

Environmental risk and management strategy: the implications for financial institutions

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Examines the legislative pressure and pressure from financial markets for companies to adopt an environmental risk strategy.

In recent years there has been an increasing awareness of the adverse impact of human activity on the natural environment. Fears of global warming have escalated and the environmental impact of industrial accidents has been generally widely publicized. As a result, businesses have been subject to both government and market pressures to adopt a corporate environmental strategy that will minimize damage to the environment in the future, and help in rectifying legacies from the past.

Despite a diversity of literature addressing the issues of environmental management, managers often remain sceptical as to the importance of environmental considerations within corporate strategy. However, the economic reality of environmental management and its failure has not gone unaccounted. For example, Union Carbide faced claims of over US\$3 billion after a chemical leak at Bhopal, and Exxon has spent over US\$2 billion cleaning up after an Alaskan oil spill. Closer to home, Shell was fined a record £1 million for a crude oil spill into the Mersey and charged £1.4 million for clean-up costs (Corbett and Wassenhove, 1993). Alternatively, Minnesota Mining and Manufacture's Pollution Prevention Pays programme has saved over US\$500 million since it was introduced in 1975.

It is the purpose of this article to provide an insight into the need to integrate environmental considerations within corporate strategy. Given that a company's financial strategy commonly holds some of the most important considerations for the success of the business, it is on this basis that the article shall explore environmental considerations addressing corporate financial objectives and the role of key financial stakeholders. A discussion of how the concept of liability is changing within the current legal system provides a grounding for environmental risk assessment. Finally, a

guide to establishing an environmental management system will be defined as a tool to complement such a strategy.

Legislation

Recent developments in environmental legislation have been a significant weapon in plans by the UK Government to enhance corporate environmental awareness, posing financial threats to corporate managers who fail to manage their environmental impact. For example, the Environmental Protection Act (EPA) 1990 makes manufacturers and disposers responsible for waste management under a "duty of care" order and requires operators of prescribed processes to demonstrate an application of BATNEEC, the "best available techniques not entailing excessive cost" and where a process discharges to more than one environmental medium the BPEO, "best practicable environmental option" must be considered. (ENDS, 1993a). To facilitate these principles a new system of integrated pollution control (IPC) has been developed allowing industrial pollution to be looked at for its effect on the environment as a whole.

Current UK legislation is based on a system of fault-based liability. In claims for environmental damage, the injured party, or their representative, needs to prove legal culpability on the part of the polluter. There are signs that the law may soon widen to incorporate principles of strict and retrospective liability.

Legal principles underlying environmental legislation in the UK are being increasingly driven by the European Commission towards stricter liability regimes for industry, or at least specific industrial sectors. For example, the European Commission's Green Paper on

Liability for Environmental Damage (1992) combines strict liability for hazardous activities with a joint compensation funds where damage cannot be attributable to specific problems (Environmental Liability Report, 1993a).

Under principles of strict liability it is necessary to prove only a causal connection between a polluting act and the resultant environmental damage, permitting defence only in certain circumstances. This encourages claims against environmental damage and potentially increases corporate liability. The principles of retrospective liability open up a debate considering how best to apportion liability for environmental damage, both historic and current. Unanswered questions remain as to the length of limitation periods for claims and types of loss recoverable.

At common law the recent case *Cambridge Water v. Eastern Counties Leather* caused considerable debate when the Court of Appeal (1992) held that no-fault liability principles in nuisance law applied to an industrial company causing long-term groundwater pollution (ENDS, 1992a). The case was overturned by the House of Lords in December 1993. Lord Goff, of the House of Lords, agreed with the Court of Appeal's findings that a principle of strict liability under nuisance law exists to the extent that a defendant's reasonable care to prevent damage does not relieve liability. In determining the new judgment the type of damage for which the defendant should be held liable was considered; it was held that no liability will arise where damage is not foreseeable.

A recent Government response to a House of Commons report (1990) on contaminated land called out for a test of legal principles from the courts; *Cambridge Water* provides such an authority. In considering the principles of strict liability Lord Goff stated, "It is more appropriate for strict liability in respect of operations of high risk to be imposed by parliament, than by the courts". This issue is currently being considered by the Government's interdepartmental committee (ENDS, 1993b).

