

Banks grapple with social issues

Private sector financial institutions have followed the multilateral banks in adopting social and environmental guidelines for project finance deals. But both public and private banks are now grappling with a new set of social concerns. **Jessica McCallin** reports

A few years ago, it seemed as if human rights and green activist groups considered multilateral development banks to be the fountain of all social and environmental evil. And, while this may still be true of the street-level anti-globalisation protestor, there is now a broad consensus among non-governmental organisations (NGOs) that the development banks have taken the corporate social responsibility case on board, and are leading their private sector counterparts when it comes to strengthening social and environmental standards.

Nowhere is this more true than with project finance deals. As the favoured financing technique for large infrastructure projects, often involving public money from the multilaterals, project finance is a prime target for

NGOs. It is also the arena for some of the campaigners' biggest triumphs.

After successfully lobbying for the World Bank and its private sector arm, the International Finance Corporation (IFC), to apply social and environmental standards to their lending decisions, NGOs went on to reap the knock-on effects of their hard work. In June 2003, 10 of the leading commercial project finance banks signed up to the Equator Principles, a set of social and environmental guidelines for project finance deals, based on World Bank and IFC standards. They have since been joined by 10 others (see pages 18–19).

The hope now is that, where the multilaterals go next, the commercial banks will follow. And – to the pleasure of the activist com-

munity – the development banks seem to have no intention of pausing in their bid to strengthen social and environmental standards. The World Bank Group, the Inter-American Development Bank (IADB) and the Asian Development Bank all intend to launch large-scale stakeholder dialogue initiatives this year, aimed at pinpointing areas in their guidelines in need of more attention. And the multilateral development banks themselves have singled out issues of social justice and human rights as needing the most attention.

The NGOs, too, see the handling of the amorphous, politically charged issues surrounding development and human rights as ripe for improvement. But there is a huge gap between what they are calling for, what the multilaterals see as realistic, and what private sector banks feel they should be held responsible for.

Rachel Kyte, the new director of the Washington, DC-based IFC's environment and social development department, says: "The world as a whole, not just the finance community, now has a better understanding of issues surrounding human rights and core labour standards. But there is still a lot of confusion amongst private banks as to how social issues and human rights apply to them. They accept that they are actors in the human rights world and, as such, have responsibilities. But there is confusion about how to meet them."

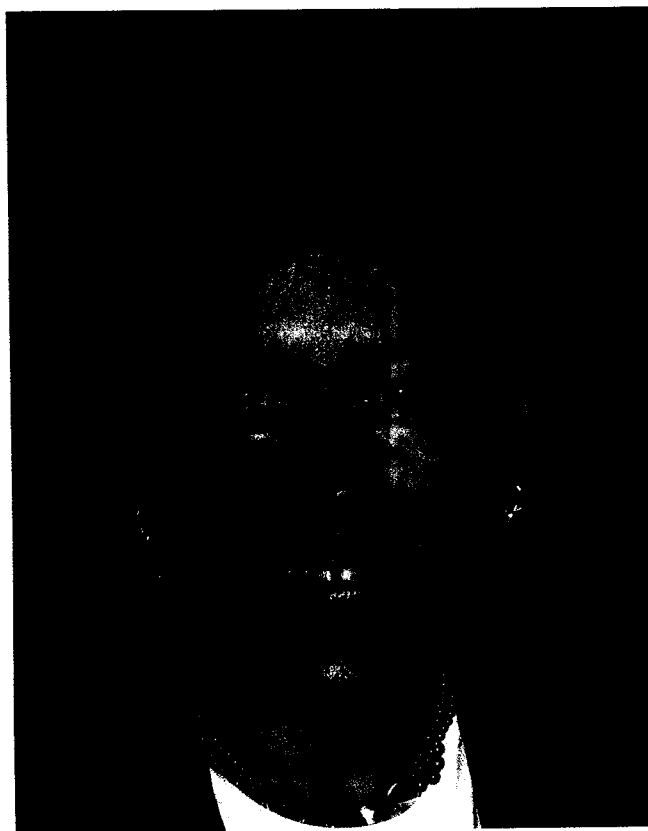
Fabrizio Donini Ferretti, Paris-based head of energy at Franco-Belgian bank Dexia, explains further: "Environmental issues are comparatively straightforward. It is [relatively easy] to measure and quantify a project's environmental impact, and put a cost on it. That is much more difficult with social issues. They are much more subjective and open to political judgement, and many banks don't see how they can be held responsible for them."

