

Stop Explosive Investments Webinar

How to read a financial institution's policy *analysing cluster munitions divestment policies*

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This fact sheetⁱ is based on the information of the Stop Explosive Investment Campaign Toolkit and Profundo's research experience for the 'Worldwide Investments in Cluster Munitions; a shared responsibility' report by Cluster Munition Coalition member PAX (the Netherlands).¹

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Introduction

A growing group of financial institutions (FIs) do not consider cluster munitions producers appropriate business partners. Some of these financial institutions have come to implement a clear and far-reaching policy on excluding cluster munitions producers. Other financial institutions have made significant efforts to ban cluster munitions from their investment portfolios, but their policies may contain loopholes that could still permit them to finance cluster munitions producers.

This briefing note explores the elements of a good cluster munitions exclusion policy. Questions that will be covered are: What would a perfect policy look like? What should you look for when you read a policy? What are common loopholes in policies? What do policies mean in practice?

Reading the cluster munitions policy is a first step. Often, comprehending the policy also requires reading between the lines. It might be that the policy leaves room for interpretation or is unclear in terms of its scope. Therefore, it is recommended to contact a financial institution directly in order to obtain more knowledge and a deeper understanding of the exclusion policy. This helps you to verify your findings and to be sure you interpret the policy correctly.

After you have identified a financial institution with a cluster munitions divestment policy, the following steps will help in analysing a financial institution's policy.

1. Does the policy apply at the group level? Research the group policy, since they usually set the investment policy and since the group directly or indirectly supervises its subsidiaries;
2. Does the policy exclude cluster munitions producers? Checking the FIs definition of cluster munitions;
3. Does the policy cover all types of investments? Defining the scope of the policy; and
4. Does the policy make any exceptions? Avoiding loopholes and pitfalls.

ⁱ See: www.stopexplosiveinvestments.org/report and www.stopexplosiveinvestments.org/campaign-toolkit.

1 Does the policy apply to the group level?

Since the financial group usually sets the investment policy and since this group directly or indirectly supervises its subsidiaries, it is important to search for the group's policy. Although subsidiaries might develop divestment policies on their own, it is important there is a group wide policy in place. If the policy is not applied to all subsidiaries, a FI might still be able to invest in cluster munitions producers by means of another subsidiary.

To find out if the policy is applied at group level, it is useful to:

- Check on the FIs website if the bank/asset manager/insurance company/pension fund is a subsidiary of a financial group; and/or
- Contact the financial institution.

Do not be misled by the name of the FI: a company called *Group* can still be a subsidiary of another group.

2 Does the policy exclude cluster munitions producers?

Financial institution's policies must exclude investment in cluster munitions producers. That means the policy should proscribe any investment in a company that, in its own name or through a subsidiary, is involved in the production or development of (key components of) cluster munitions or explosive submunitions.ⁱ Regardless of the nature of the company's other activitiesⁱⁱ, or however small a part of its total turnover is derived cluster munitions related activities.

The reason for this is that companies and groups can easily reallocate capital internally; profit from one production line can be invested in other production lines; money for general corporate purposes can be used for any of the company's activities, etc. Focussing solely on financing for cluster munitions is impossible and undesirable given the companies' financial structures. Moreover, so far, we have never come across a project intended specifically to finance cluster munitions facilities.

Therefore, to ensure no money goes to cluster munitions activities, financial institutions should exclude the company in its entirety.

FIs should be clear about how they define a cluster munitions producer. Ideally, they make use of the definition of the Convention on Cluster Munitions. A good divestment policy includes statements on:

- Producers or developers of (key components of) cluster munitions and explosive submunitions are excluded from investment;
- Companies that in their own name or through a subsidiary are involved in cluster munitions are excluded from investment;
- There are no exceptions made for any type of cluster munitions; and
- No exceptions are made for any activities by cluster munitions producers.

ⁱ For a definition of a cluster munitions producer, see page 34 of 'Worldwide Investments in Cluster Munitions; a shared responsibility', available at www.stopexplosiveinvestments.org/report.

ⁱⁱ Most (key components for) cluster munitions or explosive submunitions are produced by companies that also produce other defence and/or civil products.

