



A not-so-quiet revolution has been occurring in the hallways of the world's most powerful financial institutions. As social and environment activists make impressive headway in their quest to convince us that the planet is hurtling towards destruction by virtue of man-made stressors, banks have begun to respond to the call for more responsible financing behaviour.

The Equator Principles (see p 63 for description) initiative embodies their progress thus far. The Principles, announced in 2003 and revised in 2006, are a set of voluntary guidelines created to ensure projects are developed in a socially and environmentally responsible fashion. Given the initiative is in many ways a work

the integrity of the Principles.”

The NGOs pinpoint two projects under consideration as proof of the weakness of implementation and accountability: the Sakhalin II oil and gas project in the Russian Far East and the Botnia/ENCE pulp and paper mill projects in Uruguay. In addition to a range of other environmental impacts, BankTrack believes the Sakhalin project – a consortium comprising Royal Dutch Shell (55 per cent), and including Mitsubishi (20 per cent) and Mitsui (25 per cent) – directly impacts the already critically endangered Western Gray whale population.

According to BankTrack, the Botnia paper mill – constructed by Botnia of Finland, and contractors including Kemira, a chemical company 49 per cent owned

adviser to the project.

Botnia's mandated lead arrangers are Calyon (France) and Nordea (Norway/Sweden). Calyon has confirmed participation. Finnvera (Finland) is also involved. Multilateral institutions include: IFC, MIGA and Nordic Investment Bank but these are unconfirmed.

The implementation issue is really underpinned by two key problems: the first is that the Principles in and of themselves establish what NGOs term a “lowest common denominator” rather than international best practice approach, which can allow the least committed members to hold the standards back. According to BankTrack, this is particularly true for issues such as human rights, climate change, biodiversity and forest

A QUESTION OF PRINCIPLES

BY KIMBERLEY GASKIN

in progress, there is still considerable tension between financial institutions and non-governmental organisations (NGOs) around implementation by compliant banks. While financial institutions are talking about great leaps forward, NGOs are focusing on missteps. The reality probably lies somewhere in between.

IMPLEMENTATION ISSUES

For NGOs the most problematic aspect of the Principles is their self-governing nature, which essentially means they are applied differently across each signatory institution. The question NGOs and other parties most commonly voice is simply this: is the carrot of responsible behaviour enough to ensure compliance without the stick of regulation and punitive punishment?

Watchdog organisation BankTrack has expressed deep uncertainty about the implementation and compliance process. The organisation argues that the proof that the Principles are not fulfilling their true potential as a deterrent lies in the fact that compliant banks are still financing problematic projects. In a recent paper on the revised Principles, concerned NGOs commented: “Three years after the launch of the EPs we find ourselves in the uncomfortable situation of debating the Equator Principles II in good faith, at a time when several Equator Principle Financial Institutions (EPFIs) continue to be involved in projects that directly erode

by the State of Finland – will have seriously adverse impacts on the environment and two local community groups. In addition, the watchdog is concerned banks are still considering financing the project despite unresolved cases at the International Court of Justice alleging violations of international law, and the Inter-American Commission on Human Rights regarding Uruguay's human rights violations.

“BankTrack member groups and others have documented extensively that both projects are in gross violation of the Equator Principles. Yet, some of the very same banks that took the lead in Equator implementation are now are seeking a lead role in financing these operations. It is these financial decisions that will ultimately determine whether or not the Principles are seen as credible and effective,” they comment.

Sakhalin Energy Investment Company has been seeking more than US\$5 billion in financing from public institutions including, the UK Export Credit Guarantee Department, the US Export-Import Bank (Exim Bank), the European Bank for Reconstruction and Development and the Japanese Bank for International Cooperation (JBIC; formerly JEXIM). Due to ongoing environmental and social problems, the applications have not been approved. EBRD declared the original environmental impact assessment unfit for purpose.