Any change in the law will have a direct effect on claims made against insurers and demand for protection, and will indirectly affect the risk incurred by investors. The EC Directive on Civil Liability for Damage caused by Waste aims to provide a means of compensation for those suffering as a result of environmental damage caused by waste disposal activities, and goes as far as placing direct demands on insurers and investors. An interesting provision in the directive requires waste disposers to demonstrate some form of financial security. This financial security may be in the form of a guarantee provided by banks and other financial institutions, or it may be in the form of insurance (Street, 1992). The reaction to this has been varied.

Finance

In general the stock market and banking sectors in the UK have shown little interest in the environmental posture of organizations. However, there are signs that this is beginning to change. In reaction to the current debate surrounding environmental liabilities, financial institutions are now being drawn into the environmental arena and ethical funds have developed based solely on corporate environmental performance.

The reaction of lenders

For financial institutions, liability for environmental matters may be indirect or direct. With the movement towards strict liability for pollution instances banks could be judged to have exercised some form of management or control over the borrower's activities and be deemed an active participant in civil or criminal liability. Further, lenders may suffer indirectly because of the effect of environmental liabilities on a borrower's solvency, or the security of a borrower's loan. The borrower may face fines or closure due to its environmental liabilities and the bank may suffer loss of income. A lender who calls in security for a loan and becomes the owner of the property absorbs responsibility for any liability attached to the property, which may include costly clean up (ENDS, 1992b).

In circumstances where both direct and indirect liability arise, lenders face the prospect of paying twice for the same liability of the borrower. These are certainly considerations to be taken up by banks when deciding whether to lend and how best to secure a loan.

UK banks are particularly worried that some US standards may be adopted; for example, the precedent set in the *Fleet Factors* case some three years ago. In this instance a bank was deemed to have participated in the financial management of a company to the extent of influencing the corporate treatment of hazardous waste. On these principles the court held the bank financially liable for clean up costs.

The UK can learn from the experience of US lenders who for many years have faced liability for the environment under the actions of the US Environmental Protection Agency (USEPA). For example, Maryland Bank and Trust company in the USA had a US\$335,000 loan go into default at the end of 1991. Although this was supported by a title to land of equal value, when the bank acquired the land in settlement for the debt it was visited by the USEPA. The bank faced clean up costs of US \$500,000 before it could sell the land. No environmental assessment had been carried out as part of the lending process (Welford and Gouldson, 1993).

Many US lenders are now carrying out rigorous environmental risk assessments as part of their lending process, often increasing the cost associated with raising finance for corporate borrowers. Harrisons and Crosfield, the UK chemicals and feedstock company, learnt of their financiers' worries when negotiating a US\$120 million private placement with a group of US institutions in the summer of 1991. The Harrisons owned 110 chemical sites in the USA at the time and the institutions insisted on carrying out an environmental assessment at each one before committing themselves to finance. After a long delay the financiers agreed to visit only a sample of the sites and accept documentation for the remainder. The cost of delay and legal fees attached to the negotiations added noticeably to the costs (Lascelles, 1992).

Such environmental assessment by lenders can also protect the financial position of their customers. In 1987, Beazer, the international building and construction group, acquired Koppers, America's second largest aggregates company, borrowing US\$700 million. As part of the takeover Beazer also acquired Koppers' US timber and chemical divisions. The timber treatment division was sold with a costly clean up guarantee in 1988 while a £296 million provision appeared in the balance sheet, mainly due to the potential pollution liability for the chemical division (*Contract Journal*, 1989).

The UK government's Advisory Committee on Business and the Environment (ACBE) has supported recommendations by UK financial institutions against a fundamental reform of the existing regime of civil liability for environmental damage. The financial institutions' worry is that the risks attached to environmental liability will lead to polluters being denied access to capital markets in order to finance the cost of clean up (ENDS, 1992c, 1993). However, the former environment minister, Mr Yeo, rejected such calls, telling leading banks that they must bear some financial responsibility for lending to polluters. Although not accepting proposals for liability, banks are beginning to recognize such responsibility (Gapper, 1993).

A "Global Charter" has been produced committing banks to integrate environmental considerations into every facet of their business. This has been signed by over 30 banks, including the National Westminster Bank and the Royal Bank of Scotland. The banks which have signed the charter have committed themselves to "endeavour to ensure that their policies and business actions promote sustainable development", preferably within the market mechanisms. To enforce the charter banks may, where appropriate, conduct a corporate environmental impact assessment (ENDS, 1992d). Such a change in banking policy will inevitably result in a cost to the bank which will be passed back to customers.