3 Does the policy cover all types of investments?

In order to assess if the policy covers all types of investments, it is useful to identify the types of financing and investments the FI is involved in. FIs can be a group of global subsidiaries and affiliates, involved in all sort of activities. Table 1 gives an overview of the types of investments that are analysed in the 'Worldwide Investments in Cluster Munitions; a shared responsibility' report.

Table 1 Types of investments analysed in 'Worldwide Investments in Cluster Munitions; a shared responsibility'ⁱ

Financial service	Type of investment/product
Types of investments and services offered by the FI itself	
Commercial banking	Corporate credits Project finance
Investment banking	Underwriting Advisory services Investments made on own account Investments made on behalf of third parties
Asset management	Discretionary mandates Actively managed funds Passively managed funds
Types of investments and services managed by external asset managers	
Asset management	Discretionary mandates Actively managed funds Passively managed funds (including index trackers)

Please note that a FI can be a diversified financial group. For example, an insurance group can also be involved in providing corporate credits.

FIs should develop policies that exclude all financial links with companies involved in production/development of (key components of) cluster munitions or explosive submunitions.ⁱⁱ Because all investment could facilitate this production, no exceptions should be made for any type of investment.² Some common exceptions in investment policies are:

ⁱ For more information about the different types of investments and an explanation of terminology used in the Worldwide Investments in Cluster Munitions; a shared responsibility report, please see: www.stopexplosiveinvestments.org/uploads/pdf/2.%20Definitions%20and%20Terminology%20June%202012.pdf.

ⁱⁱ See Table 1 for an overview of the investment categories.

- **Third party investments**

Third party investments mean that the FI buys shares and bonds of a company on behalf of a third party. Most of the time this means that the third party (a person or an institution) buys (one or more) shares from an investment fund offered by the FI. This fund is managed by the FI's asset managers and usually follows a certain investment policy. FIs should exclude cluster munition producers from the portfolio of their funds.³

Yet, financial institutions sometimes argue that they do not want to impose ethical choices on their clients. This is a weak argument, considering that few financial institutions are transparent about their investments. When a financial institution does not detail its investments, its current and potential customers cannot make informed choices. Moreover, it is inconsistent for a financial institution to profit from selling investments in cluster munitions producers to others, while not wanting to invest its own funds in them.⁴

Red flag alert: the policy text indicates it is applied to the FIs own investments.

- **Funds that follow an index**

A fund following an index is a type of mutual fund; its portfolio is designed to track the components of a market index or stock index. A market index or stock exchange index is a weighted list of shares or bonds, that represents a particular stock market or a portion of it. The fund follows a chosen index and invests in the companies on that index. Indices are not managed by FIs but by independent publishers, such as Dow Jones or Standard & Poor's. These publishers have numerous other indices, which cover (segments of) all kinds of stock market. Some financial institutions have a policy in place that makes an exception for funds that follow an index, often claiming it is impossible to exclude cluster munitions producers from index funds. However, for all stock markets in the world indices now exist which are completely cluster munitions-free.⁵

Options campaigners can propose to FIs whose policy does not cover funds that follow an index:ⁱ

- Replace a few cluster munitions producers in the index fund's portfolio with a few other companies;
- Switch to another index which does not include producers of cluster munitions;
- Investors can switch to another asset manager; and
- Investors can switch from a passive, index-based investment strategy to a really sustainable, active investment policy.

Red flag alert 1: if the policy statement is about 'actively managed funds', it might not be applied to 'passively managed funds'. This in turn may mean index trackers – a type of passively managed fund – are not covered.

Red flag alert 2: if FIs state they comply with cluster munitions divestment law, please note that these laws could contain exceptions for funds that follow an index. For example, the Dutch law allows investments in funds following an index where one or more of the enterprises that produce, sell or distribute cluster munitions constitute less than five percent of the total.

ⁱ For a more detailed explanation of how to engage with financial institutions on index trackers, see: www.stopexplosiveinvestments.org/uploads/pdf/Background%20paper%20index%20trackers.pdf.