For example, he asks how a bank should deal with a project that involves – or exacerbates – a dispute between two ethnic groups. "Can a bank really be expected to take one group's side? It's just not what banks are there to do. They understand that social issues are the weak link in their reputation management and that they have a role to play in protecting human rights. But they are just not sure what exactly that entails, and what they can reasonably be held responsible for."

Many banks feel that responsibility for the social impacts of a project should lie with the project sponsors, the companies which are actually building and operating the project.

But NGOs disagree. As regards development banks, their argument is simple: these banks operate with public money and have mandates that require them to alleviate poverty. The protection of human rights, they argue, is a fundamental part of that process, and development banks should not invest in projects that curtail them.

Their argument for the private banks runs along similar lines. They may not have any poverty-reduction mandate, but if they are involved in funding a project with multilateral money, they are benefiting from public money



Rachel Kyte, IFC
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Extracting the multilaterals

too, transferring some of the project risk onto public institutions, and they therefore have obligations to the tax-paying public.

"We are not asking banks to be human rights policemen," says London-based Alex Wilkes, co-ordinator of the Bretton Woods Project, an organisation that monitors international finance on behalf of several large development NGOs. "Ultimately, human rights are the responsibility of governments. What we are asking is that banks don't infringe on the human rights of workers or communities affected by their projects."

This sounds simple in theory. The practice is a bit trickier. International human rights law rarely lends itself to neat resolution. There are treaties covering civil and political rights – the right to vote, to freedom of expression and so on – and treaties that cover social and economic rights – the right to health, housing and education. Different countries and, within those countries, different communities, put more emphasis on one set of rights over another. Which leads us back to the questions of political judgement in which the banks are so nervous about getting involved.

For example, the highly controversial Baku–Tbilisi–Ceyhan pipeline, which is to carry oil from Azerbaijan to Turkey's Mediterranean coast, involved juggling competing peoples' understanding of their human rights. Many Georgians are very keen for the project to go ahead, anxious to reap the economic benefits, whereas the Turkish Kurds, targeted for resettlement, argued vehemently that their fundamental rights were being walked over. Whose rights are more important?

"That's how it is in all walks of life," argues Petr Hlobil, oil and climate co-ordinator at CEE BankWatch, a Prague-based NGO. "There are always questions about which rights are more important. They arise in normal society all the time and it's usually up to the courts to decide on. That's why we want to see binding, not voluntary, standards and a sort of international commercial criminal court which can oversee controversial cases."

With the international community unable to agree on the parameters for an international criminal court, the idea of a court examining international commercial crimes seems like pie in the sky. "The finance community, including the multilaterals, certainly don't want to be overseen by a court," concedes Hlobil.

"Independent oversight is a tough one for the banks," says Andre Abadie, head of the environment and social risk management unit of ABN Amro in Amsterdam. "Banks have their own systems of implementing social and environmental standards, just as they have their own lending policies or credit rating systems. It would be difficult for an outsider to assess the way individual banks make decisions."

But campaigners are convinced that, ultimately, a court will be created. "Governments

Human rights and development campaigners may be broadly happy with the stance multilateral development banks are taking on social and environmental issues but, when it comes to the extractive industries, a stalemate has been reached.

As key contributors to climate change, oil and gas projects are fundamentally unsustainable, many non-governmental organisations (NGOs) argue, and therefore should be automatically outside the remit of development banks. And mining projects, they say, are particularly damaging to the environment and are all too frequently linked to conflict or serious human rights abuses.

They want development banks to pull out of the extractive industries, full stop. The banks disagree. The World Bank Group, for example, says the exploitation of valuable natural resources is crucial if many of the world's poorest countries are to fight poverty. It agrees that extractive projects can be environmentally destructive, but it says that this makes it important that the Bank is involved to ensure that basic standards are adhered to.

