5.0%
8	Thanachart Bank	8	4.1%	6	4.1%	5	3.6%
9	Bangkok Bank	13	6.6%	5	3.4%	4	2.9%
10	Standard Chartered	10	5.1%	7	4.8%	4	2.9%
11	Government Saving Bank	7	3.6%	5	3.4%	4	2.9%
12	HSBC	6	3.0%	8	5.5%	3	2.2%
13	Government Housing Bank	5	2.5%	3	2.1%	2	1.4%
14	Tisco Bank	3	1.5%	1	0.7%	2	1.4%
15	CIMB	1	0.5%	0	0.0%	2	1.4%
16	Siam City Bank	1	0.5%	2	1.4%	1	0.7%
17	Kiatnakin Bank	1	0.5%	1	0.7%	1	0.7%
18	BAAC	0	0.0%	1	0.7%	0	0.0%
		197	100.0%	146	100.0%	139	100.0%

Source: Foundation for Consumers

	Non Bank Financial Institutions	2011		2012		2013	
		number of complanits	portion	number of complanits	portion	number of complanits	portion
1	Easy Buy	40	17.5%	23	18.5%	47	25.7%
2	AEON	41	17.9%	33	26.6%	40	21.9%
3	Ayudhya Capital Services	38	16.6%	18	14.5%	15	8.2%
4	KTC	14	6.1%	8	6.5%	12	6.6%
5	Tesco Card Services	5	2.2%	1	0.8%	4	2.2%
6	Settelem	6	2.6%	8	6.5%	8	4.4%
7	General Card Services	11	4.8%	4	3.2%	7	3.8%
8	Citicorp Leasing	12	5.2%	3	2.4%	12	6.6%
9	Promise	4	1.7%	1	0.8%	7	3.8%
10	Others	58	25.3%	25	20.2%	31	16.9%
		229	100.0%	124	100.0%	183	100.0%

Source: Foundation for Consumers

From both FCPC and Foundation for Consumers complaint statistics, it is clear that Thai financial consumers are mostly troubled by debt, but the over-indebtedness problem may not be indicative of the borrowers' inability to repay alone; it could be indicative of insufficient terms disclosure on the lenders' part as well – see next section for more detail.

4.6.4 Comparing credit card application disclosures

Although Thailand has a financial consumer protection regime in place, this regime currently falls short of international standards, such as The World Bank Good Practices for Consumer Protection and Financial Literacy, in some key areas. For example, there is still no standardized APR (Annual Percentage Rate) regulation, no mandatory cooling-off period, and no standardized loan application forms, allowing many banks to disclose little or no details about relevant fees and interest rate calculations. This gives rise to widely divergent quality of financial product disclosures, as illustrated in our short survey of commercial banks' credit card application forms. The results are summarized in Table 16.

Table_16. Comparing disclosures of commercial banks' credit card application forms

	Commercial Bank										
Bank:	Krung Thai Bank PCL	Siam Commer-cial Bank PCL	Kasikorn Bank PCL	TMB PCL	BAY PCL	Bangkok Bank PCL	CIMB THAI PCL	Thanachart PCL	UOB PCL	Standard Chartered Bank (Thai) PCL	ICBC (Thai) PCL
Card:	KTC Credit Card	SCB Credit Card	K-Credit Card	TMB Credit Card	Krungsri First Choice	BBL Credit Card	CIMB THAI Credit Card	Thanachart Credit Card	UOB Credit Card	Standard Chartered Credit Card	ICBC Credit Card
Clear Interest rate	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Clear Fees	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes
Clear Penalty	Yes	Yes	Yes	No	Yes	No	Yes	No	Yes	Yes	Yes
Clear Installment payments	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	No	Yes	Yes
Font size (1=best)	4	4	3	2	1	5	5	1	4	1	5
Cooling-off period	No	No	No	No	No	No	No	No	No	No	No
Language simplicity (1=best)	3	4	2	2	3	3	3	3	1	5	3
Confidentiality protection by default	Yes	No	No	No	Yes	No	No	Yes	No	No	Yes

4.6.5 Other recent issues in Thai retail banking

Controversial Amendments to Civil and Commercial Code

On November 13, 2014, important amendments to the Civil and Commercial Code which were passed by the National Legislative Assembly were announced in the Royal Thai Gazette, and later became effective on 12th February 2015. The amendments are aimed at protecting the rights of guarantors and mortgagors who are not principal debtors. Legislative research revealed that creditors, largely financial institutions, are in a position that is too powerful in relation to the aforementioned types of debtors, who are mostly members of the public.

The amendments serve as consumer protection mechanisms. Before the recent amendments, those who acted as guarantors of debts were unprotected against unjust and/or overreaching actions on the part of the creditor, which is normally a commercial bank. Such actions included forcing the surety to be liable for the full amount of the debt beyond the amount actually guaranteed by the surety.

While most of the amendments are not retroactive, several clauses do apply to existing contracts such as loan guarantees by commercial banks, as well as export credit guarantees, letters of credit, and international borrowing. These amendments immediately caused concerns for Thai bankers and the Bank of Thailand; some said that the amendments may bring down the whole economy. Major concerns involve secured lending transactions especially for small and medium businesses. Some bankers said that banks may now have to require more collateral, including joint debtors, instead of personal guarantees, due to more stringent legal protection of the guarantor.

Some major changes are as follows:

Section 681.
"Suretyship can be given only for a valid obligation. A future or conditional obligation may be secured for the event in which it would have effect. However, it must be specified as to the purpose of the debt, the characteristics of the basis of the debt, the maximum amount of money that is secured, and the duration of the debt that is secured….

"The suretyship contract must clearly specify the debt or the contract that is secured and that the surety assumes liability only for the aforementioned debt or the contract that is secured…."

Section 681/1.
"Any agreement that states that a surety must accept the same extent of liability as the debtor or accepts joint liability with the debtor shall be void."

As is evident from the amendment in section 681 and the additive section 681/1, the amendments have not made any fundamental changes to the law other than to clarify the extent of the law in more detail. It has greatly expanded the original Section 681 and has filled in several gaps in the law that institutional creditors have used to take advantage of indirect debtors.

Section 686
Another fundamental change involves enforcement of the obligation of a surety under Section 686. The original section was a sentence long and stated only as follows: "As soon as the debtor is in default, the creditor is entitled to demand performance of the obligation for the surety."

However, this original section has been fundamentally changed and extended. In conclusion, Creditors must send a written notice informing the guarantor of a default by the debtor within 60 days from the date of default. Otherwise, the guarantor shall be released from liabilities in relation to any interest, compensation or encumbrances arising after the ending of the 60-day period.

Section 691
This new clause has the effect of invalidating Section 691 of the Civil and Commercial Code which originally dealt with limiting the rights of a surety in the event of joint liability between debtor and surety. The new amendments to the Code have replaced the language of Section 691 with a new clause that limits the liability of sureties, rather than to limit their rights. In conclusion, the guarantor may not be held liable for any part of the debt that has been reduced or waived (and paid by the debtor) Where creditors agree to reduce or waive the debt in favor of the debtor.

It is clear that the amendments in Section 686 and 691 aim to reduce burdens on the surety. On the other hand, many Thai commercial bankers expressed concern about the amendments in suretyship laws. They think the banks have to implement the stricter rules for borrowers and loan granting mechanism which will affect credit accessibility of the small and medium entrepreneur. Moreover, the bankers think that the 60 days of notification period is too short and will limit the opportunity of debtor to enter the debt restructuring process.

For the mortgage, there are the major alterations in Section 727/1: the mortgagor's liabilities are limited to the value of mortgaged property securing indebtedness; any agreement which stipulates that the mortgagor is liable more than property value is considered null and void.

Additionally, Section 728 has been changed so that a mortgagee must notify a mortgagor in writing no less than 60 days when a debtor is in default. Also, in relation to assets mortgaged as security for the performance of an obligation by another person, mortgagers must be notified within 15 days from the date that the mortgagee notifies the debtor. Otherwise the mortgagor who mortgages their assets as security for the performance of an obligation by another person shall be discharged of liabilities regarding interest, compensation and encumbrances, which are accessories of the debt.

In Section 729/1, the mortgagee may proceed with the sale of the mortgaged property by public auction if there is no other mortgage on the same property, without filing an action in court within 1 year after being noticed that the debtor is default. In the case that mortgagor cannot process the sale within the specified period, the mortgagor shall be discharged of liabilities regarding interest, compensation and encumbrances, which are accessories of the debt after that period.

Additionally, several Thai bankers also raised the issue in Section 681/1, which stipulates that joint liability with the debtor shall be void. This may lead to the loss in creditworthy of both Thai government and the banks, the largest surety in Thailand. In the bankers' view, after implementing these amendments, the Thai government's mega-projects or unprofitable state enterprises such as State Railway of Thailand will face difficulty to borrow the money.

On the other hand, the Director of Fiscal Policy Office at MOF voiced opinion that the amendments have pros more than cons because the new laws will solve the chronic problems of suretyship.

Additionally, most of the burden from the amendments will have to be borne by bank, not the public, especially in Section 686/1, 686, and 691 which will force the lender to clearly clarify the obligations and also limit the responsibilities of surety.

Following concerns raised by bankers, on 4 February 2015, the Thai cabinet approved a minor alteration in the Amendment to Civil and Commercial Code, permitting that a financial institution can accept joint liability with the debtor, so that the lender can collect debt from financial institution guarantor as if it were the borrower, and the lenders can extend debt obligation terms after negotiation.

Chapter 5. Improving Financial Access

5.1 Benefits of financial access

According to CGAP's April 2014 report, the newest crop of some 20 randomized control trials (RCTs) suggest that formal financial services, such as microcredit, savings, insurance and mobile payments, can have a positive impact on a variety of microeconomic indicators, including self-employment business activities, household consumption, and well-being.[47]

"But benefits are not limited to the microeconomic level," notes co-author Robert Cull, Lead Economist, Finance and Private Sector Development Research Group at the World Bank. "In addition to benefits to individuals, non-experimental evidence indicates that broader financial inclusion also coincides with greater local economic activity and decreased economic inequality at the macroeconomic level."

Financial Inclusion and Development: Recent Impact Evidence specifically looks at studies addressing the impact of credit, savings, insurance and mobile payments products. Research around savings is the most consistently positive and suggests it can help households manage cash flow spikes and smooth consumption. Evidence around mobile money shows that the technology reduces households' transaction costs and improves the ability to share risk through remittances. Several studies show that insurance helps poor households mitigate risks and manage shocks. Weather-based index insurance, for example, can have a strong positive impact on smallholder farmers because it encourages them to spend more on fertilizer and to shift to riskier cash crops.

While past evidence supporting the impact of microcredit on household welfare has been mixed, the demonstrated impact is much stronger than indicated by earlier studies and when applied to businesses.

"New studies are showing that the availability of microcredit can result in higher income, better ability to cope with risk and even increased well-being."

With 2.5 billion unbanked people around the world, global and national-level policy makers have been embracing financial inclusion as an important development priority. By the end of 2013, more than 50 national policymaking and regulatory bodies had publicly committed to financial inclusion policies for their countries.

Most recently in October 2013, the World Bank Group announced the global goal of universal access to basic transaction services as an important milestone toward full financial inclusion. "This accumulated body of evidence supports the convictions of policy makers who believe that financial inclusion is an important ingredient for social and economic progress," says CGAP CEO Tilman Ehrbeck, lead author on the report. "A more nuanced picture is emerging that supports broad financial inclusion efforts. On the whole, access to formal financial services helps poor families in developing countries improve their lives."

[47] Cull, Robert, Tilman Ehrbeck, and Nina Holle. 2014. "Financial Inclusion and Development: Recent Impact Evidence." Focus Note 92. Washington, D.C.: CGAP.

Providers of financial services

Financial service providers in Thailand can be grouped by their legal status and the level of supervision as follows:

1) The Formal Sector Service Providers refer to mainstream financial institutions with clear legal status. They are required to obtain a license granted under relevant business laws or originally established by specific constitutional law. These service providers in Thailand are under the supervision/examination of the Ministry of Finance (MOF) or the BOT. The supervisory regulations generally cover business undertaking, prudential measures, and / or consumer protection. The formal sector service providers include commercial banks, foreign commercial banks (foreign bank branches), specialized financial institutions (SFIs) (such as Government Housing Bank, Bank for Agriculture and Agricultural Cooperatives, Government Savings Bank, etc.), finance companies, credit fonciers companies, credit card companies, supervised personal loan companies , securities companies, mutual fund management companies, and insurance companies.

2) The Semi-formal Sector Service Providers refer to financial institutions whose legal status is granted by specific laws, and are supervised or examined by other government authorities, namely; cooperatives, credit unions, and village funds.

3) The Informal Sector Service Providers refer to individual or juristic providers that have no legal status under any business or specific law and are not supervised or examined by any government authorities, namely; savings groups, community banks, money lenders (relatives or others), and others (e.g. companies' welfare scheme).

5.1.1 Case study: M-PESA

In early 2007, the leading mobile operator in Kenya, Safaricom (part of the Vodafone Group) launched one of the most successful implementations of a mobile money transfer service, M-PESA. The product is called M-PESA since “Pesa” is the Swahili word for money and the “M” is for mobile. The service has grown rapidly since launch, and is currently used by over 8 million subscribers.