The Co-operative Bank now offers its customers ethical savings and current accounts under a comprehensive ethical policy. In respect of their environmental initiative the bank encourages its customers to take a proactive stance and any company found to be consistently flouting its environmental policy will ultimately, after friendly warnings, have its account closed. Lending managers are instructed to consider the environment when taking decisions, although no specific guidance is given.

A key example of cautious decision making by a bank, when providing corporate finance, can be seen using the example of a company called Elm Energy. Elm Energy is an electricity generating plant burning used rubber tyres to produce fuel. The first of its kind in Europe, the company was established in the UK in 1992. Despite the UK Government enthusiastically supporting the establishment of a company of its pioneering nature the banks were not so positive when the company attempted to raise £35 million development costs. The banks were satisfied with the quality of technology proposed but questioned the environmental impact that the plant would have in terms of waste disposal and land contamination. The finance negotiations took over one year to complete successfully and the legal costs attached to the proposal were greatly increased (Lascelles, 1992).

It is evident that corporate managers and financial institutions alike would not welcome a fundamental change in environmental legislation and fears surrounding developments in environmental liability are raising new questions for risk managers. For an environmentally aware manager, improving corporate environmental performance offers opportunities of gaining access to bank finance at a reasonable cost and opens the door to ethical investors.

Trends within ethical investment

When considering ethical investment to date, most effort has been expended to define the term "green fund". The result was the bifurcation of this definition.

First, there are what have been called green opportunity stocks. Investors are looking for profits from companies directly involved in environmental areas such as waste management, companies which do not necessarily conduct their businesses in an environmentally friendly way. Green Opportunity Stocks (GOS) can be found in the *James Capel Green Book* (Capel, 1991). The second approach is to invest in companies who adopt a positive attitude towards environmental issues, no matter what their business. Two funds that follow this approach are Jupiter Tarbutt Merlin's Merlin Ecology Fund (holding £10 million) and Merlin International Green Investment Trust (which manages £24 million). Eagle Star's £8

million Environmental Opportunities Trust offers a mixture of the two approaches (Fisher, 1992).

Ethical investment criteria and methodology differs from fund to fund and over time given a changing market and evolving management principles. After carrying out a comparable analysis of investment policies of ethical investment trusts, recent research has identified a further category of "negative" investment criteria. Trusts may consider it very important to avoid investing in companies with particular involvements such as association with activities leading to a depletion of the rainforests (Perks *et al.*, 1992).

A company ignoring environmental considerations would potentially close the door to this source of finance. However, while supporters argue that environmental-influenced investing is not only forward looking but also good business practice, detractors argue that environmental screening harms profitability. It goes to the heart of the short-termism debate and asks whether the search for profit and ecological concerns can be compatible.

Claims have certainly been made which uphold the merits of GOS funds. The *James Capel Green Book* reports that the 30 stocks that make up the James Capel Green Fund have beaten the market average handsomely through 1991. Eagle Star's Environmental Opportunities Trust gave its investors a 28.40 per cent return for the period from its launch in June 1989 to February 1992. This compares with an average return of only 2.17 per cent in its market of the UK equity growth sector. An example of relative growth in the popularity of ethical funds is illustrated by comparing their growth rate to that of general unit trusts. For example, ethical investment increased by 17 per cent between July 1991 and July 1992, compared to only 3 per cent for general unit trusts.

Despite this, literature establishing environmental performance measures to analyse investments and market-based research to track their financial performance has been scarce. This may be due to the fact that ethical investment did not come into existence until relatively recently. Green funds in particular have received limited coverage.

An initiative in this field is London and Bishopsgate International Investment Management, an independent fund and treasury manager specializing in global asset allocation. Pension Investment Research Consultants, who are specialists in advising pension funds about socially responsible investments, have worked with Bishopsgate to establish the UK Ethical Index.

In a historical reconstruction, over a five year period, the UK Ethical Index has tracked the FTSE with a correlation of 99.5 per cent and an average track error of

less than 0.6 per cent. They concluded that ethical investors are rational investors, able to maximize returns (Dunham, 1989). This is further supported by Perkes *et al.* (1992) with reference to an earlier quote by Ward who stated that "in general the evidence from both the US and the UK shows that you can invest with an eye to social responsibility and do as well as with a conventional portfolio" (Perks *et al.*, 1992).