The Extractive Industries Review (EIR) – an independent review launched by the World Bank in September 2001 to examine its role in extractive projects – submitted its final report and recommendations in late November. It doesn't come down on either side of the argument.

It agrees with NGOs that the multilaterals haven't done enough to strengthen corporate governance procedures in extractive projects. It also recommends a qualified degree of withdrawal from the extractive sectors, particularly where projects are commercially viable without World Bank Group support, and calls for greater investment in renewables. However, it accepts the Bank's argument that there is still a role for it to play in these industries.

"We will take a good look at all the EIR recommendations," says Rachel Kyte, director of the IFC's environment and social development department. "But I think it's unlikely that the World Bank Group will decide to pull out of all extractive industry projects. I expect it will decide to stay out of certain deals, but not entire industries."

Private banks such as Barclays and ABN Amro, with large extractive industry operations, agree. Rather than pulling out altogether, they expect the World Bank to remain involved, encouraging best practice and more sustainable operations.

The NGOs, however, show little inclination to compromise on the issue. "The EIR report is a very important document," says Alex Wilkes, co-ordinator of the Bretton Woods Project, a London-based NGO that monitors international finance. "It will form the basis of our campaigning for years to come. We firmly believe that the [multilaterals] should pull out of all extractive projects and we will campaign until they do."

The NGOs' logic is that, if extractive projects are commercially viable, they don't need public funding and, considering the damage they do, if they are not viable without the help of public finance institutions they should not go ahead.

"There is no place for public money in these projects," says Petr Hlobil, oil and climate co-ordinator at CEE BankWatch, a Prague-based NGO. "Why should public banks underwrite the risk of damaging, unsustainable activities? They should be subsidising renewable energy projects instead. Those are the projects that really need public funding to get off the ground. We're confident that within the next 10 years we can convince the multilateral banks to leave extraction in favour of renewables."

are subject to the courts," continues Hlobil. "So why shouldn't companies or banks be? Binding principles and a court system is just a matter of time."

Maybe. But until such time, all the banks, multilateral and private, say social issues will instead be dealt with through consultation, albeit detailed consultation. The World Bank expects social questions to form the mainstay of its 2004 stakeholder engagement plans. The IADB claims that it is the only bank with binding social principles – since 1998 its commercial partners have been obliged to abide by its policy on 'prior informed consent' when it comes to involuntary resettlement of indigenous peoples. But it plans to strengthen its policies on protection of indigenous rights this year. The workplace rights of HIV/Aids sufferers have also cropped up as an issue set to get increased attention.

But until the consultation exercises are completed, the multilateral development banks are staying quiet about whether they will result in new policies on social and environmental issues. And private banks, in turn, are saying they will wait and see what the multilaterals come up with before deciding

whether or not to strengthen their own lending guidelines.

"It's too soon to speculate on where social and environmental standards are heading," says Hans Hoeveler, global head of structured finance at WestLB in Dusseldorf, Germany. "Many banks are still digesting the impact of the Equator Principles. We are just going to wait and see where the World Bank group goes next and then assess our options." The barometer to measure whether or not the financial sector, both public and private, is improving its record may, therefore, lie in the number of complaints that their projects receive.

"With social and environmental issues, but social issues in particular, you only tend to find out that something is wrong when people complain," said one private banker.

To that end, both public and private banks say they are working to make sure proper complaints procedures are in place for employees and other stakeholders. On that, they have the NGOs' support. But, at the moment, that seems to be the only place where there is full agreement between financiers and campaigners on how to deal with the social impact of projects. ■

Paying for their principles?

The introduction of the Equator Principles by leading private sector banks could fundamentally alter how projects are financed, say **James Barrett** and **Joel Mack**. But much depends on how they are implemented

The globalisation of the World Bank's environmental standards took a major step forward last June, when 10 leading banks adopted the 'Equator Principles'. These are a set of World Bank-derived environmental and social guidelines that the banks intend to apply to all project finance transactions of more than \$50 million. These 10 have since been joined by 10 others which, collectively, accounted for around 80% of project financings last year, according to the Equator Principles website (see box).