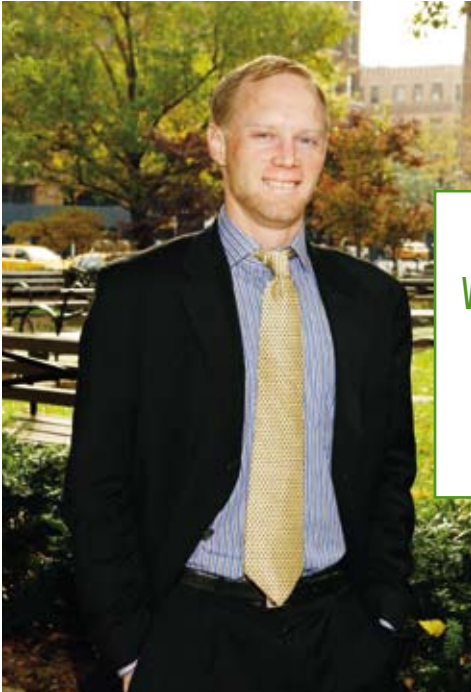
Credit Suisse has been acting as financial

Signing up to the Equator Principles is one thing; actually complying with them is another matter all together. Infrastructure magazine examines the challenges of compliance.

protection, as well as standards and practices for the extractives, dams, fisheries and agricultural sectors. Although some banks independently adopt international best practice for a range of social and environmental concerns, BankTrack is concerned that many others simply comply with the Principles which have been weakened in some areas since the revisions made in 2006 thanks to a change in the International Finance Corporation standards on which they are based.

The second key issue is the relativism involved in implementation and the attendant issues of transparency and accountability.

The variation in commitment levels between Equator banks is in fact a source of consternation for the banks that are committed, with some voicing concern over banks hitching a “free ride” on the coat tails of those who are really pressing into implementation. Clearly the NGOs and the press hold the Equator institutions’



by basing their choice of project finance partners on their level of Equator compliance.

Comments Shawn Miller, director, environmental and social risk management

PROJECT APPROVALS SHOULD SPEED UP, WHICH IS A SIGNIFICANT RISK MITIGANT AND WILL HAVE A POSITIVE PROJECT COST OUTCOME.

SHAWN MILLER, CITI

at Citi in New York: “In some ways the Equator banks hold each other accountable. If a signatory is not upholding the standards, other banks will find out quite quickly as project financings are usually financed by more than just one financial institution. We all want to ensure that, as a group, we are upholding the Equator standards and maintaining the integrity of the process.”

Mike Cleary head of project and structured debt at Westpac Banking Corporation (Westpac) points out that the mechanics of financing large projects – which usually require the participation of multiple financial institutions – is enough in itself to virtually force de facto compliance on almost every bank operating in the project finance sector. “Because so many banks – up to 85 per cent of the market – have signed up, even those banks that haven’t signed have to comply because the projects begin to evolve in response to the compliance requirements from major banking partners,” he comments.

Cleary adds that the issue of non-

compliance by a signatory can largely be remedied by the same pressure. “If the core Equator banks refuse to do business with signatories that flout the Principles non-compliance will cease to be an issue,” he says.

REPORTING RAMIFICATIONS

The banks acknowledge that transparency in implementation was a problem in the first few years, but they argue that the revised Principles have attempted to address this issue. Comments Citi’s Miller: “Numerous stakeholders, including NGOs, socially responsible investors, and even some Equator banks, raised the issue of how they can know the robust standards that banks have adopted have truly been implemented.

We responded to that in the updated version of the Principles, which introduced a new measure, Principle 10, which requires all Equator banks to report at least annually on the implementation of the Principles. At a minimum, institutions have to report on the number of transactions reviewed according to the A, B, and C categories and then also have a discussion around implementation.”

The banks also point out that the use of external, independent auditors and environmental consultants in preparing such reports keeps them honest. Of course it’s all theoretical at this stage as the requirement for an annual compliance report hasn’t yet kicked in.