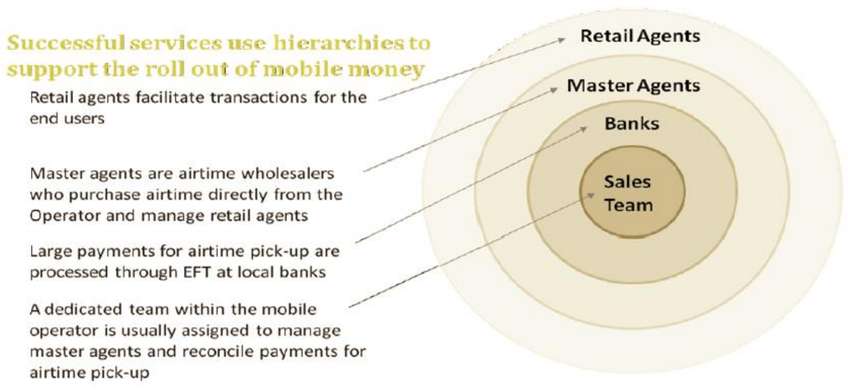
M-PESA is a SMS-based system that enables users to deposit, send, and withdraw funds using their mobile phone. Customers do not need to have a bank account and can transact at any of the country’s over 11,000 agent outlets. Registration and deposits are free and most other transactions are priced based on a tiered structure to allow even the poorest users to be able to use the system at a reasonable cost. Transaction values are typically small, ranging from USD 5 to USD 30.

The service was initially developed by the Vodafone Group which owns a 40% stake in Safaricom and the 6 month pilot phase of the project was partly funded by the UK Department for International Development. The current arrangement between Safaricom and Vodafone Group is a revenue share model where Safaricom controls the on-the-ground operation of the product and Vodafone Group manages the development and delivery of the technical service. An M-PESA Holding Company Limited was registered for the launch of the service and is controlled by directors that are independent of Safaricom Limited. This company acts as a trustee for M-PESA customers and holds all funds from the M-PESA business in trust to ensure that those funds are safeguarded at all times.

M-PESA was the first product of its kind to be introduced in Kenya and is widely viewed as a successful implementation that should be used as a model for other developing countries.

Network Development

Safaricom relies on its extensive airtime distribution network to build out the agent network. The entire network follows an agent aggregator model. At the top of the hierarchy are master agents who are mostly Safaricom’s own dedicated airtime resellers, but can also include large organizations such as Group 4 Securicor, branches of Equity Bank, and some larger supermarket chains such as Nakumatt. The next level in the hierarchy is made up of retail agents that are attached to and managed by approximately 300 master agents. A single agency agreement is signed with a master agent who in turn recruits multiple outlets to act as M-PESA retail agents. This approach has allowed Safaricom to very quickly increase the number of M-PESA retail agents by signing agreements with a limited number of master agents.



Source: Paradigm Solutions & Consulting, 2009

Microfinance Integration

The initial service scope included integration with microfinance institutions to facilitate loan disbursals and repayments. During the pilot phase of the project, Vodafone Group partnered with Faulu Kenya, a local MFI that lends small amounts to several thousand small business owners, who then repay a few dollars a week into the Faulu bank account. The normal structure for doing so is to form groups of about 20 borrowers who meet each week and submit cash to the group treasurer and he in turn takes the money to a local bank. This may involve a lengthy bus journey and therefore reduces the treasurer's productive working time. M-PESA seemed like an excellent fit for facilitating these payments and could make a significant difference in the lives of these customers.

In practice, a number of obstacles were identified in integrating with Faulu's back-office processes. Many of their reconciliation methods were manual and paper based and reconciling M-PESA transactions in parallel with their existing systems only seemed to add complexity and additional work for Faulu back-office staff. Furthermore, Faulu was not able to maintain a stable internet connection (even though Vodafone provided a dedicated satellite and mast for them), and this was a key requirement for processing back-office transactions. Finally, closer to commercial launch of the service, Faulu became extremely cautious about the stability of the system and the security of its money.

Eventually, Safaricom decided to proceed with a full commercial launch of the service without the microfinance capabilities and Vodafone Group later once again pursued development of a microfinance module for M-PESA.

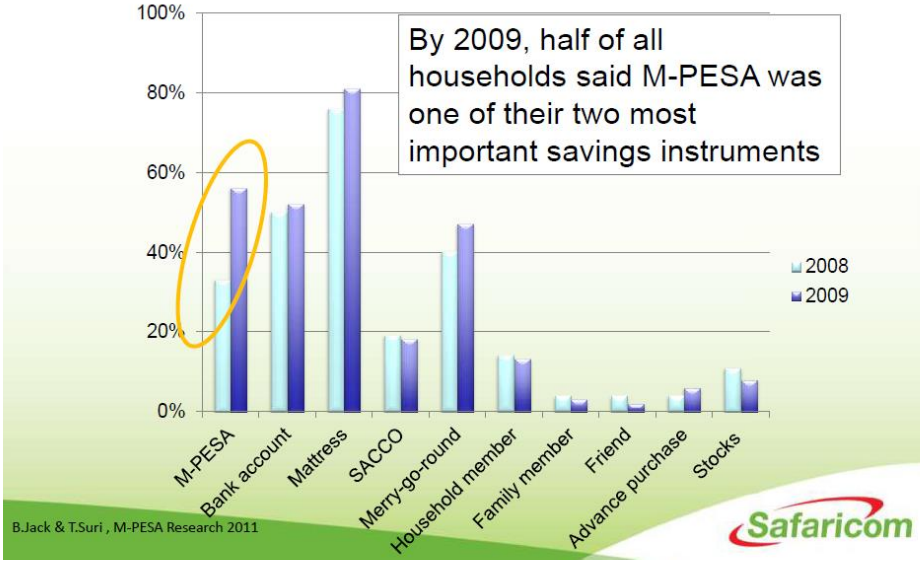
In 2010, Safaricom and Equity Bank jointly launched M-KESHO, a co-branded suite of financial products that will ride on the M-PESA transactional 'rails.' One third of M-PESA accounts are held by people who are otherwise unbanked, and this is the segment that the new product is targeting.

In late April 2010, the Central Bank of Kenya issued new agent banking regulations which for the first time allowed banks to engage a wide range of retail outlets for transaction handling (cash in & out) and product promotion (receiving account applications, though applications must be approved by a bank staff). This paved the way for banks to begin utilizing the M-PESA platform and associated network of M-PESA outlets as a channel.

M-KESHO is a full savings account issued by Equity Bank but marketed as an "M-PESA Equity account." Like M-PESA accounts, M-KESHO accounts have no account opening fees, minimum balances or monthly charges. But unlike M-PESA accounts, M-KESHO accounts pay interest, do not have a limit on account balances, and are linked to limited emergency credit and insurance facilities.

M-KESHO is fully integrated into the M-PESA user interface on customers' mobile phone, and is also accessible through Equity Bank's own mobile banking service (available on JAVA or USSD). Customers can deposit and withdraw money from their M-KESHO account by transferring value to/from their M-PESA account, which they can in turn cash into or cash out from at any M-PESA outlet. Deposits into M-KESHO are free to the customer, whereas withdrawals incur a KSH 30 (40¢) payable to Equity Bank plus the normal KSH 25 (33¢) cash out fee payable to Safaricom.

Safaricom is also connecting M-PESA with the accounts of other banks, enabling customers to cash in/out of their bank accounts through M-PESA. But Safaricom and Equity have agreed on a short-term exclusivity on M-KESHO, relating to product co-branding, use of select M-PESA agents to promote the bank's products, and user interface integration.



The success of M-PESA is often attributed to the following factors:

1. Anchor product or products – National remittance is the main product offering of M-PESA. Safaricom positioned the product as a fast, safe and easy way to 'send money home'. The service also enables airtime purchase, bill payment, ATM withdrawal and purchase of goods and services.
2. Rapid growth of mobile phone penetration – by the end of 2008, mobile penetration in Kenya was 39% or over 15 million subscribers. The subscriber base rose to over 29 million, or 67 percent penetration, by year-end 2013.
3. High literacy levels – literacy levels in Kenya are over 90% for males and over 80% for females
4. Low access to finance – In Kenya 38% of people didn't use any form of financial service; formal, semi-formal or informal rior to the launch of M-PESA while only 19% of the population had access to formal financial services. The country has approximately 4 or 5 million bank accounts for a population of 31 million.
5. High demand for services – due to lack of other competitive money transfer services and the need to reduce dependency on cash for security reasons. In addition, national money transfer is a common practice in Kenya especially amongst urban migrant workers wishing to send money back to their families in the villages. Prior to M-PESA, many people would have to resort to sending money with someone (possibly a stranger) who was travelling to their village.
6. Conducive regulatory environment – The Central Bank of Kenya is actively involved in the regulation of mobile money services in Kenya. They have taken an open approach to allowing telecom operators to offer mobile money services without the requirement for bank partnership.
7. Ready technology adoption – prior to the launch of M-PESA many Kenyans were familiar with the basic operations of a mobile such as texting and making voice calls. In Kenya, 83% of the population 15 years and older have access to mobile phone technology.

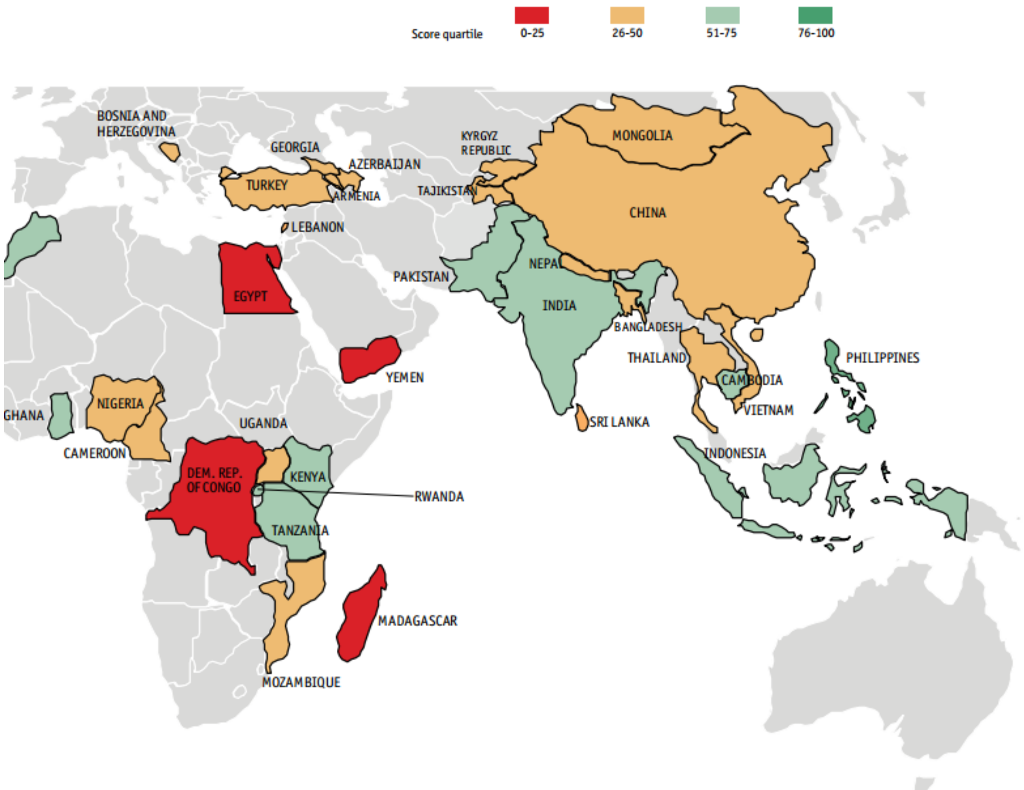
5.2 Situation in Thailand

5.2.1 Financial access: private actors not (yet) interested

The Economist's Global Microscope 2014 report, which assess regulatory environment for financial inclusion across 12 indicators and 55 countries, ranked Thailand number 23 in the world with a score of 48 out of 100, tying with Ecuador, Dominican Republic, El Salvador, and Bosnia.[48] The report observes the landscape as follows:

"The overall landscape of financial inclusion in Thailand is characterized by government-supported financial institutions. Major players in providing financial services to the poor include Specialized Financial Institutions (SFIs) and the Village Fund (VF). The SFIs are state-owned banks and two are particularly important to financial inclusion: Bank for Agriculture and Agricultural Cooperatives (BACC), which provides financial services to rural farmers, and Government Savings Bank (GSB), which provides financial services to the urban poor. The VF is one of the largest micro-credit programs in the world, providing an important source of small-credit at village level throughout the country. Commercial banks in Thailand have yet to offer services to low-income populations. Regulation for financial inclusion has not been extensively developed; a specific plan to promote financial inclusion has yet to come into effect, and other regulations governing financial inclusion are characterized by the fragmentation of regulators."

Figure 12. Financial access score across Asia, 2014



Source: The Economist, Global Microscope 2014.

48 "Global Microscope 2014." *The Economist.* Retrieved October 30, 2014. http://centerforfinancialinclusionblog.files.wordpress.com/2014/11/eiu_global_microscope_2014.pdf

Thailand is an economically dynamic upper middle income country, with Human Development Indicator measures in the middle of the development scale. It has a well-developed financial infrastructure that reaches the great majority of the population, leaving a little more than 10% of its population unbanked (see below) – a figure comparable to that found in the U.S. and other industrial countries. However, this one figure masks a considerable unevenness across regions and across types of financial products.