As the following quotation from the pre-

amble to the principles suggests, the lenders intend to use them globally to enhance the environmental and social responsibility profile of their borrowers' projects – and they intend to make funding conditional on compliance with the principles:

"These principles will foster our ability to document and manage our risk exposures to environmental and social matters associated with the projects we finance, thereby allowing us to engage proactively with our stakeholders on environmental and social issues ... In adopting these principles, we undertake to

review carefully proposals for which our customers request project financing. We will not provide loans directly to projects where the borrower will not, or is unable to, comply with our environmental and social policies and processes."

This development sends a clear signal to the markets that major private sector banks consider environmental and social responsibility to be important factors in their lending decisions, wherever the project may be sited.

But to what degree will the application of the principles change the playing field for project developers? To what degree will they change project design or siting decisions, or impose significant additional costs on developers? Before we consider these issues, it is worth considering what obligations the principles impose on their signatories.

The Equator Principles are based upon standards developed and applied by the World Bank and its private sector arm, the International Finance Corporation (IFC), to industrial projects in developing countries.

They are centred around three key elements:

- development of an environmental impact assessment (EIA) that evaluates project impacts;
- public input into the EIA process; and
- implementation, monitoring and enforcement of the applicable guidelines during the construction and operation phases of each project.

The banks will categorise the risk of individual projects in accordance with internal guidelines based upon the IFC's screening criteria, which in turn provide that proposed projects are classified into one of three categories, depending on the type, location, sensitivity and scale of the project, as well as the nature and magnitude of the project's potential environmental and social impacts.

'Category A' projects have the greatest potential for significant adverse impacts, and will require a full EIA. 'Category B' projects are those with less adverse potential impacts, and will require an EIA likely to be narrower in scope than for a Category A project. 'Category C' projects are those with minimal or no adverse impacts, requiring no EIA. Category A and Category B project EIAs need to comply with:

- the host country laws, regulations and permits required by the project;
- the minimum standards applicable under the World Bank and IFC Prevention and Abatement Guidelines, which reflect (a) the environmental guidelines contained in the World Bank Pollution and Prevention Abatement Handbook (PPAH), dated 1 July 1998, and (b) a series of environmental, health and safety guidelines that IFC staff prepared in 1991–93 and for which there are no parallel guidelines in the PPAH; and
- for projects located in low and middle income countries, the applicable IFC Safeguard Policies (a listing of which is

appended to the Equator Principles document).

In each case, the EIA must demonstrate to the lender's satisfaction that the project complies with (or justifies deviations from) the PPAH and the IFC Safeguard Policies. In addition, borrowers, or a third-party expert, will need to prepare an environmental management plan (EMP) which addresses project compliance, mitigation, action plans, monitoring, management of risk and schedules.

To satisfy the Equator Principles, borrowers also will need to consult with groups affected by the project, including indigenous peoples and local non-governmental organisations (NGOs). The EIA, or a summary, needs to be made available to the public for a reasonable minimum period in the local language.

Finally, to ensure compliance with the principles, the banks will include, in their loan covenants, requirements that the borrower (i) complies with the EMP in the construction and operation of the project; (ii) provides regular reports on compliance with the EMP, prepared by in-house staff or third-party experts; and (iii) where applicable, decommissions the facilities in accordance with an agreed decommissioning plan. The banks further state that, as necessary, they will appoint an independent environmental expert to provide additional monitoring and reporting services to ensure compliance during the life of the loan.

So what do the Equator Principles mean for project developers? The banks that have committed to apply the Equator Principles to new project financings are, in effect, agreeing to do what the World Bank, IFC and other non-private lenders (for example, the US Export-Import Bank) have done for some time now – namely, impose and enforce environmental and social standards on their borrowers.

The Equator Principles thus extend the application of the World Bank/IFC environmental guidelines to many projects not otherwise involving the World Bank and the IFC. This development is particularly significant in those developing countries which lack an adequate environmental regulatory infrastructure. In such circumstances, the World Bank guidelines serve as a potentially effective regulatory proxy, with the World Bank/IFC – and now the banks that have adopted the Equator Principles – playing the role of environmental regulator for the life of the loan.