A recent study by Luther and Matatko (1994) addresses the question of an appropriate choice of benchmark against which to measure the performance of ethical investments. Luther and Matatko found that ethical investment in the UK is characterized largely, but not entirely, by investment in smaller companies. Over the period 1985 to 1992 they recognized research which has shown that both small companies and ethical trusts had underperformed the UK market. However, they concluded that the "systematic" component of ethical investment returns appears to be better described by a benchmark made up of both a market and a small company index, which could cause problems in assessing their results.

While many believe that the research into the financial performance of ethical investments is inconclusive, investors are certainly important stakeholders in a company (Perks *et al.*, 1992). Environmental considerations are becoming an integral part of decision making whether or not in association with "ethical investments" and ethical investors a recognized stakeholder group. There is a need to acknowledge the potential impact that a pollution incident or merely a poor environmental reputation could have on share prices.

The impact of ethical investments is not limited to the amount that they invest and the value of their returns. Publicity attached to fund decisions may have a disproportionately large influence. Ethical investors, such as the Merlin Ecology Fund, have been a major force in campaigning to raise environmental issues onto corporate agendas. Given market pressures within the supply chain to assess the corporate environmental performance of business partners, anyone ignoring environmental considerations may risk the loss of customers and suppliers, as well as financiers, to their competitors. As Porter (1990) argues, "the conflict between environmental protection and economic competitiveness is a false dichotomy stemming from a narrow view of the sources of prosperity and a static view of competition".

Both threats and opportunities run hand in hand with environmental considerations in finance and as the debate surrounding environmental liabilities continues a company should be aware of the issues involved. Stakeholders are not investing blindly and environmental pressure group are quick to uncover skeletons in the

closet. For risks to be minimized and opportunities taken to fruition, claims of environmental management by corporate managers must have firm foundations. Environmental questions of corporate management must span the entire corporate system.

In order to reduce the risk of financial loss attached to environmental liability claims, many corporate managers may seek protection in environmental insurance. In some instances banks are requiring customers to take out environmental insurance to underwrite their own liability. This practice is most common in the USA. In 1992 the Fleet National Bank announced that borrowers seeking loans over US\$1 million would be required to take out green insurance. This banking practice is not common in the UK but given the potential effect of the EC Directive on Civil Liability for Damage caused by Waste it could be implemented in the future.

The insurance market is, not surprisingly, concerned with the implications of environmental liability and customer demands. However, they are unwilling to carry the costs of environmental protection alone. Experience in the USA demonstrates both the scale and potential costs of using legal remedies to target environmental protection (Lapper, 1994). The US General Accounting Office has suggested that the cost to the USEPA and private sector could be US\$300 billion over the next 30 years (CBI, 1993). Complying with these regulations would undermine large parts of the banking and insurance sector.

In the UK the clean up of derelict land has been estimated at £20 billion with a cost of making it fit for use at twice as much. Already, over £5 billion has been drained from the London market by asbestos claims alone (*Economist*, 1992). A possible explanation for the massive 1993 losses at Lloyds may have been the unexpectedly high levels of claims relating to "natural disasters" and the costs incurred by companies for pollution clean up.

The reaction of insurers

Developing legislation in Europe is causing insurers to reappraise how they approach their method of underwriting and the services they offer.

Trends in the UK insurance industry have shown that insurers are reacting to pressures surrounding environmental liability by endorsing their public liability policies to restrict pollution cover to "sudden and accidental" incidents. The purpose of this is to avoid gradual pollution claims. Where available, liability for gradual contamination and leakage is provided through Environmental Impairment Liability (EIL) policies (Gray, 1993).

Such a process of change is not simple. New forms of environmental impairment liability are written on a "claims made" basis. In the past general liability policies were frequently written on an occurrence basis. Problems may still exist in apportioning liability where one policy follows the other. There remains an ambiguous basis for apportioning liability especially for historic pollution (Napier and Clabon, 1992).

A recent CBI report comments "liability for remedying environmental damage may well become the key environmental challenge facing businesses of the 1990s" (Lascelles, 1993). The CBI recognizes that corporate costs of environmental clean up are potentially very high (CBI, 1993). One method of tackling this problem is for industry to set up its own insurance fund and share the costs. The Chemical Industry Association, for example, have adopted an Environmental Impairment Liability Insurance Facility (CEILIF) available to all its members (Wilkinson, 1994).