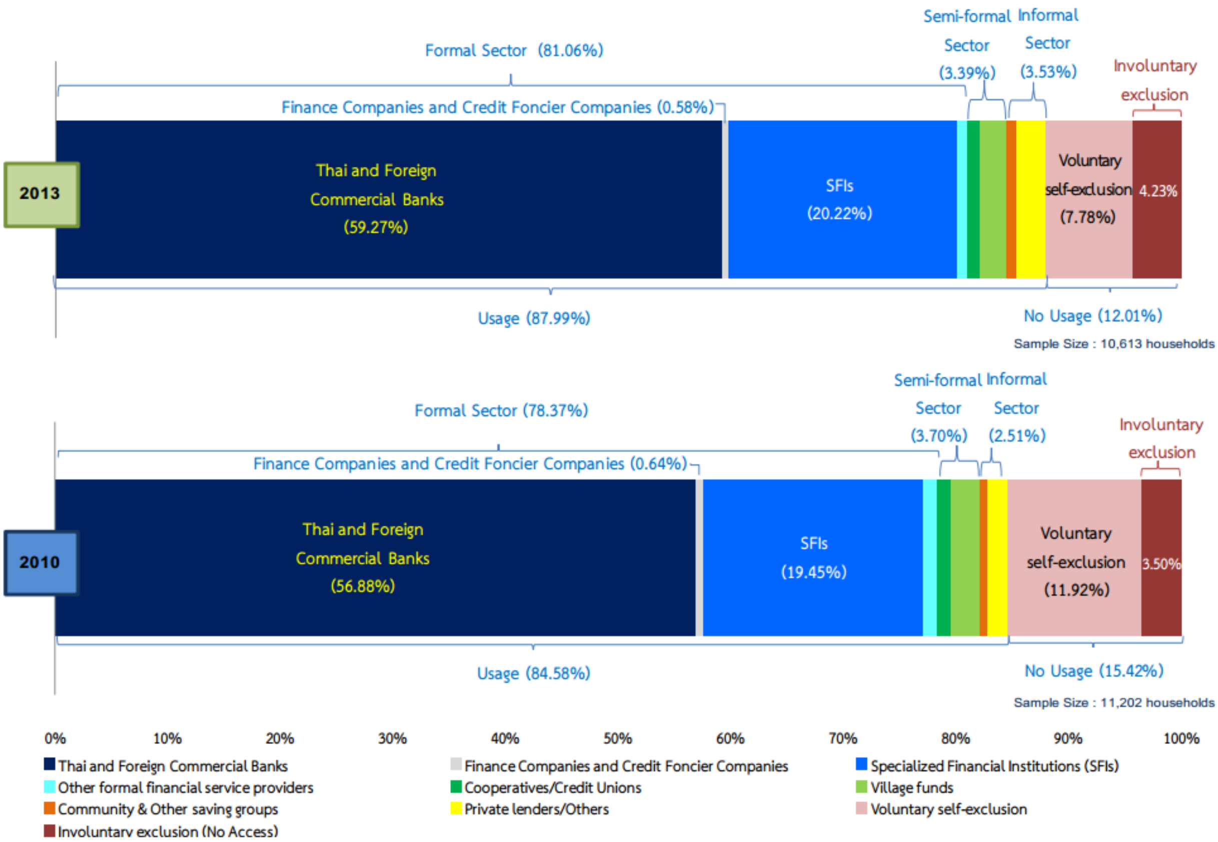
In 2013, the Bank of Thailand (BOT) conducted financial access survey. The responses from 10,613 heads or representatives of households regarding the need and usage of 9 financial services reveal that 87.99% of the households used at least one financial service, while 12.01% did not use any financial service. All non-usage households are further categorized into 2 groups. One was considered "involuntary excluded" (those who had demand, but could not access to any financial service) (4.23%) and the other was considered as "self-excluded" or voluntary excluded (7.78%) (those who are capable of accessing at least one financial service, but chose not to use any financial services).

The BOT survey found that the percentage of voluntary self-excluded decreased from 11.92% found in the previous survey in 2010. This can imply the increase of demand for financial services since the past 3 years. Regarding the increase in usage from each group of financial service providers, the percentage of households that used formal financial service providers increased the most compared to the result of the 2010 survey, (+2.69%) followed by an increase in usage from informal financial service providers (+1.02%).

This data may lead one to conclude that the increase in demand for financial services during the past 3 years had been mostly fulfilled by formal financial service providers. However, a small portion of such increasing demand had been served by informal financial service providers.

With regards to usage from each type of financial service provider, the majority of households were customers of commercial banks (59.27%) followed by SFIs (20.22%), while the rest used financial services from semi-formal and informal financial service providers. The percentage of usage in the latter group has slightly increased from 2.51% to 3.53%.

Figure 13. Results of Financial Access Survey of Thai Households, 2013



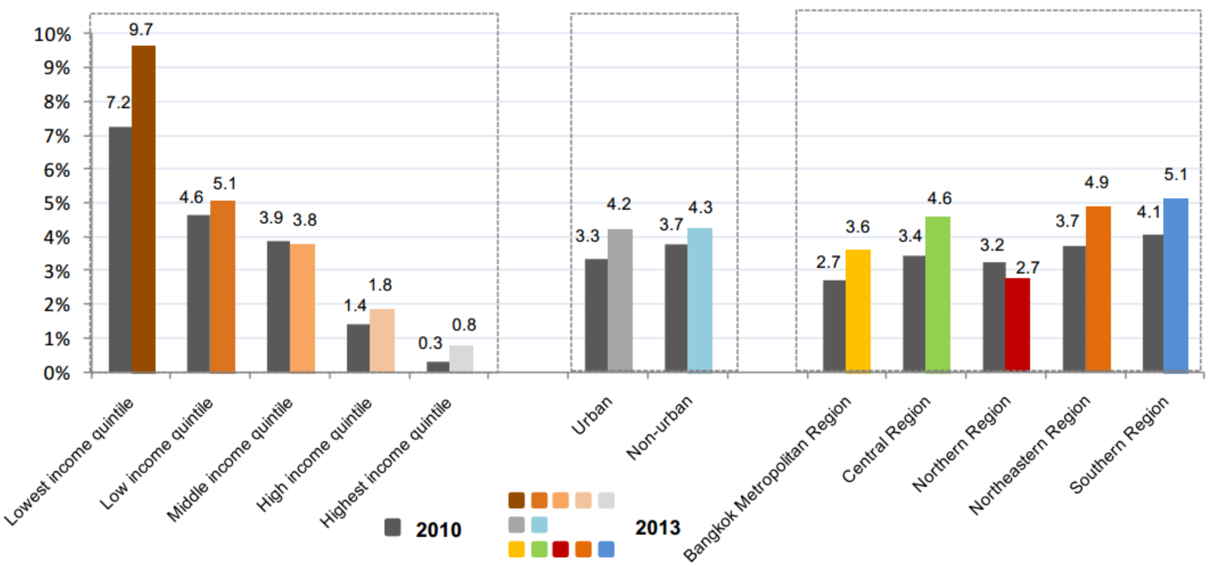
Source: Bank of Thailand

The increase in the percentage of involuntary excluded households was found in almost every group of income level and region. This might have resulted from the increasing demand that could not access to any type of financial services.

Furthermore, the survey found that the lowest income group of households and those who lived in the southern and northeastern region showed the highest percentage of involuntary exclusion (see details in

Figure 14).

Figure 14. Involuntary exclusion percentage, by income level and geography, 2013

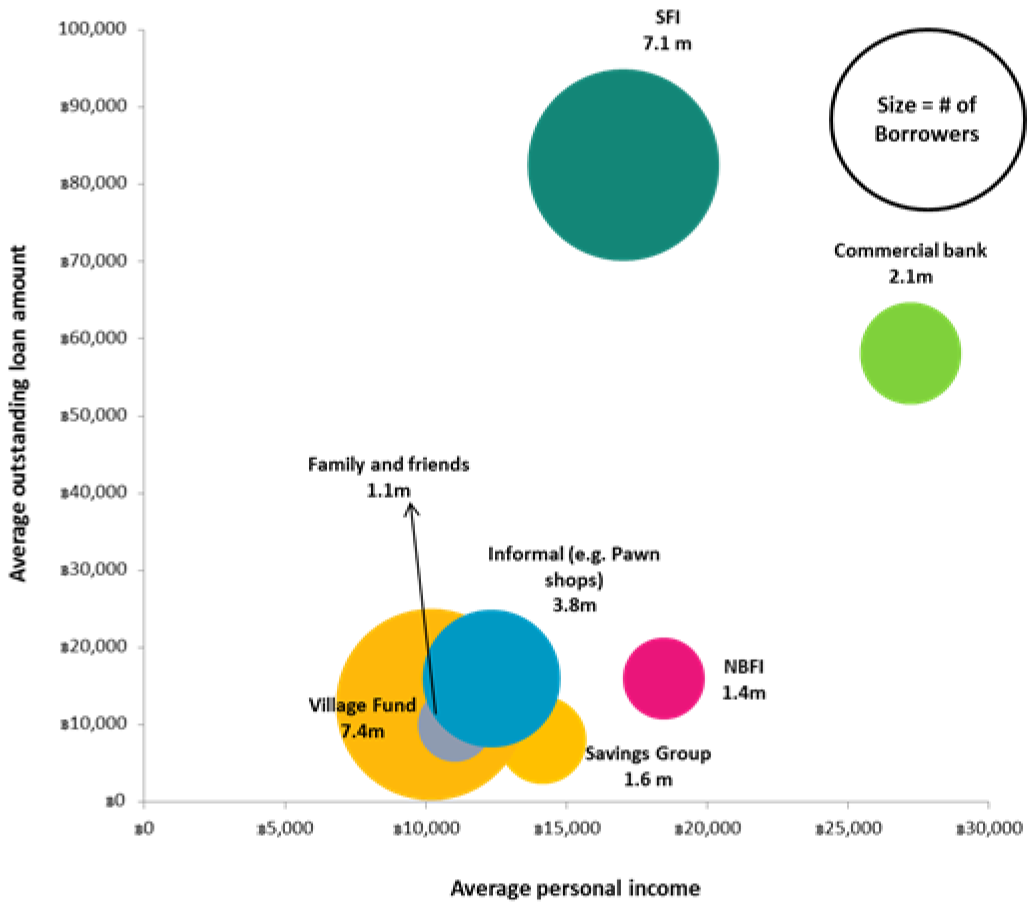


As with all such data, these figures mask considerable diversity including localized exclusion and privation. For example, Asian Development Bank reports that some 38% of low-income families have used one or two types of financial services, while another 16% do not use financial services at all. Almost 80% of middle- to high-income families use three or more types of financial services. Nearly half of low-income households do not borrow, as compared with 27% of middle- to high-income households. About 28% of low-income households do not have access to savings products compared with 6% from middle- to high-income groups (ADB 2011). This data is supported by the findings of Demirguc-Kunt and Klapper (2012) which indicate that 40% of low income households and 20% of middle to high income households do not hold accounts with formal financial institutions.

However, with looked at in detail, there is a clear distinction of sources of financing between Bangkok and other urban high-income provinces, and rural areas of Thailand. While 77% of adult Thai population has deposit accounts, only 36% can access loans from commercial banks; this means that over 28 million adult Thais have to access loans from other sources.

According to 2013 FinScope Survey, over 7.1 million Thais borrow from state-owned Specialised Financial Institutions (SFIs) such as Bank for Agriculture and Agricultural Cooperatives (BAAC) and Government Savings Bank (GSB). Only 2.1 million Thais, or 4.7% of adult population of 45 million, borrow from commercial banks. Average income of commercial bank borrowers is almost double that of SFI borrowers, a clear sign of commercial banks 'leaving' lower-income market, especially the rural areas, to the mix of SFIs, Non-Bank Financial Institutions (NBFIs), semi-formal structures such as government-mandated Village Funds, and informal institutions such as village-level savings groups.

Figure 15. Average outstanding loans vs. average personal income, by source of financing



Source: FinScope Thailand 2013 and consultation with industry

5.2.2 Financial behavior of Thais

The FinScope survey and qualitative demand research have uncovered a number of "common financial behaviors" of Thais across all regions and demographic groups which highlight key areas in which financial capabilities can be strengthened. Notable behaviors that we observed are as follows.

1. Adequate basic arithmetic skills and understanding of "purchasing power"

Most low-income FGD participants can do simple arithmetic calculations. The demographic which answered basic division least correctly is low-income rural workers in Chiang Rai, of whom only 64% correctly. The percentage of people in other demographics who answer this question correctly ranges from 83% (low-income farmers in Chai Nat) to 100% (middle-income farmers in Chiang Rai and virtually all urban groups in all provinces).

Most people have never heard the term "inflation" but in general, most answer correctly that if prices go up next year, they will be able to buy fewer things. The demographic which is most confused about inflation and does not understand the impact of prices on purchasing power is low-income rural workers in Chiang Rai, of whom only 2.8% answered correctly.
2. People feel financially "stressed" when managing their money

FinScope survey reports that over 80% of Thai population knows that budgeting is useful in that it helps them manage their finances. However, only one-third says they track monthly income and expenses. This is in line with results from qualitative research, which shows that even for middle-income groups, less than 15% of all respondents say they record income and expenses.

Of all participants across all five provinces and demographics, less than 5% regularly do household accounting. Roughly 20% of all participants said they used to do so in the past, but stopped after a short time because they “feel stressed” at seeing more expenses than income, “income is too uncertain” to record, “do not see the use” of such records, and/or they “feel too lazy” to continue. “I feel stressed” was cited most often as the key reason they stopped recording income and expenses. Almost everyone who says he/she records income and expenses regularly says that the main purpose for doing so is to reduce unnecessary expenses; roughly half say they also use these records to budget for next month.

The above finding from qualitative research corresponds with the FinScope survey, which shows that 60% of Thais say dealing with finances is “a burden” or “stressful.” This finding suggests that creating incentives for people to overcome budget stress will be an important building block to enhancing financial capabilities. In other words, it is not sufficient to provide financial education tools; those tools will need to be embedded with constructive advice, feedback and incentives to encourage their use.

3. People put little emphasis on long-term saving

Only 42% of FinScope respondents say that they “save enough” to cover household expenses each month. When asked what they save for, all the reasons cited that have over 50% response rate are related to short-term needs or emergencies. Long-term saving needs such as retirement/old age and education were voiced by less than 30% of all respondents. These items are similar in that they have a fixed schedule and the amount is well-known to the household. From the FGDs, less than 10 participants say that they have plans to cope with unexpected expenses such as emergencies, such as buying life insurance and setting aside savings.

