Building sustainability into syndication

Applying the Equator Principles can dramatically improve the environmental and social risk profile of project financings. But their application can often be improved, say **Rachael Bailey**, **Tracey Ryan** and **Nicky Hodges**

In the three years since their introduction, the Equator Principles have driven substantial environmental and social performance improvements in project finance. These voluntary guidelines, which essentially involve private sector banks committing to apply World Bank/International Finance Corporation (IFC) social and environmental risk management procedures to projects which they finance, have been adopted by institutions accounting for more than 80% of project finance flows.

There is now widespread awareness of the benefits of using the appropriate expertise at the outset to manage potential environmental and social risks throughout the project cycle, and thereby secure better financial terms at financial close and syndication. Ensuring that environmental and social risks are fully under control now plays a key part in securing confidence in project finance deals.

As experience in applying the principles grows, we have found that financial institutions which are looking to improve their environmental and social risk management would benefit from looking at the following key areas: ensuring the early involvement of experts; building the capacity of project sponsors; transparency; verification of mitigation and monitoring beyond financial close; and effective stakeholder engagement and consultation.

Early involvement

Project financiers often seek advice from environmental and social experts at short notice prior to financial close. This late involvement limits the ability of experts to identify shortfalls in compliance, verify project data, advise on the scope of environmental and social studies, and recommend further mitigation measures and measures to engage with stakeholders.

Ideally, environmental and social due diligence advisers should be involved at the project identification stage (see illustration) by the host government and/or project sponsor, although in practice they tend to be engaged once the lead arranger has been selected. Due diligence audits can be undertaken at short notice prior to financial close to ensure there are no 'show stoppers'. However, a more proactive approach will facilitate long-term environmental and social performance improvements.

Early involvement is vital in situations where a project sponsor has known shortfalls in its environmental and social practices, but has stated a clear commitment to making improvements. Banks recognise the value in assisting sponsors to improve their environmental and social performance to the required level. This approach is commendable, as it builds the capacity of sponsors, thereby affording opportunities for long-term sustainability improvements.

Such an approach can also prevent shortfalls in compliance becoming an obstacle to worthwhile projects. At a time when campaign groups are placing increasing pressure on banks to turn down 'risky' projects, there is clearly a need to be pragmatic and consider the potential environmental and social risks together with the ability of sponsors to manage those risks.

Building capacity

The capacity-building role of Equator Principles signatories is important, given that the principles effectively place the primary burden of responsibility on project sponsors, which have differing levels of maturity and experience in environmental and social risk management. The greater the emphasis that is given to building the capacity of the project sponsor prior to financial close, the greater the potential for successful agreement at financial close and syndication.

Several Equator banks have responded to this challenge by developing lists of environmental and social consultants from which project sponsors can identify relevant expertise to support them to meet their responsibilities under the principles.

Mitigation and monitoring

Effective monitoring over the life of the loan is as important as the due diligence prior to financial close. In our experience, banks may use reputable professional advisors to review independently the project's Equator compliance during the due diligence stage, but then rely on monitoring reports provided by the project sponsor. This makes it difficult, if not impossible, to provide verification of the project's ongoing compliance. Inadequate monitoring can result in environmental and social management plans being put on the shelf after financial close and the prerequisite measures to achieve compliance not being implemented. This poses potential reputational risks for the lenders themselves.

Transparency

A number of NGOs have argued that there is a lack of transparency as to how banks ensure that projects accord with the Equator Principles. Revisions proposed by Equator signatories include a commitment for banks to report periodically and publicly on their implementation process and experience. While this commitment is rather vague, it does provide an important opportunity for Equator banks to demonstrate and exchange best practice. Many signatories already provide information on the projects that they have financed or rejected in their sustainability reports. It is also encouraging to note that some Equator banks and project sponsors have published project-related environmental statements and management plans on their websites.