As framed, the Equator Principles establish in the private sector banking context a potentially formal structure by which borrowers must demonstrate compliance with World Bank/ IFC standards. In particular, borrowers will have to evaluate carefully the environmental and social impacts of their projects, culminating in the development of an EIA that mirrors, in some respects, the assessments required in the US under the National Environmental Policy Act (commonly known as NEPA).

Borrowers will also have to develop EMPs that, by all appearances, will become a governing document, concerning environmental and social regulatory compliance, during the project construction and operation phases.

Borrowers will have to show compliance with the EMP, the World Bank/IFC guidelines and social policies and, of course, host country laws and regulations. Borrowers also will have to provide periodic reports and continual compliance monitoring during project construction and operations (which may include the participation of the bank's outside expert to oversee compliance).

Consequently, compliance with the Equator Principles could raise project costs and create delays for developers – perhaps substantially. Cost estimates associated with complying with World Bank guidelines, for instance, have been placed at 5–10% of the total project cost, and the time developers spend demonstrating that their project meets applicable World Bank standards can run from six months to more than two years.

Moreover, because compliance with the standards is a condition of funding, projects that fail to satisfy the Equator Principles (and thus, by definition, the World Bank standards) may be left with few meaningful financing opportunities. This is increasingly likely as more banks sign up to the principles.

The manner in which the banks implement the Equator Principles will determine whether these new guidelines raise project costs, dramatically delay project schedules, and create additional funding risks. When they issued the Equator Principles, the banks were careful to point out that they “view these principles as a framework for developing individual, internal practices and policies ... [and] are adopting and implementing these principles voluntarily and independently, without reliance on or recourse to IFC or the World Bank”. In other words, each bank will be implementing the Equator Principles its own way, so it is conceivable that the principles will be applied quite differently from one bank to the next.

The banks' implementation of the Equator Principles, in turn, raises a number of issues that are not clearly addressed. These include:

- the extent to which the banks intend to impose the principles on projects in industrialised nations with well-developed environmental regulatory systems in place (we note that the Equator Principles express the banks' intent to apply the principles globally);
- assuming that the principles are applied globally, whether the banks intend to apply them differently for projects sited in emerging, rather than industrialised, nations;
- whether borrowers will be subjected to a bank-designed EIA and EMP process even if the borrower shows that it will be carrying out an equivalent level of evaluation and planning (as likely would be the case for a project sited in, say, California);
- how project monitoring will be structured (for example, self-monitoring and/or the retention of outside experts who could wield a disproportionate amount of clout in determining project compliance with bank standards);
- the level of participation afforded NGOs in the EIA/EMP process; and

Equator Principles signatories

as of end-January 2004

Barclays

Citigroup

Credit Suisse Group

Dresdner Bank

HVB Group

KBC Bank

Mizuho Corporate Bank

Royal Bank of Canada

Standard Chartered Bank

Westpac Banking Corporation

the extent to which the banks intend to apply the Equator Principles solely to project financings (as the language of the Equator Principles would suggest), or also to other financial arrangements, such as general corporate loans, capital market financings, and the like.

Many of these issues are only likely to be resolved over the next several months, as banks begin to implement the principles in earnest.

At this point, it is fair to say that the Equator Principles underscore the fact that the World Bank/IFC environmental and social guidelines reflect the core of what now appear to be the internationally accepted standards of environmental and social responsibility. Borrowers who are contemplating a project financing, whether or not involving the World Bank or IFC, would therefore be well advised to take the World Bank/IFC standards into account in the design and siting of their projects.

As discussed above, there are many implementation issues to be worked out. Accordingly, prospective borrowers may wish to confer with their lenders on implementation issues to help ensure that the banks' programmes are structured in a commercially reasonable manner.

How large an imprint the Equator Principles leave on environmental performance depends, ultimately, on the lenders' resolve to enforce the principles against their borrowers. That resolve, in turn, will be reflected in the terms of credit agreements, and meaningful oversight over borrower compliance with the principles during the project's construction and operation phases. In that respect, the true impact of the Equator Principles remains to be seen.

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