Other major expenses that typically require long-term planning include house building, marriage, and monk’s ordainment ceremony. However, low-income respondents in the FGDs view these expenses as non-urgent, and can be downscaled and tailored to fit their financial situation. For instance, they can use local material and own labor when building a house, and wait until they accumulate enough savings to marry or become ordained as a monk. This flexibility reduces the incentives to plan ahead. This finding suggests that Thais do not yet place much emphasis on long-term saving and do not use long term savings products to reach their savings goals. There is significant room for long-term saving products and corresponding financial education to be integrated into the delivery of such products including product design and marketing.

4. “Fear of debt” and lack of understanding hampers responsible borrowing

Household debt in Thailand compared to GDP is rising at a pace that is generating concern. In Q1 2013, household debt as a percentage of GDP had risen to 75%, up from 51% only 6 years earlier. During the same period, disposable household income relative to GDP has stayed more or less flat at around 53-54%, suggesting that debt-servicing capacity has not increased in line with debt burden. In this climate, a clear understanding of debt and its implications must be a key component of every national-level financial capabilities program. Less than 30% of all rural workers across all four provinces in the qualitative research know how to calculate interest payments, when given interest rate and initial principal amount. Overall, more than half of all participants are not aware of the interest rate that they are being charged on their outstanding loans, saying that they simply pay the amount indicated on monthly invoice from banks and NBFIs.

Coupled with the finding from FGDs that "small monthly payment amount" is cited as one of the top two loan features people prefer, this suggests that Thai borrowers overall cannot compare loan terms well, and there is a considerable risk that borrowers may be misled or inadvertently put in an over-indebtedness situation; for example, they may choose a debt restructuring offer that slightly reduces monthly payment, simply because they do not see that it increases their overall debt burden (especially unregulated loans such as informal loans that charge flat rate and do not offer declining balance).

5. Lack of awareness of consumer rights and grievance channels

Only 2% of respondents in the FinScope survey said that they "had problems or dispute" with financial service providers. Among those few who said they had, the majority of complaint is "cannot pay on time" followed by "interest or fees to high." This result is largely consistent across different regions, except North municipal area which "bad debt collection practices" came in second after "cannot pay on time."

Table 17. Awareness of consumer rights across regions

		Cannot pay on time	Bad debt collection practices	Misunder-stood contract	Misleading Advertis-ing	Interest /fees too high	Personal info was used	Complaint not resolved
Bangkok	Municipal Area	28%	10%	16%	16%	26%	0%	3%
Central	Municipal Area	50%	11%	11%	11%	17%	0%	0%
	Non-municipal Area	55%	0%	10%	5%	25%	5%	0%
North	Municipal Area	50%	30%	0%	0%	20%	0%	0%
	Non-municipal Area	46%	8%	8%	8%	31%	0%	0%
Northeast	Municipal Area	60%	5%	10%	5%	10%	5%	5%
	Non-municipal Area	67%	0%	0%	0%	33%	0%	0%
South	Municipal Area	48%	5%	14%	5%	24%	5%	0%
	Non-municipal Area	80%	0%	0%	0%	20%	0%	0%
Averages		44%	8%	12%	9%	23%	2%	2%

Source: Achavanuntakul and Diaz, 2013.

When asked "What did you do when you have a problem," over 47% of respondents said they "did nothing," 42% contacted the financial provider directly, and less than 5% contacted the Bank of Thailand or consumer protection agencies.

6. Confusion and mind-set barriers to using new products and services

Overall, Thais are well-equipped with technology and are familiar with financial providers: 88% use cell phones (this figure is 83% even for low-income group, i.e. those who earn less than 3,000 Baht per month), 75% have a deposit account, and 79% say they "trust banks with their money." However, only 1% of Thais currently use mobile banking. More importantly, significant gaps in the understanding of products build a "mind-set barrier" which erodes the willingness to try or use new products and services. For example, microinsurance qualitative research finds that although Thais are familiar with the term prakan ("insurance" in Thai), some respondents are confused between government welfare/social protection programs and insurance as a financial product, and most people do not understand concepts such as premium and benefits.

5.2.3 Overall regulatory landscape and impact on banking practices

When considering opportunities for broadening financial access, one needs to examine whether and in what ways the policies, rules, and organizing principles relevant to small-scale finance in Thailand either facilitate or impede expanded access and inclusion. In other words, it is worth examining whether the institutional framework and the regulatory environment support the deepening and outreach of financial services markets to the excluded, taking into account the usual characteristics of microfinance, especially considering the needs of low-income populations for tailored low-minimum savings, credit, transfer remittance, and insurance products .

Commercial banks in Thailand largely pursue the 'universal banking model,' i.e. offering the full range of financial products and services via branches, associated companies, and subsidiaries under a unified brand. Thai banks' tendency to follow this model with a focus on high-end markets has been somewhat in tension with the pressures from policymakers to extend their services to a wider population.

As BOT reports, the stability of Thai commercial banks improved steadily in the decade after the depths of the Asian crisis, with the ratio of gross non-performing loans (NPLs) to total loans decreasing from a peak of 50% in early 1999 to about 8% of total loans in late 2008. The increased stability is also reflected in the capital adequacy ratio (CAR or ratio of capital to risk-weighted assets), which measures banks' capacity to absorb foreseeable losses. In the above period, the CAR rose from about 10% to nearly 15%. These changes, together with policy reforms, internal strengthening of the banks, including what some have labelled "a return to conservative lending culture," have made the system much more resilient to negative shocks. As a result, the global financial crisis of 2008-2009 had only limited direct impact on the Thai banking sector.

Systemic reform which began in the 1997 financial crisis can be said to culminate in 2007 with three new laws that are central to financial services supervision:

- The Amended Bank of Thailand Act B.E. 2551,
- The Financial Institution Business Act B.E. 2551 (FIBA, replacing the Commercial Banking Act B.E. 2505 and the Act on the Undertaking of Finance Business, Securities Business and Credit Foncier Business 2522), and

- The Deposit Protection Agency Act B.E. 2552 (DPA, replacing the blanket deposit guarantee scheme implemented right after the 1997 Financial Crisis).

The first two in the above set of three laws aim to strengthen the supervisory framework by clearly delineating the BOT's responsibilities from those of the Ministry of Finance. The BOT is empowered to supervise and close financial institutions, and given additional power to conduct consolidated supervision over financial conglomerates, implement prudential regulation to comply with the Basel Core Principles, and oversee consumer protection (Satsanguan and Lewis 2009).

FIBA defines financial business broadly to include banking, insurance, securities, and derivatives, placing authority for enforcement of the Act and issuance of notifications with MOF. Prudential norms covering the full range of risks, asset classification, liquid reserves, agency, and other areas are to be defined by BOT.

Section 5 of FIBA describes BOT's residual authority to deal with other kinds of financial activities (including, by implication, microfinance) as follows:

"Where any business, undertaking in the manner of public fund raising through deposit acceptance or any other means, granting of credits or undertaking financial business, affects the overall economy of the country and there is no specific law governing such business, the Bank of Thailand may propose for an enactment of a Royal Decree prescribing such business to be subject to the enforcement of this Act, either in whole or in part, including related penalty provisions. In this regard, supervisory regulations of such business may also be prescribed."

A few other provisions are worth mentioning for their impact, actual or potential, on financial inclusion. "Financial institutions" for the purposes of FIBA are commercial banks (including retail banks), finance companies (corporations engaged in any kind of financial business), and credit foncier (real estate finance) firms. Significantly, Specialized Financial Institutions (SFIs), the major providers of microfinance, are not included. Retail banks are defined as limited-charter banks which are focused on retail and SME finance, and excluded from high-risk areas such as foreign exchange operations and derivatives. Only commercial banks are legally allowed to accept demand deposits (checking and regular savings accounts), while all financial institutions except credit foncier companies are permitted to accept term deposits (CDs). FIBA limits ownership risk by restricting single shareholders to a maximum of 10% equity, and foreign owners to an overall maximum of 25% (up to 49% with special permission from BOT).

Thus, in terms of financial inclusion, this regulatory structure provides a basic framework – with an array of limitations – that BOT can apply to the supervision of commercial microfinance activities. Institutions and services that fit within the scope of commercial banking, retail banking, or finance business, along with other activities with potentially systemic effects, can be overseen by BOT. Non-bank institutions offering microfinance services are not legally permitted to accept demand deposits. Ownership limits apply as well to Non-Bank Financial Institutions (NBFIs), a factor to be considered by prospective owners both foreign and domestic.

Other legal-regulatory norms spell out in more detail what the potential providers of small-scale financial services face in striving to enhance inclusion within the regulated sector. Most obvious is the general interest rate cap of 15% under the Civil and Commercial Code, raised to 28% for personal and microfinance loans (see below). It is by no means clear that even the higher rate would accommodate the start-up costs of a regulated microfinance provider in the absence of subsidy (governmental or social) or before it is able to establish a large and efficient market presence. BOT sets most of the other relevant norms through notifications, including those dealing with minimum capital, capital adequacy, branching and branchless services, and the schedule for classification and provisioning of loans. All of these norms have significant influence on the ability of a bank or non-bank to provide microfinance services on a sustainable basis.

Another relevant body of standards is that covering risk management. Often, for example, risk-weighting of assets would make it quite costly for an institution to pursue a substantial portfolio of microcredits, which are typically unsecured. BOT's credit risk guideline includes in the same category (with a 0.75 risk-weight) unsecured credits up to 100,000 Baht, individual guaranteed credits up to 3 million Baht, and SME loans up to 50 million Baht in the same relatively high category (with a 0.75 risk-weight). There is no sub-category for microfinance or group-guaranteed loans, which presumably would be, therefore, regarded as unsecured credits and subjected to the same treatment. Nevertheless, this treatment is better than that given by regulations in many other countries, and BOT cited financial inclusion as the rationale for adopting these standards: "[BOT] assigned new risk weights for assets related to retail customers and SMEs as a market incentive for commercial banks to service these customer segments" (BOT 2006).

Yet, this treatment imposes costs on microfinance that may not be justifiable in light of global experience (i.e. of best-practice providers) or bearable by a new provider. It is also worth comparing the 0.75 norm to that applicable to fully-mortgaged housing loans (risk-weight 0.5) and Thai government securities (risk-weight 0). On the other hand, in some of the other regulatory areas mentioned (e.g. capital adequacy, loan classification and provisioning), the appropriate treatment of microfinance might require more- rather than less-stringent norms.

The last of the reforms mentioned above, the Deposit Protection Agency Act, came into force in 2008, replacing the prior open-ended deposit guarantee with a one far more limited in scope. The Act applies to all financial institutions, and defines deposits as monies that financial institutions receive from any person with an obligation to repay. The Deposit Protection Agency is established as the regulatory authority, with a Committee that issues regulations under the Act and a Deposit Protection Fund to cover payments to depositors. The Agency is empowered to nominate officers of institutions brought under BOT's control, and to act as liquidator. Protected deposits are comprised of savings and interest held by financial institutions – in Baht and in accounts in Thailand, excluding any deposits of persons residing outside Thailand. The amount guaranteed per account has gone through a phased reduction from the unlimited guarantee in place in 2008 to a maximum of 1 million Baht as of August 2012. Interviewees have expressed concern about the tax on deposits imposed by DPA, amounting to 0.47% of deposit value, with nearly all of it dedicated to the FIDF bailout fund (1.4 billion Baht) created in the wake of the 1997 crash (TMB interview).

Not surprisingly, Thailand's commercial banks have tended to cluster at the high end of the economy where the profits are, primarily in corporate services. The main competition has been for lucrative corporate business. But bankers suggest that this market is now becoming saturated, with thin margins. Many of the commercial banks are moving beyond traditional clients into the supply chains. Here, they tend to compete for firms that have been established for a minimum of two to three years, with start-ups facing more difficult credit constraints.

Researchers began detecting, even before the 2008 crisis, a move by the banks away from a near-exclusive focus on traditional corporate banking toward retail banking and SME clients, since this path offered better diversification and profit. At the same time, Thai banks were relying on local deposits as their main source of funds. Faced with intensifying competition, banks turned toward modernizing their services, expanding their networks and customer base, and differentiating themselves by offering more financial products such as short-term bills of exchange, special deposits, and cross-selling of products such as life insurance and mutual funds (Satsanguan and

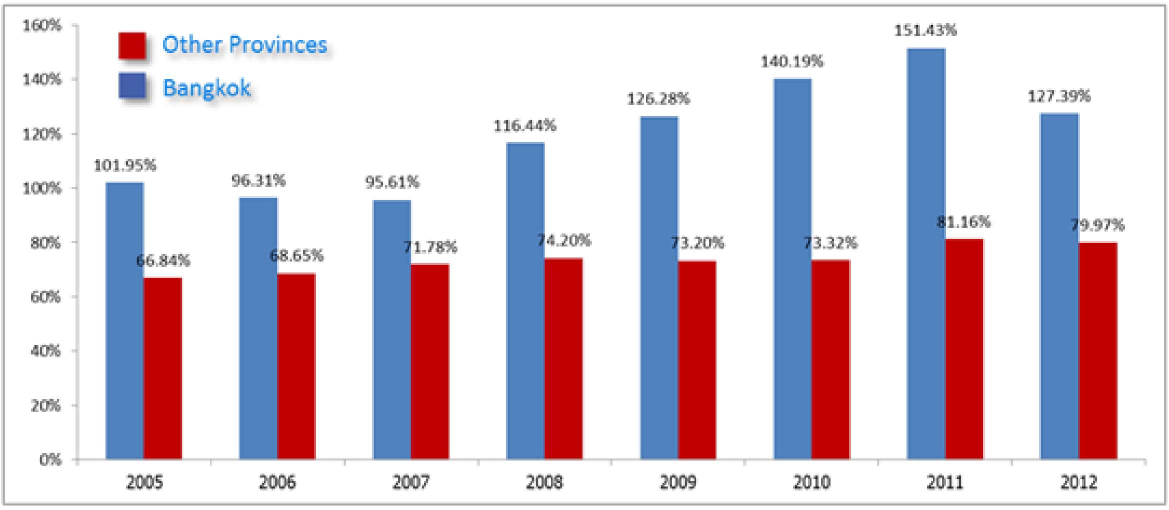
Lewis 2009). This tendency was surely encouraged not only by saturation at the top end of the market, with a consequent need to move toward the middle and lower end , but also policy initiatives such as the two Financial Sector Master Plans (see below).