- **Civilian project financing for a company also involved in cluster munitions**

There is no way to prevent a company from legally reallocating capital within a group. Including clauses in a general corporate loan contract that prohibits companies from using borrowed or invested funds to manufacture cluster munitions, or that restrict a company's use of the financing to civilian projects, will therefore not prevent the money from being used to manufacture cluster munitions.⁶

Red flag alert: the policy uses terms like 'earmarking' and 'ring fencing'. This refers to clauses in a general corporate loan contract. These clauses are insufficient to prevent a company from reallocating capital within a group.

- **Assets managed by external managers**

FIs can outsource the management of their assets to external asset managers. Although the FI does not manage its own assets, it is still responsible for the investments made. FIs can make use of a discretionary mandate. A discretionary mandate gives asset managers the authority to manage the assets on behalf of a client in compliance with a pre-defined set of rules, such as banning cluster munitions producers. It is the responsibility of the FI to choose an asset manager that complies with its responsible investment policy.

Red flag alert: the policy indicates it is limited to investments where the FI has full control. It is useful to ask how the FI deals with investment made on behalf of external asset managers.

FIs might argue that certain element of a good divestment policy are 'impossible'. Often this means it is difficult or costs more time and/or money to effect the change. However, if it is possible, it should be done.ⁱ

4 Does the policy make any exceptions?

As highlighted in the section above, some policies contain exceptions. Common loopholes in cluster munitions policies include:

- **The policy does not apply at the group level**

Ideally, the policy should be applied at the group level. If the policy is only applied by one or several subsidiaries, this is a welcome first step. The fact a subsidiary has a cluster munitions policy in place can be a useful way to encourage the parent company to follow suit.

- **The policy does not exclude the entire company**

Cluster munitions companies are usually also involved in other military or civilian activities. FIs that are involved in corporate credits and project finance might want to provide finance to the non-controversial activities of the company. However, as there is no way to prevent a company from legally reallocating capital within a group, this is not a sound policy.

- **The policy does not cover all types of investments**

FIs might argue that the policy is applied to 'all investments', while actually they mean 'all investment that we consider relevant', 'all investments made on our own account' or 'all investments except investment X and Y'. When in doubt, ask the FI if the divestment policy is applied to the specific investment category you have questions about.

ⁱ For an overview of frequently heard arguments by financial institutions and how to reply, see the Campaign Guide: Targeting Financial Institutions: www.stopexplosiveinvestments.org/campaign-toolkit.



In general, note that jargon, definitions and terminology may differ from financial institution to financial institution. Not all FIs have the same understanding of definitions or terms like 'finance', 'investment' and 'asset management'. When in doubt about the mutual understanding of the policy, make sure you include definitions of the terms in your communication with the FI.

References

- 1 Stop Explosive Investments (n.d.), "Campaign toolkit", online: www.stopexplosiveinvestments.org/campaign-toolkit, viewed in March 2016;
Stop Explosive Investments (n.d.), *Campaign Guide (2): targeting financial institutions*; Stop Explosive Investments (n.d.), *Stop Explosive Investments: disinvestment from cluster munitions: Questions & Answers*;
Profundo (2012, 15 October), *Index Trackers and Cluster Munitions*, IKV Pax Christi and FairFin;
Netwerk Vlaanderen (2010, May), *The scope of banks' sustainable investment policies - the issue of direct and indirect financing*; IKV Pax Christi and FairFin (n.d.), *Definitions and terminology*;
PAX (2014, November), *Worldwide Investments in Cluster Munitions: a Shared Responsibility*, the Netherlands.
- 2 Stop Explosive Investments (n.d.), *Stop Explosive Investments: disinvestment from cluster munitions: Questions & Answers*, p. 2.
- 3 IKV Pax Christi and FairFin (n.d.), *Definitions and terminology*, p. 2.
- 4 PAX, *Worldwide Investments in Cluster Munitions: a Shared Responsibility*, the Netherlands, p. 112.
- 5 IKV Pax Christi and FairFin (n.d.), *Definitions and terminology*, p. 3; Profundo (2012, 15 October), *Index Trackers and Cluster Munitions*, IKV Pax Christi and FairFin.
- 6 PAX (2014), *Worldwide Investments in Cluster Munitions: a Shared Responsibility*, the Netherlands, p. 9.