Westpac’s Cleary anticipates some issues around the new reporting function as banks try to balance the requirement to be transparent and the always delicate issue of client confidentiality. The Principles acknowledge the issue, stating that the reporting should be done in a way that protects confidentiality, but should at a minimum include the number of

feet to the fire when it comes to implementation. Chris Tonkin, head of natural resources at ANZ Banking Group’s (ANZ) project and structured finance group, says financial institutions come under tremendous scrutiny when they sign up. “Banks that sign are all aware that their projects will be subject to intense analysis. And great pressure is brought to bear when projects don’t reflect the Principles properly,” he comments.

But, as indicated above, the pressure from these bodies has not yet been sufficient to ensure implementation and compliance is robustly maintained. It is equally clear that much power rests within the banks to effect change, simply



WHAT ARE THE EQUATOR PRINCIPLES?

Announced in 2003, the Equator Principles (the Principles) are a set of 10 self-imposed principles aimed at ensuring the projects financed by financial institutions are developed in a socially and environmentally responsible manner. They also cover the advisory function, locking the compliant entity into a commitment to making clients aware of the full extent of the Principles and how they relate to the project at hand.

The Principles apply to projects globally with a total project capital cost of US\$10 million and over.

Based on the environmental and social standards used by the International Finance Corporation (IFC), the private sector lending arm of the World Bank Group, the Principles are by no means a hammer wielded by watchdogs to pulverise banks into better behaviour: the IFC emphasises that the voluntary program is intended to provide a common framework for the implementation by each compliant financial institution of its own internal social and environmental policies, procedures and standards related to its project financing activities.

The Principles were reviewed and amended in June 2006 following feedback and some trenchant criticism from NGOs concerned about the lack of transparency and accountability. (See feature p XX for a discussion on the issues around the self-regulating mechanism)

They are not formally policed by the IFC or any other body, and they include no punitive measures against signatories that breach the standards.

Principle 1: Review and Categorisation

When a project is proposed for financing, the Equator Principles Financial Institutions will, as part of its internal social and environmental review and due diligence, categorise such project based on the magnitude of its potential impacts and risks in accordance with the environmental and social screening criteria of the International Finance Corporation (IFC) (Exhibit I).

Principle 2: Social and Environmental Assessment

For each project assessed as being either Category A or Category B, the borrower has conducted a Social and Environmental Assessment (“Assessment”) process to address, as appropriate and to the EPFI’s satisfaction, the relevant social and environmental impacts and risks of the proposed project.

Principle 3: Applicable Social and Environmental Standards

The Assessment will establish to a participating EPFI’s satisfaction the project’s overall compliance with, or justified deviation from, the respective Performance Standards and EHS Guidelines.

The Assessment process should address compliance with relevant host country laws, regulations and permits that pertain to social and environmental matters.

Principle 4: Action Plan and Management System

For all Category A and Category B projects the borrower must prepare an Action Plan (AP) which addresses the relevant findings, and draws on the conclusions of the Assessment. The

AP will describe and prioritise the actions needed to implement mitigation measures, corrective actions and monitoring measures necessary to manage the impacts and risks identified in the Assessment.

Principle 5: Consultation and Disclosure

For all Category A and, as appropriate, Category B projects the government, borrower or third party expert must consult with project-affected communities in a structured and culturally appropriate manner.

The Assessment documentation and AP, or non-technical summaries thereof, will be made available to the public by the borrower for a reasonable minimum period in the relevant local language and in a culturally appropriate manner.

Principle 6: Grievance Mechanism

For all Category A and, as appropriate, Category B projects to ensure that consultation, disclosure and community engagement continues throughout construction and operation of the project, the borrower will, scaled to the risks and adverse impacts of the project, establish a grievance mechanism as part of the management system. This will allow the borrower to receive and facilitate resolution of concerns and grievances about the project’s social and environmental performance raised by individuals or groups from among project-affected communities.