From the outset environmental insurance requires a scientific background to underwriting and a high level of risk management based on a comprehensive environmental performance assessment (Napier and Clabon, 1992). The Loss Prevention Council are currently undertaking research on this issue (Wilkinson, 1994). Where available, environmental insurance schemes may require a site survey to be carried out as part of a corporate risk assessment policy, prior to insurance being granted. Further, given that a site survey only identifies the condition of certain aspects of the site, at a given point in time, insurers may frequently request the adoption of a corporate environmental management system to support insurance provided. This would greatly increase the cost of environmental insurance.

Insurers currently offering EIL cover in the UK are mainly large international groups with experience gained as a result of different legal circumstances across the world. In 1989 the London office of Swiss Re led the underwriting of an environmental policy for chemical firms. Swiss Re has now been joined in the market by AIG and Reliance National, both American insurers active in Britain. Currently the UK market has offered few buyers for services offered; this is believed to be due to the requirements attached to policies. As environmental liability evolves this market may change (*Economist*, 1992).

The focus of environmental insurance may meet further restriction in the future. A statement by the Association of British Insurers (ABI) prior to the judgment in the Cambridge Water case stated that existing partial pollution exclusion wording was likely to be withdrawn in favour of absolute exclusions if the judgment went against the appellant, Eastern Counties Leather. Despite the judgment in favour of Eastern Counties Leather,

rejecting retrospective liability, given trends within European legislation and the reaction of insurers around the world the need to consider absolute exclusion has not been totally removed. Absolute pollution exclusion in general liability policies already exists in the USA, Italy and more recently Germany and France.

From 1 January 1994 the French insurance market has restricted pollution cover under general liability insurance to a maximum of FF 10 million (US\$1.7 million). All risks above the limit will have to be insured separately through the pollution insurance pool Assurpol, with a separate premium and a more restrictive EIL wording. Assurpol has also replaced the previous claims-made policy wording with a form of "discovery trigger". This action has followed a decision by the French courts that claims made policy wording was invalid and that the only valid trigger of coverage was the causative act (Environmental Liability Report, 1993b). Legislation is also having an impact on the German insurance market with compulsory environmental insurance requirements for dirty industries from 1993 (*Economist*, 1992).

A comment by the European Insurers Association in reaction to the Green Paper on Remedying Environmental Damage summarizes the current feelings of insurers: "Insurers are already cautious of providing pollution insurance ... and are concerned that any change in ground rules could lead to policy being incurred in situations where it was never intended". As the current debate surrounding environmental liability continues the only way to ensure that environmental risks and their financial consequences are at least minimized is to adopt a comprehensive environmental management system.

Developing an environmental management system

The successful formation and implementation of environmental considerations within corporate strategy is not a simple process. The range of environmental issues confronting institutions is extremely broad and their impact potentially hinges on the speed at which legislation and market pressures are evolving. Companies need to internalize environmental issues, developing environmental objectives that, to be efficient, must be consistent with long-term corporate strategy. This means that when confronted with any environmental issue it will be recognized and an appropriate response initiated.

Wood's (1991) framework of corporate social performance addresses this issue of internalization at three levels of activity: the institutional level, the organizational level and the individual level. At the institutional level location may be considered. For example, given different legal requirements a company

may adopt the highest possible standard and realize the financial benefits of environmental quality management. Alternatively, a company may locate in an area with the most relaxed legal requirement. California's tough laws have been given as a major reason for manufacturers leaving for Nevada or Arkansas. This movement may be at the risk of a change in legislation within the new locality and its associated costs.

At an organizational level environmental consideration may centre around acceptable levels of operating emissions. For example, Bayer spends 20 per cent of manufacturing costs on environment management (Corbett and Wassenhove, 1993). At an individual level, particularly in smaller companies, each employee should recognize their contribution to corporate environmental management. This philosophy is an integral part of the Body Shop's management and a prime example of its success.