As a result, commercial banks by and large have put in place the infrastructure for service outreach to a wider client base. ATM networks have expanded deposit and payment services. As a result, rural people can open accounts and transfer funds. ATMs per 100,000 adults in Thailand nearly quadrupled, from just over 20 to nearly 78, in the period 2004-2010, although they remain concentrated in urban areas (Lewis, Susewan and Tambunlertchai, 2013).

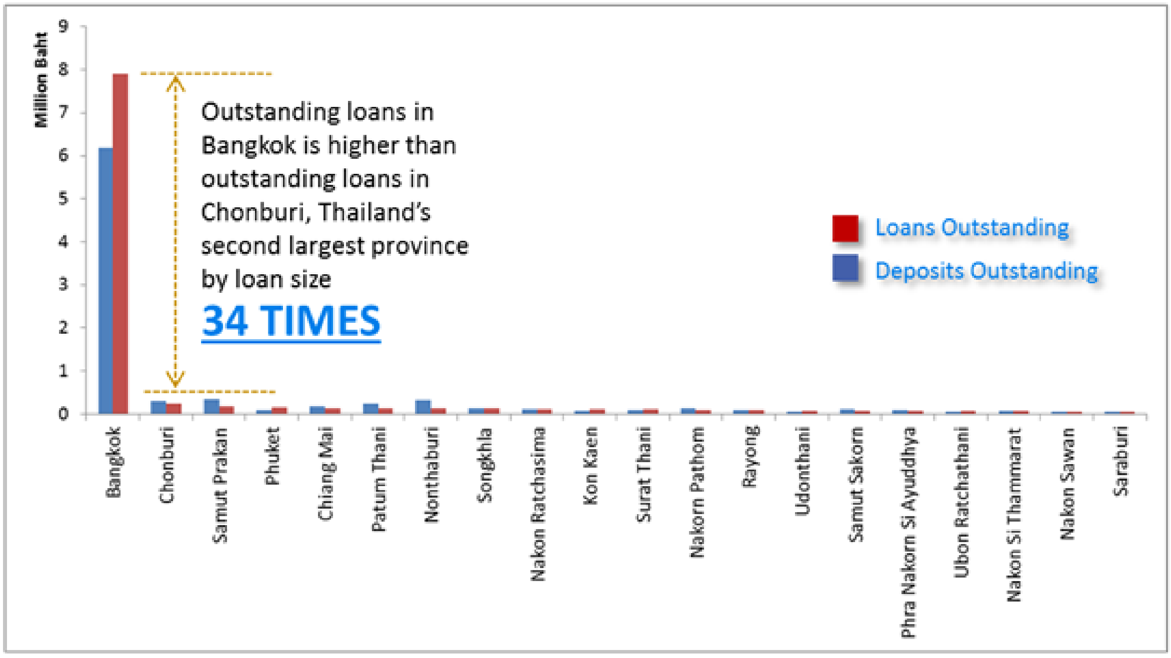
Another trend in the sector has been toward industrial centralization – resulting not only in the consolidation of banks but also geographic concentration of credit and increased financing of the central government. The commercial banks, and to a greater extent the SFIs such as GSB, are collecting savings around Thailand for large projects including infrastructure-building, primarily in urban areas. This is clear when one looks at loans to deposits ratio by province.

Between 2005 and 2011, the loan-to-deposit ratio in Bangkok rose continuously from 101.95% to 151.43%, only dropping down to 127.39% in 2012. During the same period, average loan-to-deposit ratio for all other provinces rose at a much slower pace, from 66.84% in 2005 to 81.16% in 2011, dropping slightly to 79.97% in 2013. These figures show that commercial banks have been 'moving' deposits from non-Bangkok provinces to lend in Bangkok much more than lending in those same provinces. Another sign of huge disparity is the fact that outstanding loans in Bangkok at the end of 2012 was 34 times the size of outstanding loans in Chonburi, the province with second most loans outstanding.

Figure 16. Loans to deposits ratio, Bangkok vs. other provinces, 2005-2012, and provinces with most outstanding loans and deposits.



20 Provinces with Most Outstanding Loans and Deposits, 2012, in order of Loans Outstanding (million Baht)



Source: Bank of Thailand, author's calculations

The government's pro-growth policy promotes growth champions in the external sector, with a combination of public sector tenders and private sector growth targets, resulting in the push for infrastructure investment credit. Many of the large, politically-connected Thai businesses are in the construction sector. These factors tend to tilt both commercial bank and SFI financing in favor of more profitable (and prestigious) big projects, which results in an unintentional bias against small-scale credit (TDRI and BOT interviews, cited in ADB, 2014).

The financing of public infrastructure – along with state budget outlays in other areas such as SFI and Village Fund programs – creates fiscal pressure and growth in government debt. The IMF estimates gross public sector debt at about 45% of GDP for 2012, and projects an upward trend to 50% in the next few years.

Government demand for credit, and the safety of bonds as investments, may be competing with private lending and investment sector demand, making small-scale lending (microfinance), at capped interest rates, particularly unattractive for the commercial banks. Financial institutions (including SFIs) currently hold some 55% of domestic government debt (including state enterprise debt).

The risk-weights and other prudential norms applicable to the range of assets held by the banks make public bonds and treasury bills relatively attractive, but not clearly superior to higher interest-bearing loans, whether commercial, housing, or personal. Prime lending rates stand at between 7.13 and 7.5%, while government bonds range from 2.8 (3 month) to 3.61% (10 year) – with T-bills at 3.01%, the one-day repo rate at 2.75%, and headline inflation at 2.89% (core inflation: 2.23%). Moreover, Thailand has a healthy level of credit extension in the economy, with broad money equal to 124.3% of GDP in 2011 (source: BOT). In other words, there appears to be little evidence for "crowding-out" in the sense of government demand driving up interest rates. Still, the attractiveness of public debt as an asset class is evident in the size of the banks' holdings, and the IMF has expressed concern about the sustainability of Thailand's public debt in future (IMF 2012).

5.2.4 Branchless Banking

Outreach for banking services currently includes a range of branchless methods to extend services, including the direct use of non-branch methods by the banks such as sub-branch offices, outlets at schools and markets, and outreach by means of motorbikes and boats. Alternatives that do not involve banks directly – or do not involve them at all – are agent banking, point-of-service payment and transfer systems, bank-based (or –linked) mobile phone finance, and mobile phone and e-wallet systems (e-money) not tied to the banks. Most of these methods are being tried in Thailand. On both the agent banking and e-money fronts, Bank of Thailand (BOT) has been cautious and slow to legalize these services. Each of these modalities still has regulatory restrictions that limit its potential. The rationale for going slowly appears partly to be the focus on prudential supervision, and partly the idea that Thailand is less in need of such "leapfrogging" than much poorer countries.

Agents

The outsourcing of certain banking functions is spelled out in Bank of Thailand Notification 9/2553: Rules for Establishment of Financial Institutions (Banking Agent). The regulation authorizes six types of agent activity that commercial banks may use, but prohibits any of them from opening deposit accounts or carrying out loan approvals or disbursements. The main agent types – Depository, Withdrawal, Transfer, and Payment (one type for cash, another for credit cards) – can in most cases be other banks, and in some cases other financial institutions or Thailand Post Co. Ltd. For withdrawals and transfers, only Thailand Post may be used as agent. Electronic payment service providers may be used for credit card transactions. Finance companies may use these same agents for deposit, loan approval, or disbursement. Permission must be obtained from BOT for certain of these agents, as well as for purposes not indicated in the regulation.

This arrangement represents a liberalization of regulatory controls, although it is still not as liberalized as should be in order to promote financial access. For example, informal rural community banks such as savings groups cannot act as bank's agents due to their lack of banking license, and e-money must still be backed by bank deposits, thereby limiting the scope to existing bank clients rather than unbanked population (see next section).

Currently BOT approves certain types of agencies, while under the prior regulation (from 2010), it required preapproval of approved not only agents, but also the agency agreements and systems to be used. Initially, agent approval was a laborious process involving a long list of questions, requiring some six months to complete. This is now reported to take about one month, and some agency arrangements require no prior review. KTB is a leader in this area, having experimented early on and now using agents with a real-time link to the bank. Others moving to set up agencies include other the commercial banks, GSB, and BAAC. The SFIs can set up agencies without BOT approval. KTB obtained BOT approval to use certain cooperatives as agents. KTB installs software to enable transactions (mainly savings deposits) at the cooperative's offices by means of a web link to KTB, and the institutions share fees.

The focus of agents is also changing. Agents are typically used for the physical outreach of ordinary banking services to under-banked groups – for example, the collection of cash savings. But increasingly, their services are provided through electronic means, and this brings them under an additional regulatory framework, that dealing with electronic commerce and banking (see below). Thailand now has an array of non-financial companies and organizations that also provide payments and mobile banking services. In addition to Thailand Post, commercial banks and SFIs, these companies include Counter Service, Tesco Lotus, and Jaymart. These firms provide a channel for customers to pay utility and credit card bills, make loan and insurance payments, and pay for certain purchases.

The payments services providers have grown in part in response to the market for agency services to financial institutions. Increasingly worldwide, these kinds of providers often together with mobile phone companies earn their profits from dealing independently in electronic funds services, and are in some cases (for example M-PESA in Kenya, Tanzania, South Africa, India and Afghanistan; and GCASH and Smart Money in the Philippines) seeking to enter the microfinance field to provide complementary services such as loans . The success of M-PESA (see 5.1.1 above) is a story of both innovative private sector investment and enabling regulatory oversight. This public-private interaction is an important model for pro-poor innovation.

<u>Electronic services</u>

The Electronic Transactions Act B.E. 2544 (2001) governs payments by electronic means along with payments and financial services provided by means of electronic communication including mobile phone banking. It sets up the Electronic Transactions Commission, headed by the Minister of Information and Communication Technology and including includes a further 12 members representing the financial sector, the legal community, electronic technology experts, and others. The Commission develops policies, licenses service providers, and monitors operations, while financial supervision of this sector remains with BOT. A 2004 regulation requires that non-bank institutions intending to issue e-money must obtain permission from BOT, since this issuance is similar to the deposit-taking business of commercial banks.

The Act is further elaborated by the Royal Decree Regulating Electronic Payment Service Business B.E. 2551, which came into force in early 2009. The Decree, for the purpose of maintaining financial stability and enhancing the credibility and use of e-payments, establishes three different categories of these services with distinct requirements:

List A: Services that require notification to the Electronic Transactions Commission. These are payment cards and systems for purchasing a product or service from a specific retailer or group ("closed loop").

List B: Services that require registration with the Commission. These include network services (e.g., credit card) and electronic data–capturing network services, along with switching services and issuing prepaid e-money to pay for multiple products and services under a single management entity and distribution system.

List C: Services that require a license. These include the following:

- Account debit
- Settlement services
- Electronic payment services through a particular instrument or a network
- Switching services through multiple systems
- Bill payment services
- E-Money services for buying specific goods and services from many providers without restriction on the number of firms or outlets.

Providers of List C services must meet regulatory requirements including the following:

- Minimum registered capital of 200 million Baht (if the provider is foreign-based, the Thai business must be a separate legal entity).
- 100% reserve for money stored in e-wallets.

Tariffs must be clearly disclosed to customers and require notice to BOT unless fixed by regulation (IFC 2011, BOT 2010).

The development of this sector has contributed to international concerns about Thailand's compliance with international Anti-Money Laundering (AML) standards. The International Monetary Fund's 2007 report on this described the framework as a combination of unenforceable guidelines, circulars, and regulations, which did not comply with the standards of the Financial Action Task Force (FATF). The Money Laundering Control Act B.E. 2551 (effective 19 November 2009) stipulates that e-money service providers are classified as non-banks according to the Ministry of Finance's Notification concerning the Business of Electronic Money Card and E-payment Service Providers (see above) are required to comply with the Act and regulations.

For example, they are required to report transactions to the Anti-Money Laundering Office, comply with Know Your Customer requirements, and conduct Customer Due Diligence. A new act is being formulated that will cover e-money. Currently, customers can register quickly and easily for an e-wallet by providing details of their national identification (National ID cards are widely held and are thus not a barrier to opening a bank account or e-wallet.) This information is then verified by the Ministry of Interior within 24 hours. There is some concern that the new regulations will make this process more challenging and slow development in this area (IFC 2011, BOT 2010). Others suggest that AML concerns have little relevance to microfinance, since the threshold transaction amount for the law's application is 50,000 Baht, higher than per-transactional needs or low-income market.

Electronic services in Thailand have been growing rapidly. At the end of 2014, BOT reported that it supervised a total of 147 licensed electronic services providers (the majority in List C). The reported number of e-money transactions reached the value of 20-21 billion Baht per month since the end of 2014. As of July 2014, there were 141 million cards or accounts in the system. The regulatory arrangements for financial supervision and AML do not appear to have dampened enthusiasm.

Major electronic payment service providers include Jaymart, Tesco Lotus, and Thailand Post. Jaymart sells mobile phones and related items, and has developed its stores as designated payment points, and partners with Family Mart in providing payment services for products, utilities, credit card and insurance bills, etc. Customers have access to over 100 Jaymart pay points, and over 700 Family Mart stores as at the end of 2014. Tesco Lotus is a major operator of supermarket and convenience stores, offering similar payment services at in-store service counters. As at the end of 2014, Tesco operates 39 department stores, 113 Tesco Value stores, 190 Tesco Market stores, and 1,257 Tesco Express convenience stores across the country.