Principle 7: Independent Review

For all Category A projects and, as appropriate, for Category B projects, an independent social or environmental expert not directly associated with the borrower will review the Assessment, AP and consultation process documentation in order to assist EPFI’s due diligence, and assess Equator Principles compliance.

Principle 8: Covenants

An important strength of the Principles is the incorporation of covenants linked to compliance. Where a borrower is not in compliance with its social and environmental covenants, EPFIs will work with the borrower to bring it back into compliance to the extent feasible, and if the borrower fails to re-establish compliance within an agreed grace period, EPFIs reserve the right to exercise remedies, as they consider appropriate.

Principle 9: Independent Monitoring and Reporting

To ensure ongoing monitoring and reporting over the life of the loan, EPFIs will, for all Category A projects, and as appropriate, for Category B projects, require appointment of an independent environmental and/or social expert, or require that the borrower retain qualified and experienced external experts to verify its monitoring information which would be shared with EPFIs.

Principle 10: EPFI Reporting

Each EPFI adopting the Equator Principles commits to report publicly at least annually about its Equator Principles implementation processes and experience, taking into account appropriate confidentiality considerations.

transactions screened by each compliant financial institution, including the categorisation accorded to transactions (and may include a breakdown by sector or region), and information regarding implementation.

But Cleary believes the tightrope banks

have to walk here could be too wobbly. “Client confidentiality is paramount so it will be hard to be too explicit regarding projects declined on environmental and social grounds. I wonder how meaningful the reporting will be given the imperative to protect the client,” he comments.

BankTrack isn’t particularly impressed by the revised standard on reporting. “Although the revised Equator Principles now includes new transparency requirements, they fall short of what would be minimally adequate to provide a confident accounting of EP compliance.

Only revealing the number of transactions screened and categorisation accorded to each transaction would still provide minimal information of use in ensuring a level playing field in implementation. The EPFIs should stay in step with the industry standards being developed for transparency issues,” comments the body in a recent white paper.

BankTrack has recommended Equator institutions supply performance, process, project-level and impact data. More specifically the NGO wants Equator-compliant institutions to report annually on the categorisation for each project screened, the number of projects rejected on environmental and social concerns, an explanation of any deviations from standards, information about loans suspended or called in due to non-compliance with environmental and social requirements, a breakdown of core business activities by sector and region, and an assessment of implementation of environmental and social policies and management systems.

The organisation also wants Equator bank clients to clarify non-confidential project information – on the purpose, nature and scale of projects and any risks to and potential impacts on communities.

Steve Smith, partner, financial services at Blake Dawson Waldron (BDW), believes the new reporting regime will be a good tool for encouraging true compliance with the Principles. But he also believes market forces work well. He comments: “Often you will see a group of banks funding a project where some are compliant and others are not. The approach we have seen is that the deal has to be compliant.”

Smith adds that banks’ ability to sell down project debt may be impacted by their compliance status. “Bank generally

don’t hold the whole of their project debt; they usually sell down a portion. Project debt is sold down and most ends up in the secondary market, so even banks that aren’t EP compliant really have to think about where they are going to sell down the debt. Syndicates that don’t have EP compliant members may have to make the deal EP

**SYNDICATES THAT DON’T HAVE
EP-COMPLIANT MEMBERS MAY HAVE TO
MAKE DEALS EP-COMPLIANT OR THEY WON’T
BE ABLE TO ACCESS SECONDARY MARKETS**

STEVE SMITH, BDW

complaint or they won’t be able to access secondary markets.”

LESSONS FROM RAPU RAPU

Another instrument of compliance is emerging as companies – the end client – begin to mould their projects knowing the biggest financiers have changed their criteria for funding deals. Tonkin at ANZ says that after three years of a relaxed approach, companies are finally paying vigorous attention to the Principles. “In the developing world if they don’t get it right they are dead in the water,” he comments.