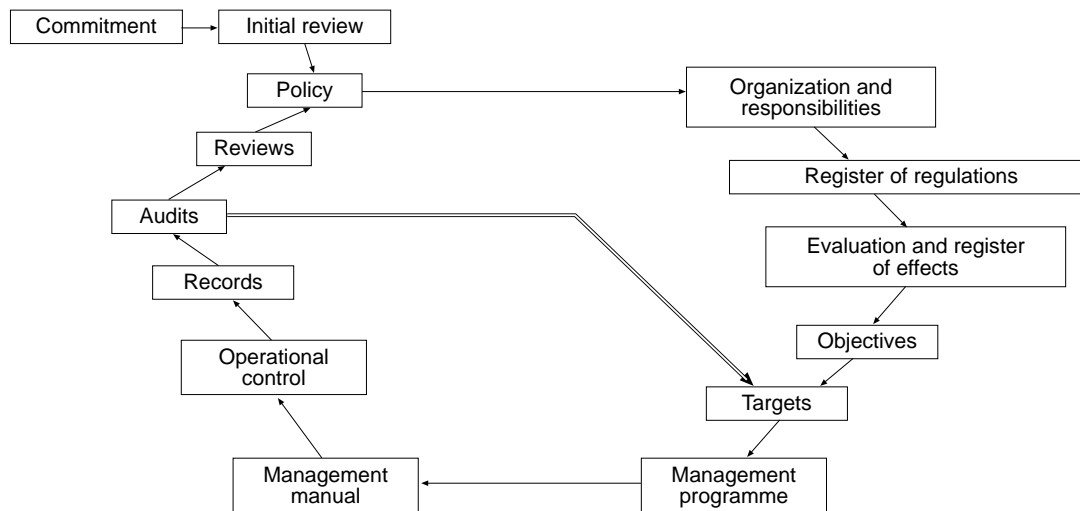
The development of a comprehensive environmental management system will facilitate the adoption of an environmental strategy and support such a programme of internalization and promote the adoption of an environmental strategy. The establishment of recognized corporate guidelines on developing an environmental management system is currently being developed in the UK in the form of BS 7750, a corporate initiative in this field.

Published in March 1992 by the British Standards Institute, the draft standard BS 7750 is providing a key test of the effectiveness of voluntary action by industry and commerce to improve their environmental performance. The results of pilot trials have been evaluated and the standard has now been issued in its final form. It is hoped that the standard can be used as a tool for the future implementation of the EC's Eco-Management and Audit Scheme (EMAS), a wider environmental framework, including an environmental disclosure requirement. EMAS is expected to come into force in mid-1995.

The emphasis of BS 7750 lies in an assessment of the environmental effects of corporate projects across the "life-cycle" of processes, products and services. The main components of the system as outlined in Figure 1 highlight the need for commitment and encompass an initial review, development of an environmental policy, of and responsibility for personnel, utilization of pollution registers, establishment objectives and targets, an environmental management programme, operational controls and records, audits and reviews (BSI Draft Directive, 1991; ENDS, 1992).

Given the dynamics of both the natural and economic environment within which a company operates, it is important that, excluding a preparatory review, the

Figure 1. Implementation of an environmental management system



components of BS 7750 are recognized as a cycle of activity. These need to be reviewed and updated continually in light of change for the system to be effective.

The successful establishment of such a corporate system will provide a firm foundation for pursuing a risk management policy and gain the support of both lenders and insurers. The risk of corporate projects being delayed, or prevented, while lending decisions are made and insurance cover is considered will be reduced greatly.

Conclusion

Given such myriad influences impinging on management to adopt strategic environmental goals and a proposal for environmental management systems, companies and financial institutions have little excuse for ignoring environmental considerations within project appraisal.

A recent report by the Advisory Committee on Business and the Environment (ACBE, 1993), financial sector working group, summed up the potential impact of changes in environmental liability. The working group held, "because of the fears and uncertainties of insurers, their opposition to compulsory insurance is so strong that its introduction could lead to the removal of cover for environmental pollution insurance from the market". Further, "lenders fear the possibility of being deemed potentially liable for clean up costs", and "where contingent liabilities are considered too great or indeterminable, prudent lenders will not lend". A closer look at the financial markets in this article has supported this conclusion.

Environmental considerations within corporate strategy are of increasing importance in order to ensure the recognition and management of environmental risks attached to finance and insurance. Financial institutions are key stakeholders in a company and their influence on decision making and management practice should not be underestimated.

Given the demands for natural resources and the environmental impact of economic activity, it is important to recognize that environmental considerations permeate all strategic levels of the organization. Each corporate process, product and service, both past and present, potentially affect the environment through either extraction, formation, use or disposal of natural resources. At an operational level, most projects will have an environmental impact. To pursue the financial opportunities and evade the threats created by changing environmental liability a comprehensive risk management programme must be developed as part of corporate strategy.

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