Thailand Post is also becoming a significant player. It offers a “Domestic Online Money Order” that can be processed and sent in 15 minutes with a fee of 50 Baht for amounts up to 10,000 Baht. In 2008, BOT estimated that 50% of customers paid for services at the office of the service provider, and 25% at banks – leaving considerable room for growth in electronic payment services (Lewis, Susewan and Tambunlertchai 2013).

Counter Service concentrates on payments services, and has long been the biggest provider. Customers’ point of contact is with agents of the company who pay for the Counter Service franchise. Counter Service partners with 7 Eleven to offer Counter Service payment facilities available at 7 Eleven convenience stores. Counter Service serves as a channel for bill payments to over 700 partners. In addition to the usual utilities, credit card, loan, insurance, and mobile phone payments, customers can also pay for bus tickets, air tickets, concert and movie tickets, hotel rooms, and course registrations through Counter Service (Lewis, Susewan and Tambunlertchai 2013).

The firm provides services through some 9,000 store outlets (mainly 7 Eleven but also BigC), some 60% of them outside of the urban areas, as well as other service points in rural districts. Counter Service charges 10 Baht each (compared to 5 Baht for Tesco Lotus and Thai Post) for payments up to 30,000 Baht per customer per store per day. The firm was approached by the banks several years ago to handle deposits and withdrawals, but it is precluded by the terms of its electronic payments license and the agent banking regulations (although it may serve as agent to a non-bank company, as it has done for Krung Thai Card). Having evolved from its early days handling physical cash payments, Counter Service now has a real-time electronic link to nearly all its clients. In late 2010, the firm began seeking BOT approval to provide small-scale finance services, including the handling of consumer credit applications for financial institutions (“Counter Service seeking microfinance opportunity,” Bangkok Post, 12/11/2010).

Thailand also has a growing market for mobile banking services, which are offered through three major mobile network operators – Total Access Communications (DTAC), which paired up with Kasikorn Bank (K-Bank) to provide ATM SIM cards; Advanced Info Service (AIS), which offers money transfer services; and True Corporation, which also offers money transfer services through its True Money scheme. The value and volume of transactions have grown substantially over the years. In 2006, there were only 238,501 mobile banking transactions, but in 2011 this grew to almost 20 million transactions worth 186.5 billion Baht. The government is looking into the possibility of offering mobile banking services through the SFIs as a means of combating loan sharks (Supply Side Report 2012, Lewis, Susewan and Tambunlertchai 2013). At the moment, it appears that there is little true mobile phone banking (True Money’s e-wallet is an example), but internet banking by smartphone is fairly common in urban centers such as Bangkok.

The experience of DTAC illustrates the issues involved in setting up mobile banking services in Thailand. The company established a limited-scale e-wallet service (M-Pay) soon after the 2008 Royal Decree on electronic services, which enabled it to get into this market without a banking license. It also bought another existing e-wallet provider. The broad standards in the 2001 Act allowed BOT to take a conservative approach of keeping new services within the traditional framework. Meanwhile, the telecom sector has been preoccupied with developing its core services, and so the mobile banking market has been slow to evolve. For a telecom operator such as DTAC, BOT is an unknown quantity, since DTAC is accustomed to dealing with the telecom regulator. DTAC holds one of the 17 e-money licenses, which allows deposit-taking but no payment of interest or intermediation. E-money must be backed by bank deposits, thereby limiting the spread of e-money only to existing bank clients, not unbanked populations.

DTAC conforms to the BOT strategy by integrating the security of bank infrastructure (in its partnership with K-Bank) with the nimble client service of a competitive mobile network operator. But it has been frustrated in its wider search for cooperation from the banks. This effort arises from a continuing need for synergies in the mobile banking market, and the fact that DTAC itself has ample experience in telecoms but none in banking. For their part, banks can set up electronic banking via smart phone applications with no need to deal with the telecoms regulator. But a true non-Internet-mediated e-money service uses special SIM cards or applications on basic cell phones – and this requires approval from the telecoms regulator.

BOT is encouraging the banks to provide mobile banking, perhaps with the idea that control of this market by the banks this will facilitate prudential oversight. But the banks are slow on the uptake, and telecom firms such as DTAC are struggling on their own to link up with customers, especially in rural areas, through the ubiquitous mobile phone agents and others. One possible step would be for DTAC to apply for a banking license in order to stretch its operations beyond the limits of its e-money license.

From the perspective of many bankers, Internet penetration is viewed as not yet “sufficient” to support wide adoption of online banking, nor is most people comfortable using mobile phones for financial services. But the experience of success stories in other countries, particularly M-PESA in Kenya (see 5.1.1 above) suggests that their perspective can be broadened.

5.2.5 Enabling environment

A broader dimension of the financial services market has to do with the commercial framework and infrastructure. A number of factors enable or constrain the expansion of financial inclusion, such as credit reporting, the framework for secured finance, and other policy and social factors.

Credit information

The Asian Financial Crisis gave strong push for the development of credit reporting in Thailand. In 2005, the Ministry of Finance approved the merger of the two existing credit reporting agencies, and the National Credit Bureau, Co., Ltd. (NCB), a majority state-owned company, was established. NCB provides consumer and commercial credit reports to its 78 members, who include domestic and foreign banks, credit card issues, consumer finance companies, and others. It has information on approximately 56 million consumer accounts from 16 million people, and approximately 4 million commercial accounts from 200,000 businesses. NCB does not provide data to non-members and all members are required to submit data to NCB regardless of whether they make any inquiries. Some 80% of credit inquiries are for consumer lending. Individuals can check their own credit histories (in person, at an ATM, or online) for a fee, and can dispute any information they deem incorrect. Banks report that information from the credit bureau has been extremely helpful in identifying bad applicants, and that their improved ability to access risks has enabled them to make more loans with better profits. NCB is now moving to expand its services in such areas as credit scoring (including for individuals and SMEs), and to reach new clients such as leasing companies (Kunvipusilkul 2008, NCB interview).

An important constraint to financial inclusion arises from the limited reach of NCB into the low-income sector. The law governing this field, the Credit Information Business Act B.E. 2545, defines both “credit” and “financial institution” inclusively. Loans, guarantees, purchases, and other transactions identified by NCB’s governing committee are to be reported. In practice, however, potential borrowers do not enter the system until they are involved in a banking transaction or in some cases a motorbike lease. Informal borrowing, trade credit, payment (or non-payment) of utility bills and other debts are not recorded in the NCB. Further, the system is in some instances overly restrictive. Banks have complained that they are not able to obtain information from NCB on guarantors, even with their consent (and despite guarantees being explicitly included). Rather, guarantors must submit inquiries about themselves and forward the results to the banks – a needlessly time-consuming and inefficient process (Kunvipusilkul 2008, NCB interview) .

Last, membership of NCB is still not comprehensive. Cooperatives, the Village Fund, and BAAC are not members of the system, although most bank and non-bank financial institutions (NBFIs) are members and contribute to NCB. For-profit financial institutions appear to have every incentive to become members of NCB. In the case of BAAC, the option of membership is open, but the bank has said that its own information on clients is not yet organized in a form appropriate for disclosure. It is also likely that the state guarantee of BAAC’s credits partly undercuts the usual incentive in favor of membership. In practice, credit information is reported and accessed exclusively by the members (with limited exceptions), and most creditors who are not financial institutions appear to have little interest currently in joining the system.

As a result, even with NCB, the information constraints applicable to small-scale credit are significant. It is likely, however, that the system will continue to evolve and become more inclusive. Thailand’s universal ID system and its developing electronic infrastructure should make it possible to expand the system. But for now, it appears to have little relevance to financial inclusion at the low end of the market.

Secured finance

Another important component of the broader market environment is the structure for collateral lending. Good practice suggests a system in which the widest array of goods – physical and intangible, present and future, discrete and collective – should be permitted to serve as collateral, so that lenders and borrowers can leverage as much asset value as possible. This requires a system with a clear scheme of lien priorities, a mechanism of recording and notice, and enforcement that is sufficiently certain as to make out-of-court repossession routine. This kind of system originated in the U.S. and has been refined other countries such as Canada and New Zealand in the common law world, and the Netherlands and certain of the East European countries in the civil law world. These systems enable a wide range of lending, trade credit, leasing, securitization, and other transactions by small and large debtors as well as creditors of all description, whether financial intermediaries or not. This brings efficiency and security to both retail and wholesale financial markets, with important benefits for financial inclusion. Where modern secured finance systems are in place, they underwrite often vast portfolios of small business credit at relatively low cost and risk. This is a simple idea but can be complicated to realize.

SMEs comprise the segment that usually reaps the most immediate and direct benefits from secured transactions, and yet in Thailand the SMEs still have difficulty obtaining working capital. Thailand has provisions in its legal framework that support secured finance. But since collateral must be physically held by the lender, it would have limited utility if this is a productive asset.

If, for example, a motorbike taxi jacket – which serves as the license or medallion for this kind of enterprise – is used as security (as it is sometimes done at present), it creates much more value if this does not require it to be in the possession of the creditor, thereby depriving the debtor of its use in earning income to repay the loan. The same applies to the use of an inaccessible cash deposit in a bank account, which is also now used as possessory security, sometimes as “forced savings” against microcredit.

A thriving medium- and small-scale commercial credit market therefore requires a system that supports a much wider range of collateral, with security based on agreement and notice rather than outright possession. Further, non-possessory security has greater benefits for inclusion if it is not limited to real estate mortgages, since these transactions are costly and limited to those with documented ownership of property.

Many financial sector stakeholders in Thailand highlight the limitation of secured finance – at the low end of the market – to possessory, real estate, and a narrow range of other forms such as motorbike leases. The 15% interest rate cap applicable here (i.e. outside the Personal Loan exemption) makes it more difficult to use secured financing. The rate cap is consistent with well-functioning system in this area, which reduces costs and risks to a level compatible with such interest rates. But the difficulty is compounded where the rate cap is combined with a system that lacks the necessary comprehensiveness, flexibility, transparency, and certainty.

Some industry representatives view that the effort to reform the secured finance system has lost some steam, partly due to recent political turmoil in Thailand. A Commercial Collateral Bill aimed at increasing the types of assets that can be used as collateral was approved by the Thai Cabinet in July 2009 but has not been past as at the end of March 2015. The bill would have expanded collateral, set up registration and priority systems, and increased efficiency in enforcement.

Pending any revival of reform to the secured finance system, change will come from practical innovations within the system. Traditionally, private financial institutions in Thailand have required physical collateral, mainly in the form of real estate and/or a guarantor. However, banks have become more flexible in recent years, accepting some current assets such as inventory or receivables as collateral from qualified borrowers.

For example, this approach is used in the Capitalization of Assets program of the SME Development Bank. Private sector institutions have also begun using such assets to secure short-term financing, but not in small-scale transactions where this would be uneconomical. Further, inventory and receivables only have collateral value when companies are doing well, but become less viable – and more risky – during a recession, such as in the aftermath of the 2008 crisis (APEC 2012). It is also worth noting that moveable security (i.e. not a real estate mortgage) does not lead to more favorable risk-weighting of a loan under BOT capital rules.

In light of the above constraints, financial institutions have developed instruments, both formal and informal, that can serve as security or at least approximate it. Land and moveable security are reported to be used informally as collateral for small-scale credits. Individual and group guarantees serve as collateral substitutes to leverage repayment. Leasing and factoring are also used, but not to their full potential. Note that bringing credit-like transactions such as leasing and factoring into the formal secured financing system would both (a) put these deals on a par with other similar ones, thus creating consistent priorities and making collateral information comprehensive; and (b) facilitate finance leasing as well as securitization that does not require sale (as in classic factoring).

In the area of leasing, basic vehicle and motorbike leases are available, but the leasing of capital equipment less so. There is yet no specific legislation on finance leasing to bring uniformity to this area. As a result, leasing is underutilized, and the market for resale of leased equipment (other than vehicles) – a condition for effective leasing and collateral lending – can develop only slowly. Factoring suffers the same underdevelopment, due in part to the lack of specific legislation to sharpen the general guidelines given in the Civil and Commercial Code. Factoring is used in the form of firms' sales of invoices, but is said to be quite costly for short-term working capital finance. SME Development Bank is engaged in this form of finance, helping to extend the market for it. The Bank is also involved in the collateralization of machinery, lending against equipment recorded in the Central Machine Registry, and of intellectual property such as patents and trademarks (TMB interview, Suwanaporn undated, APEC 2012).

<u>Other issues</u>

A wide range of other policy, legal, and infrastructural factors enable (or disable) financial inclusion in Thailand. We touch on a few of the most noteworthy here. Taxes are an issue for businesses and particularly for financial services providers (less so for low-income individuals, since tax is not applied to income below 150,000 Baht or on earned interest below 20,000 Baht).

Corporate income tax rates have been reduced from 30% to 23% in recent years. A 7% VAT applies to goods and services, with a Specific Business Tax of 3% substituted for it in certain industries such as financial services (lower for certain banking transactions). Stamp duty of 0.1% applies to transactions such as loans, leases, hire-purchase, etc. Foundations and associations are taxed at a rate of 10% (with limited exceptions) on gross receipts including donations (Price Waterhouse Coopers, PWC 2011). These tax laws clearly have provide incentive effects on for both parties to a prospective financial transaction, on the decision whether to formalize an organization or deal, as well on the choice of a corporate or charitable organization status for microfinance promoters.

Social capital is less formal but no less as important as a viable source of loan guarantees. There are many savings groups and other informal local community banks in Thailand that successfully rely heavily on cross-guarantees and trust, while others are plagued by group defaults or leaders absconding with group funds. An important enabling factor is the role of 'development monks' in rural communities in Thailand. Many monks have drawn on the cohesion and spiritual practices of these communities to launch a wide variety of savings, credit, self-help, and welfare initiatives, many of them achieving great success in mobilizing resources.