Tonkin explains that the Rapu Rapu situation has put the frighteners on many corporates. The polymetallic project, based in the Philippines, is owned by Australian company Lafayette. The project has been subject to fierce protest from locals supported by NGOs, the Catholic Church and various other local and international bodies on the grounds that it

has inadequate environmental and social impact processes. Concerns centre on the geography of the project, which is situated in the typhoon belt, toxic spills, tax and revenue issues, and the continuing fraught relationships with the local community.

In December 2006, a typhoon damaged the mine site and created a mud flow right underneath the site, resulting in 24 deaths from two local villages. The project was shut down, delaying the first shipment from the mine. The project has been reopened, but has suffered serious financial consequences. While it is impossible to gauge to what extent the death toll and local disruption has impacted corporations, Tonkin believes the financial consequences have waved a few flags. “That definitely brought to the attention of quite a few companies what can happen if you don’t get social and environmental issues right.”

The mine renewed operation on 8 February, but NGOs continue to agitate for the withdrawal of the permanent lifting, arguing that that the mine lacks a social licence to operate as it is so strongly opposed by local communities and the withdrawal of financial support by Equator banks.

THE COST OF SELF INTEREST

Of course the key element which suggests banks are more likely to comply and then implement appropriately, the examples above notwithstanding, is simply that the Principles make good, hard business sense. Comments BDW’s Smith: “Self governance is likely to work in the end simply because the Principles marry altruism with self interest. The temptation to be avoided is to think the Principles are just something banks do to make themselves feel good and therefore may be avoided if there is a bottom



line justification. Moral arguments aside, the Principles help protect the bottom line by providing a proper mechanism for assessing environmental and social risk.”

The point is often repeated by compliant institutions, particularly when they are questioned about the cost of implementation. “The cost of a project going wrong far exceeds the cost of complying with the Principles,” comments Westpac’s Cleary.

Curiously, none of the banks have actually quantified the cost of compliance, which includes staff, administrative, documentation and reporting costs. It’s an interesting omission given the fine pricing often involved in winning tenders. Tony Hill, environment partner at Blake Dawson Waldren (BDW), emphasises that the costs need to be looked at in the context of benefits arising from implementation. “A more correct question is, does the cost of implementing exceed the benefits? I’d argue there are more benefits than cost of compliance because implementation of the Principles leads to better decision-making, and better risk management,” he comments.

Citi’s Miller points out that the Principles don’t really involve much new cost. He believes that, over the past 15 years, projects in emerging markets have been subject to significant environmental review anyway. “Even in countries without robust regulatory systems there have been compliance costs related to environmental and social sustainability because financial institutions were often involving multi-lateral funding agencies like IFC or an export credit agency, and usually those institutions required an environmental or social review,” he comments.

Miller believes the Principles have simply brought a more robust framework on which the whole industry can rest. “If project sponsors know from the beginning what is required from an environmental and social review perspective, there will be fewer stop-starts. I really think that project approvals should speed up, which is a significant risk mitigant and will have a positive project cost outcome.”

Tonkin at ANZ understands the basic argument that better measures promote better projects. But he is dubious that at this stage it can be argued that more revenue will flow, particularly when none of the banks have crunched the numbers on the cost of implementation. “Compliance with the Principles doesn’t guarantee a more profitable project. Banks that sign up on that assumption may be sorely disappointed. Signing up to the Principles is simply the cost that banks have to wear to be able to operate in the sector – and it’s a reasonable cost,” he says.

The question of opportunity cost

inevitably arises when banks indicate their willingness to say no to a project on the basis of the Equator principles. No banks were willing to disclose which projects they turned down on the basis of client confidentiality, but most said they would do so. But getting to a “no” stage is pretty unlikely, say most interviewees, simply because few banks would let negotiations progress to that point.

Hill at BDW says an absolute no would be unlikely based on the Principles alone. “However, the Principles will be relevant in the decision-making process because they provide a contextual framework to link the consideration of environmental and social impacts of a project with its commercial risks.”

BDW’s Smith adds that projects are rarely considered on an absolute yes or no basis. “Once the assessment has been done, if there are elements of a project that breach the standards, the response is not to refuse the project but to put processes in place to manage it so it does become compliant,” he comments.