Research on Thai kinship networks (Kinnan and Townsend, undated) suggests that these are important in financing investments that are too large to be collateralized with tangible assets and therefore must rely on social enforcement. Extended kin relationships are found to perform this function in assuring lenders that their loans will be repaid. By implication, being indirectly connected to the financial system is as beneficial as a direct connection. Not every household in a village needs to use the banking system directly in order to benefit, if interpersonal gifts and lending are widespread.

This further suggests that evaluating financial access strictly by comparing those who use the banking system to those who do not may result in inaccurate findings. Indirect access to the formal financial system by means of group membership or social relationships, combined with the insurance-like effects of kin networks, appears to provide greatest resilience, particularly in rural villages. Other experience affirms that indirect access alone leaves people vulnerable to shocks – as well as to the breakdown of group discipline and to opportunism or coercion by group leaders.

Chapter 6. Business case for sustainable banking in Thailand

6.1 Level of "sustainable banking" in Thai banking industry

As mentioned in Chapter 1, Dr. Katrin Kaeufer at Massachusetts Institute of Technology (MIT) defines five levels of socially responsible and green banking. Level 1 and 2 are defined as follows:

Level 1: Unfocused corporate activities.
At this level, banks sponsor "green" events and undertake public relations activities that are not related to the core business of the company ("greenwashing"). Most mainstream banks have been at this level of green for a long time.

Level 2: Isolated business projects or business practices.
Banks develop isolated products or activities that they add to their conventional banking portfolio. These account for only a small percentage of total business activities. Such token products and activities may be a reaction to changes in public opinion, and they are enacted in isolated areas of the bank, not as part of a company-wide application of socially responsible and green business principles and practices. Examples here are added "green products" to a conventional portfolio.

Our review of Thai banks' practices, both commercial banks and Specialized Financial Institutions (SFIs), found that the majority of banks are at Level 1 in Dr. Kaeufer's definition. A few commercial banks, namely Krung Thai Bank, KasikornBank, and to a lesser extent Krungsri Ayudhya Bank, TISCO, and Bangkok Bank, can be said to be at Level 2 due to their products and services that are in line with sustainable development and/or improving financial access.

All SFIs are at Level 2, although most of their products and services may reflect the need to operate in a way that is consistent with government mandate, rather than the banks' own initiative.

No Thai bank has yet integrated environmental and social risk assessment and management into their lending process, which is one of the first steps toward "responsible wholesale lending" practice.

Our review of Thai banks looks at the following 5 criteria:

1. Products with integrated financial education component – financial products that integrate financial education in the product delivery or at point of sale
2. Financial education programs – financial education programs that are separate from product, e.g. conducted as part of "corporate social responsibility" (CSR) activities
3. Sustainable wholesale lending – "green" lending program such as renewable energy loan
4. Integration of environment and social risk management in loan approval process
5. Improving financial access –Products targeted at low-income segment

The results for each bank can be seen in the following table:

Krung Thai Bank PCL	Products
Products with integrated financial education component	NONE
Financial education programs	NONE
Sustainable wholesale lending	• KTB-Energy Saving Loan ○ Use of loan as expenses in construction/renovation of factory, premises/building, site and/or manufacturing/alteration/installation of machinery and equipment including materials used in energy saving or alternative/ renewable energy. ○ Support and promotion of energy saving and conservation through use of renewable/ alternative energy or operation for economic purposes. ○ Implementation of new or alternative energy projects such as power/ electricity generating to be used in business establishments and/or for sale to the Electricity Generating Authority of Thailand (EGAT) • KTB-Energy Saving Loan Loan for investment and/or working capital in project/scheme to bring about energy saving, use of alternative or renewable energy and clean energy both in case of production for own use or production for sale, pollution elimination/reduction to conserve the environment including expenses on improvement or renovation of business establishment site, building construction and related machinery and equipment. • Environment Loans for Private Sector The Bank provides low interest capital funds for the private sector in the following environmental operations: ○ Treatment systems of air/water pollution, waste disposal system, equipment for control, treatment or disposal of pollution from their own business activities/operations. ○ To be employed as service provider for waste water treatment or waste disposal under the National Environment Promotion and Conservation Act B.E.2535(1992)
Integration of environment and social risk management in loan approval process	NONE
Improving financial access	• Community Bank Community Bank was first established in February 2002 to serve as provider of financial services, in particular capital funding, to communities. In addition, with different organizational networks of non-government organizations (NGOs) and other independent organizations from both the

	public and private sectors, it helps coordinate efforts in know-how development in such areas as production, management, and marketing in communities. Currently, KTB community bank provides several products as follows: ○ KTB Micro Bank: loan for street vendors ○ Loan for community's financial services providers ○ Loan for organic agriculture in north-eastern region ○ Personal computer and other equipment loan for community organization ○ Securitization program for several cases, e.g. private entrepreneurs in national park, street vendors in municipal areas, The Treasury Department's land tenants. • Microfinance for trade Loan service for retail customers who lacking opportunities to access funding. KTB has initiated strict process for credit approval. Only customers in trade-related business which has repayment ability and potential market with good liquidity will be selected. • Micro Bank for Lady Loan service for members of Project for Thai Women Empowerment Fund to use as revolving capital for the career building and income earning as well as help improving their quality of lives.

SCB PCL	Products
Products with integrated financial education component	NONE
Financial education programs	• Investment Symposium Seminar for retail customers for general knowledge of economics and investment. • Seminar for Wealth Management Clients Sub-group seminar in investment guidelines and strategy.
Sustainable wholesale lending	NONE
Integration of environment and social risk management in loan approval process	NONE
Improving financial access	NONE

Kasikorn Bank PCL	Products
Products with integrated financial education component	• Personal Financial Advisory Services (K-Expert) This service was created with three major focus areas: simple financial management tips, how customers can fulfill their dreams by financial discipline, and savings for future security. K-expert services provide several publicly accessible spreadsheets on debt solution and tax management. Additionally, clients also can call K-expert officers who can provide financial advisory in branches.

Financial education programs	• Financial Literacy for Bank Clients and the General Public To provide the audience with reasons why financial planning plays a vital role in our daily lives and future, and the advantages and disadvantages of investment. • Youth Camp Tour To teach students how to record their daily expenses, and to provide basic knowledge on small investment ideas. • askKBank.com Online content which provides a search channel for financial knowledge and various lifestyle topics that are classified under seven titles, including Finance & Banking, Corporate Business, SME, Investment, Smart Planning.
Wholesale Lending	• K-Energy Saving Guarantee Program The K-Energy Saving Guarantee Program features equipment leasing/hire purchase financing and/or long-term loan aimed primarily at energy efficiency projects under management of an Energy Service Company (ESCO). ESCOs are consultancy firms that offer integrated services for the implementation of energy efficiency projects and provide a guarantee that energy savings generated by the project will be sufficient for loan repayment. • Top-Up Loan for Energy Saving (Lighting Solution) The Top-Up Loan for Energy Saving (Lighting Solution) program features long-term loan aimed primarily at energy efficiency projects under management of an Energy Service Company (ESCO) or a supplier. ESCOs and suppliers are consultancy firms that offer integrated services for the implementation of energy efficiency for lighting solution projects and provide a guarantee or warrantee that energy savings accrued from the project will be sufficient for loan repayment.
Integration of environment and social risk management in loan approval process	NONE
Improving financial access	NONE

TMB PCL	Products
Products with integrated financial education component	NONE
Financial education programs	• Young Investor Program To create potential investors by providing key financial knowledge such as business planning, feasibility study and basic investment.
Sustainable wholesale lending	NONE
Integration of environment and social risk management in loan approval process	N/A
Improving financial access	NONE

BAY PCL	Products
Products with integrated financial education component	NONE
Financial education programs	• Simple Finance Class To provide personal financial literacy skills, i.e. instill basic financial knowledge and skills in managing loans and responsible savings.
Sustainable wholesale lending	NONE
Integration of environment and social risk management in loan approval process	NONE
Improving financial access	• Krungsri Microfinance Provides sale and lease-back via hire purchase and secured loan contract to customers who already hold titles to cars and other types of vehicles. The bank operates "Srisawad Ngern Tid Lor" brand which serves the under-banked segment, i.e. providing cash loans to motorcycle owners or farmers who want to purchase tractors. Such loans designed to accommodate their seasonal cash flow.

Bangkok Bank PCL	Products
Products with integrated financial education component	NONE
Financial education programs	• Bualuang Family Banking Seminar Bangkok Bank and its affiliates organized the seminars in several provinces to encourage families to plan for their financial future. The seminars also shared knowledge and options for building financial stability for families using the financial-planning expertise of the four companies covering all aspects of the topic. Expert teams comprising staff from Bangkok Bank and its three affiliates also offered personal consultancy and advisory services on financial planning – particularly planning for saving, investments and life protection – to interested customers at the seminars.
Sustainable wholesale lending	• Bualuang Green Loan Bualuang Green Loan can be used for investments in energy-saving projects, to improve the efficiency of your energy consumption, development of alternative/renewable energy, support green label products, support waste management (turning waste into energy), or development and production of bio-products (replacing chemical products).
Integration of environment and social risk management in loan approval process	NONE
Improving financial access	NONE

KKP PCL	Products
Products with integrated financial education component	NONE
Financial education programs	• Investment Club KKP PCL conducts the project to organize seminars for customers and the general public on regular basis to provide knowledge of finance and modern investments. • KK Financial Literacy Project KKP PCL organized a savings promotion and personal financial management for a model organization project for staff members and also organized an activity to provide the knowledge about savings for young people and also the a group of house makers in debt and saving management. • KK intelligent Investment Institute (KK iCube) The KK intelligent Investment Institute was set up to provide complete investment knowledge of standards for small investors who are customers of KK Trade Securities Co. Ltd., as well as for non-customers.
Sustainable wholesale lending	NONE
Integration of environment and social risk management in loan approval process	NONE
Improving financial access	NONE

TISCO PCL	Products
Products with integrated financial education component	NONE
Financial education programs	• Investment Forum Seminar TISCO Bank holds an Investment Forum seminar twice a year. The seminar offers exclusive financial and investment strategies from expert speakers and specialists. • Financial Planning for Retirement Seminar TISCO Bank arranges activities to promote the benefits of the Provident fund and the importance of financial planning by organizing many seminars for clients and other interested groups. • Financial Literacy for Youth Program TISCO launched financial literacy courses for student in high school and undergraduate levels with collaboration from TISCO voluntary staff who have strong background of financial knowledge. • Financial Literacy to Communities Project This course aims to add financial knowledge to the community. However, this project currently in the design stage. Some content has been adapted from the Bank of Thailand guideline, focusing on household financial matters such as home income/expense accounting and debt

	management.
Sustainable wholesale lending	NONE
Integration of environment and social risk management in loan approval process	NONE (signatory of UNEP FI)
Improving financial access	• "Somwang" : one of the TISCO group's subsidiary which focus on the microfinance. Currently, Somwang operates nationwide to allow clients to access source of financing at an affordable cost. This brand's main products are motorcycle loan and loan against vehicle license.

CIMB Thai PCL	Products
Products with integrated financial education component	NONE
Financial education programs	NONE
Sustainable wholesale lending	NONE
Integration of environment and social risk management in loan approval process	NONE
Improving financial access	NONE

Thanachart Bank PCL	Products
Products with integrated financial education component	NONE
Financial education programs	NONE
Sustainable wholesale lending	NONE
Integration of environment and social risk management in loan approval process	NONE
Improving financial access	NONE

UOB PCL	Products
Products with integrated financial education component	NONE
Financial education programs	NONE
Sustainable wholesale lending	NONE
Integration of environment and social risk management in loan approval process	N/A
Improving financial access	NONE

LH Bank PCL	Products
Products with integrated financial education component	NONE
Financial education programs	NONE

Sustainable wholesale lending	NONE
Integration of environment and social risk management in loan approval process	NONE
Improving financial access	NONE

Standard Chartered Bank (Thai) PCL	Products
Products with integrated financial education component	NONE
Financial education programs	NONE
Sustainable wholesale lending	N/A
Integration of environment and social risk management in loan approval process	Yes (parent bank is signatory of Equator Principles)
Improving financial access	NONE

Industrial and Commercial Bank of China (Thai) PCL	Products
Products with integrated financial education component	NONE
Financial education programs	NONE
Sustainable wholesale lending	NONE
Integration of environment and social risk management in loan approval process	N/A
Improving financial access	Not Available

Government Saving Bank (GSB)	Products
Products with integrated financial education component	NONE
Financial education programs	• School bank and Community bank project. GSB provide fundamental financial services like savings to promote the saving behavior at the community level by set up several small sub-branches in the school and community. Additionally, the bank also supports the financial literacy at the community level through school bank and community bank.
Sustainable wholesale lending	NONE
Integration of environment and social risk management in loan approval process	NONE
Improving financial access	• Community Bank: Personal Loan This loan is offered to low income clients with the simple regulations and relatively low loan amount. This project also covers expenses in job training program for members

	of community bank. • Loan for Small Organization in Community GSB grants loan for several types of organization such as rural development loan, loan for community enterprise or OTOP entrepreneur, as well as small retailers.

Government Housing Bank (GHB)	Products
Products with integrated financial education component	NONE
Financial education programs	NONE
Sustainable wholesale lending	NONE
Integration of environment and social risk management in loan approval process	NONE
Improving financial access	• Special interest rates for low-and-middle income clients This loan aims to support low-and-middle income clients who want their own homes with a credit limit of 1.5 million Baht.

Bank for Agriculture and Agricultural Cooperatives (BAAC)	Products
Products with integrated financial education component	NONE
Financial education programs	• Smart Farmer The program provided knowledge on household accounting, record keeping, and farm enterprise accounting from the level of community enterprise to individual farmers. • School bank project BAAC provides basic products such as savings account to promote saving behavior at the school. The students and teachers who volunteer to operate the bank school will gain basic financial knowledge such as saving management.
Sustainable wholesale lending	• Credit for Environmental Conservation Loan to support the participation in environmental conservation under the scheme as follows ○ Investment in forest planting, including land preparation, planting seedling, supplies for forest planting and necessary costs of investment ○ Investments in the construction of bio-gas ponds and supplies and equipment involved with bio-gas ponds. ○ Investment in farm-related activities intended to raise farm household income. The activities must conform with environmental conservation laws, and must not damage natural resources or the

	environment.
Integration of environment and social risk management in loan approval process	NONE
Improving financial access	• **Loans for Farm-Related Activities** This type of loan is intended to meet expenses and/or investment costs for activities related to agriculture. These activities use agricultural produce, either from farmers themselves or provided from other sources, as raw materials for processing as finished of semi-finished goods for sale. Qualifying activities may be for either production or services related to agriculture such as maize, rice, sugar cane and also husbandry. • **Loans for self-employed people** This loan grants the opportunity for the self-employed who mostly have unstable cash flow and lack of financial access.

EXIM Bank	Products
Products with integrated financial education component	NONE
Financial education programs	NONE
Sustainable wholesale lending	• Clean Development Mechanism Loan A medium- to long-term credit facility to support Clean Development Mechanism (CDM) projects, such as biogas and biomass power plants, available in conjunction with Term Loan for National Development.
Integration of environment and social risk management in loan approval process	NONE
Improving financial access	NONE

Overall, the "business case" for Thai commercial banks to adopt sustainable banking practices can be summarized in the following table:

Aspect of sustainable banking / Potential business benefits	**Better risk management**	**Increasing market share of existing client base**	**Entering new market**
Responsible wholesale lending	Yes – Integrating social and environmental impact criteria into lending process, especially project finance, can help reduce • risks of lawsuits • reputation risks, and	N/A	Yes – By targeting emerging enterprises that generate net social and /or environmental benefits, such as renewable energy, organic farming, and community development.

Aspect of sustainable banking / Potential business benefits	Better risk management	Increasing market share of existing client base	Entering new market
	• financial risks that stem from unmanaged social and environmental risks, especially projects that have potentially large adverse social and environmental impacts which are not sufficiently contained or addressed by existing regulations.		
Responsible retail lending	Possible – If better consumer protection is combined with financial education to reduce risks, e.g. repayment risks from over-indebtedness. Topics of particular interest to financial consumers include personal debt refinancing and better disclosures of fees.	Yes – through integrating financial education into product delivery or point of sale in such a way as to become "selling point" and generates consumer appreciation. For example: increasing deposit rate and reducing lending rate for frequent savers.	N/A
Improving financial access	N/A	N/A	Yes – Microfinance products, particularly lending and remittance, will be of interest to underserved market in Thailand. Commercial banks may overcome the limitations of traditional model by utilizing new channels, such as • Mobile banking • Cooperation with existing local community banks or saving groups

Further information for these business cases is summarized below for each component.

6.2 Business case for responsible wholesale lending

As mentioned in Chapter 1, sustainable banking is moving toward practices and sharpening the business case. Our literature review has revealed that A few leading banks have embraced a new paradigm. They are making shared value a critical part of their core business strategies and maintaining an edge in the face of growing competition, client demand, and regulation. The banks that have achieved this have overcome three common challenges:

- They bypass the prevalent trade-off mentality between social good and business success by proactively pursuing profits from purpose—by identifying links between core business performance and societal needs and developing intentional and smart business strategies to pursue them.
- They avoid the trap of low return expectations by innovating for ROI—finding the internal space and ability to create new products and services that generate competitive returns from social and environmental markets.
- They realize long-term growth by making markets—working proactively to grow and strengthen supply and demand conditions, often leveraging corporate philanthropy in new ways and working in close collaboration with external partners, including NGOs.

With regard to "responsible" lending practices, our review of Thai banks as summarized in the above table shows that most commercial banks in Thailand are still vaguely aware of the concept, relying only on directives and regulations from Bank of Thailand (BOT) as bank regulator. Several international institutions such as the International Finance Corporation (IFC) have arranged sustainable banking seminars and Equator Principles conferences. Nonetheless, Thai banks still conduct haphazard social or environmental activities through their CSR campaigns which are largely unrelated to their expertise and normal business operations. Social, environmental, and governance (ESG) risks are still seen mainly as "compliance risks," with the implicit assumption that such risks are sufficiently contained in relevant legal and regulatory frameworks.

However, this assumption is growing increasingly at odds with reality. Thai banks are aggressively expanding their reaches into the neighboring countries such as Myanmar, Laos and Cambodia, in anticipation of the upcoming ASEAN Economic Community (AEC), while democratic institutions in those countries are still sorely lacking, leading to significant ESG risks that are not internalized in the legal and regulatory framework, meaning that they are largely unseen from Thai banks' perspectives.

The Baht 115-billion Xayaburi dam in Laos, the first large dam being built in the mainstem of Mekong River, is a case in point. The dam is funded by a consortium of Thailand-only banks. As of September 2013, the construction is continuing apace despite numerous concerns being raised by scientists and environmental experts as to the dam's potential devastating impact to river ecosystem, agriculture, livelihoods, and food security of millions of people. The project could significantly reduce fishery catch and biodiversity, a major source of income for millions of people along the Mekong River, extensive river erosion and flooding, water contamination, and resettlement of thousands of poor and vulnerable fishers and farmers. Moreover, it also threatens to undermine the authority of Mekong River Commission (MRC), the intra-regional body under which Xayaburi was the first project.

The Laos government gave the green light for dam construction, despite objections from Cambodia and Vietnam and recommendation of the MRC's Strategic Environmental Assessment (SEA) to delay the project for 10 years while further studies are carried out. The World Bank has endorsed SEA's findings and confirmed that it will not fund any of the Mekong mainstem dams.

In July 2014, the Supreme Administrative Court has overturned previous decision of the Administrative Court, agreeing to hear the lawsuit that members of the local communities near Xayaburi dam construction site brought against Electricity Generation of Thailand (EGAT) and other government agencies. The trial is expected to begin in 2015.

Many researchers, such as Srivastava (2007), argue that banks should consider social and environments even in their analysis of project financing as (i) management of social and environmental risks in strategic decision making and lending will increase financial stability through decreasing non-performing loans, and (ii) it will create opportunities for development of financial products and services with social and environmental benefits. All these help banks better compete. Accordingly, the banking business is moving away from the so called 'conservative banking' with risk-aversion approach, to 'sustainable banking' with growth approach. Moreover, the integration of sustainability with management system will result in tangible benefits: the horizon of market will be enhanced because new area of lending sources will be identified, and the reputation and overall goodwill of the bank will increase manifold.

6.3 Business case for responsible retail lending

The Office of Consumer Protection Board (OPCB), under the Office of the Prime Minister, has the overall responsibility for consumer protection in Thailand. With regard to financial services, OCPB has regulations on credit cards, hire purchase cars and motorbikes, hire purchase electrical items, and loans for personal use. The office co-operates with each of the relevant financial authorities for the purposes of public relations and dispute resolution. OPCB oversees random investigations to ensure financial institutions are complying with regulation on loan contracts, and also undertakes investigations in responsible to complaints with regard to deceitful advertising.

In the past few years, Bank of Thailand (BOT) has issued many circulars to commercial banks in order to improve financial consumer protection. For example, in 2012, BOT issued a circular regarding sale of security and insurance products that requires commercial banks to disclose information related to product offering to customers sufficiently and appropriately, as well as to protect consumer rights. This is in response to complaints from many consumers regarding "forced" product bundling offered by banks, especially the bundling of insurance with loans products.

However, financial consumer protection regime in Thailand still falls short of international standards, such as The World Bank Good Practices for Consumer Protection and Financial Literacy, in some key areas. For example, there is still no standardized APR (Annual Percentage Rate) regulation, no mandatory cooling-off period, and no standardized loan application forms, allowing many banks to disclose no details of relevant fees and interest rate calculations. This gives rise to widely divergent quality of financial product disclosures, as illustrated in our survey of commercial banks' credit card application forms.

Overall, the financial product on which consumers lodged the highest number of complaints with FCPC is credit card, followed by personal loan, commercial loan, and hire purchase respectively. In 2013, over 53 percent of all complaints FCPC received are relating to loans: number one is request for assistance on debt restructuring, queries on interest calculation that caller felt is incorrect, and

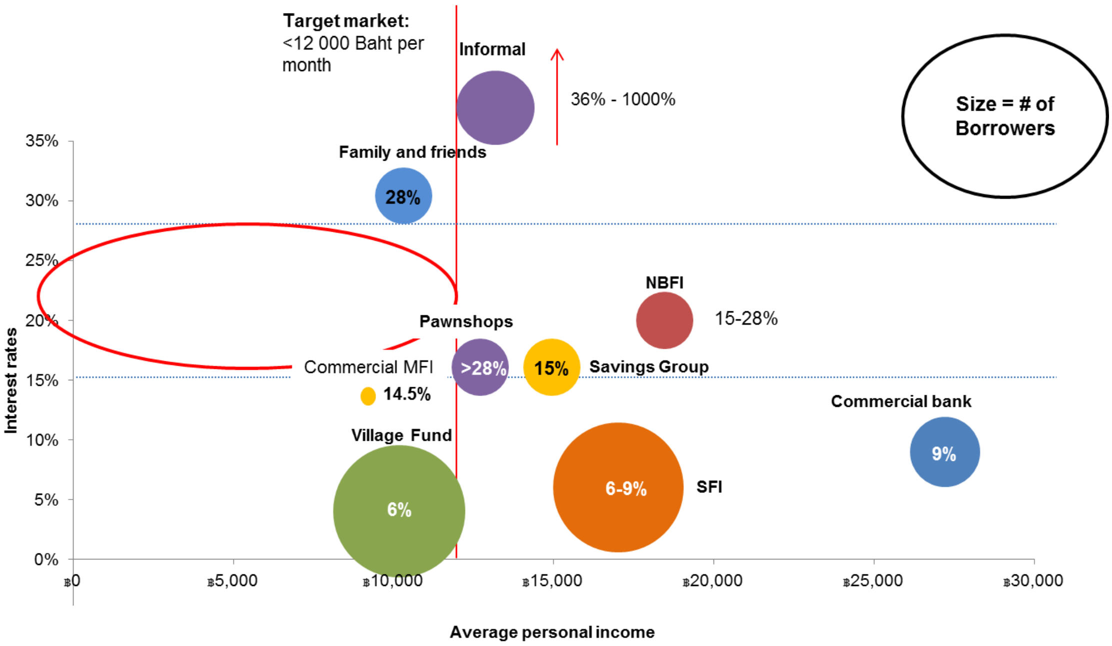
complaints regarding high fees for late payment (some institutions charge 200 to 450 Baht or higher regardless of debt balance, and even for payment that is only one day late).
Financial complaints lodged at Foundation for Consumers, which caters to lower-income consumers, highlight a distinctive consumer vulnerability which is not seen in the FCPC report. This vulnerability is over-indebtedness problem. Complaints regarding late payment, being prosecuted for debt delinquency, refinance, and direct debit loan repayment, all of which indicate over-indebtedness problem, approximately account for 75 percent of total complaints the Foundation received in 2013.

Complaints from financial consumers as summarized above are in line with macro situation. Household debt in Thailand has been increasing for several years, reaching 82 percent of GDP as at the end of 2013, making it among the most indebted country in Asia in terms of this data, alongside Malaysia, Taiwan, and South Korea. In a press release in April 2014, FitchRatings warned that "Systemic risks would rise if household debt growth does not slow down. These risks could become an increasing source of asset-quality problems - particularly if a worse-than-expected slowdown amidst Thailand's political turmoil results in sharp rises in unemployment and inflation. This increases the contingent liability risk the sovereign could face if support for the banking sector is required in the event a large economic shock undermines capacity for households to service debt."

Financial complaints data, as well as household debt information, suggest that there are likely significant business benefits from improving retail lending practices of the bank. Benefits seem especially attractive in 1) designing products that increase consumer incentives to save and reduce debt burden, and 2) integrating financial education into retail product delivery.

6.4 Business case for increasing financial access

Given the financial behavior of Thais and existing loans landscape as articulated in Chapter 5 and summarized in two charts from FinScope survey on the next page, we propose that the market is still wide open for financial institutions to serve those with less than 12,000 Baht monthly income, at the lending interest rate between 15-28 percent per annum. Potential business models that may be feasible for these conditions includes: co-operation with local community banks and savings groups to act as "paying agent" or "collection agent" for banks, as well as mobile banking models that have the capacity to convert "e-money" into real cash.



Insurance
- Majority of risks covered are by the community and the state
- Private insurers cover motor vehicles and credit-life

Savings
- 80% of people feeling they can trust banks with their money, but majority use for moving cash (remittances)
- Deposits at SFI's (GSB) are growing at more than 30% a year

Credit
- Many households, especially farmers, regarded these as a "cash flow lifeline"
- Borrowers are prepared to accept widely divergent interest rates

Institution	Consumer Loans	Micro-Loans (<THB 200k)	Deposits	Remit-tances	Payments Collection	Pre-paid / Stored Value Cards	Insurance /risk protection
Government							✓✓✓
Commercial Banks	✓✓✓	✓	✓✓✓	✓✓✓	✓		
SFI: BAAC	✓✓✓	✓✓✓	✓✓	✓	✓		✓✓
SFI: GSB & GHB	✓	✓✓	✓✓✓	✓			✓
NBFIs	✓✓✓	✓✓✓					
Credit Unions / Co-Ops	✓✓	✓	✓✓				
Village Fund	✓	✓✓✓	✓				
Moneylenders / Pawnshops	✓	✓✓					
Post Office				✓✓	✓		
Private Insurers							✓
Community-based institutions							✓✓✓
Modern Trade Outlets					✓✓✓	✓✓	
Mobile Network Operators				✓	✓✓	✓✓✓	

Payments
- 65% of utility payments are made at 7-Eleven stores
- Mobile payments are growing exponentially

Degree of usage
Low ✓ -
High ✓✓✓

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