CORPORATE IMPLICATIONS

The point – confirmed by all the institutions interviewed by *Infrastructure* magazine – is a critical one, firstly because it brings us back to the thorny issue of relativism: one bank’s management of an environmental issue can be one NGO’s flagrant breach of the Principles.

The second implication is the how the costs borne by the client are impacting the sector. An interesting by-product of the Equator initiative is that it seems to support corporations that are multi-nationals at the expense of the smaller companies. Reshaping projects so they can attract funding from Equator banks – which now represent the clear majority of the market – is a costly business.

Comments ANZ’s Tonkin: “There’s no

IT IS POSSIBLE THAT OVER THE LONG TERM SOME OF THE PRINCIPLES MAY BE INCLUDED IN SOME INTERNATIONAL TREATY FRAMEWORKS.

ANTHONY HILL, BDW

doubt that the Principles make it more difficult for smaller companies to develop projects. The environmental and social assessment measures required have moved from being a cost to being a significant cost, which smaller companies will not find it easy to afford.”

An even more interesting issue to contemplate is the interaction of corporate and financial institutions when it comes to compliance. How do banks enforce the Principles once money has been given to a project? It’s a problem when a bank loan is involved, but it’s an even bigger problem a bond has been issued as the money is well and truly out the door.

Smith at BDW says banks do have recourse to financial sanctions when it comes to bank loans, such as charging default interest rates, halting funding or asking for their money back. “This is a severe sanction that would encourage compliance” he says. But the flaw in the plan is that these measure increase the risk of return for banks and could prompt the very thing the Principles are trying to avoid. “Once a project is up and running the impact of withdrawing financial support could be huge. The other problem is that the environmental and social impact of a project collapsing may well be as drastic as carrying on,” he says.

GOING FORWARD

The very flexibility of the Principles that makes them subject to criticism does have a very positive angle: they are intended to be revisited and revised as scientific understanding about the environment and social change matures. Most market participants believe the Principles will continue to evolve in response to both ethical and financial imperatives. Comments BDW’s Hill:



“The current voluntary framework is good for now as it provides a forum to test a quasi-regulatory mechanism without it being binding.” Although the Principles are by no means ideal, they are at least a solid

starting point, argue market participants. “Clearly there are issues on the financing to be resolved, such as managing the decommissioning process, issues around refinancing when the new supporter is not a compliant bank and how deals involving Equator banks which are minority partners with non-equator banks will be handled. But I suspect these issues will be addressed and resolved more over time,” says Hill.

A more intriguing possibility is the evolution of the Principles into a compulsory standard. Hill points out that international responses to environmental issues have often started with a set of general principles which evolve over time to more binding obligations. “It is possible that over the long term some of the Principles may be included in some international treaty frameworks.”

Most interviewees agree that the most significantly developing area in environmental regulation over the next 20 yrs will be the monetisation of environmental risk. That is, having regulatory mechanisms in place which place a price on environmental risk so there is a more direct financial linkage between the environmental issue and financial risk. It’s already happening with carbon risk, and most foresee a broader greenhouse emissions trading system than

COMPLIANCE WITH THE PRINCIPLES DOESN'T GUARANTEE A MORE PROFITABLE PROJECT. BANKS THAT SIGN UP ON THAT ASSUMPTION MAY BE SORELY DISAPPOINTED.

CHRIS TONKIN, ANZ

the one currently in place under the Kyoto Protocol.

Citi’s Miller believes there are a range of possibilities for managing the environmental risk offsets; bringing these ideas to fruition will be the next iteration of the Principles. “At this point the principles are essentially a risk management framework for preserving brand and reputation, and ensuring banks are not financing activities that harm our brand. But going forward it, I think this will be about enhancing and looking for business opportunities that have positive environmental and social aspects. Emissions trading and carbon trading are certainly spurring interest across the sector.” 🌱