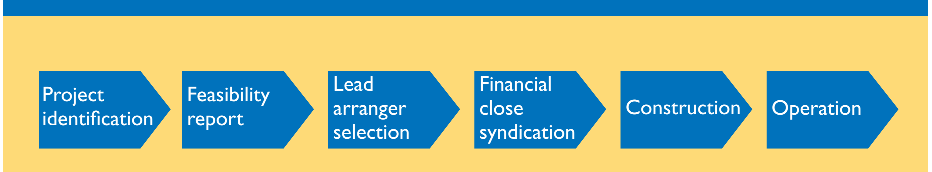
Effective stakeholder engagement

The new IFC Performance Standards – which influenced the revisions to the Equator Principles that were unveiled in early July – state that 'affected local communities' should be the main target for community engagement. Project lenders, which may be more familiar with engaging with NGOs, increasingly need to understand the complex and varied challenges of community engagement and the potential risks associated with failure.

In our experience, this presents an ongoing challenge for project sponsors, which often lack the knowledge, skills and techniques to engage effectively at the community level. Project sponsors that lack confidence or experience may be over-reliant on discussions with official representatives, such as local mayors and government officers. While it is important to engage with elected representatives, statutory consultees and other key stakeholder bodies, it is risky to assume that they fully represent the views and aspirations of the affected population.

It may not be immediately obvious which communities are directly affected by a project. A combination of specialist and local input is usually required to identify which communities

The typical project finance process



Building the BTC pipeline – but can banks build in better environmental risk management?

are likely to be affected by different types of impacts. For example, dam projects have different impacts on local communities according to location. Those upstream may be affected by the loss of access to forest resources flooded or made inaccessible by the dam. Communities downstream may be affected by changes in water flows on which they rely for irrigation.

Impacts will also vary depending on the age, gender, class, caste or ethnic groups affected. An essential stage in the community engagement process is the categorisation of the different types of impacts and the identification of the potentially affected communities. This informs who needs to be consulted and the most appropriate way in which this can be achieved. It is a process that needs to be reviewed as a project develops and as lessons are learnt from ongoing community engagement.

Managing expectations

Community engagement requires more than the provision of information to affected communities. It is often necessary to manage expectations and to prevent the spread of misleading information. This requires an appreciation of previous projects in the area, as affected local communities may develop unrealistic expectations based on their past experience.

In one example, local communities that would be affected by a road construction project had heard about the very high rates of compensation paid to land owners along the route of a recently constructed oil pipeline. In anticipation of the road project also offering high rates of compensation, the community members expressed strong support for the proposed route, despite it involving the potential loss of existing homes and farmland. In fact, the sponsors of the oil pipeline project had paid land compensation at rates far in excess of government guidelines, partly to accelerate progress of a project dogged by delays. An ongoing process of local community engagement was essential to correct the subsequent unrealistic expectations of financial gain.

When to disclose information

The timing of information disclosure remains a contentious and sensitive issue. The new IFC Performance Standards encourage early consultation. There are many examples where local people have been consulted on a project and made aware of a potential impact at a very late stage. There are also risks associated with early consultation when there may be little detailed information available on a project. One risk is that job seekers may speculatively migrate to an area in search of work, which may present an increased burden on local communities and increased potential for clashes between different social groups who wish to capture the benefits of the project.

Role of project sponsors and lenders

Project sponsors may have limited control over consultation where government agencies play a leading early role in project development. In our experience, government agencies in certain countries may block public release of the findings of consultations on environmental and social impacts of projects.

In these situations, project sponsors need both to engage with government agencies to persuade them of the importance of disclosure and to take the lead on undertaking further disclosure and consultation. Project lenders may be able to offer a supportive role in this process and to use their leverage as providers of finance to request information. Lenders can also act as an outlet for information disclosure or as a receiver of views on the project. We have found that, in certain contexts, local communities may be more willing to direct consultation responses to the project lender rather than to the project sponsor.

The new IFC Performance Standards encourage the use of existing mechanisms for local consultation. This can empower affected communities, facilitating the presentation of the project in a way that they can understand, and allowing them to discuss their concerns and provide meaningful inputs to the project. It can also support the development of democratic mechanisms of governance in nascent democracies.

However, these existing channels are, in some cases, inadequate. Many countries, particularly former Soviet states, suffer from historical barriers to the free expression of views by ordinary citizens. In these countries, new models of engagement can help to overcome these barriers to effective consultation. We would suggest that the IFC Performance Standards recommendation to use existing local mechanisms should not be followed where such mechanisms would act as an impediment to effective consultation.

Conclusions

The Equator Principles are clearly driving forward improved environmental and social performance in project finance. Project sponsors are increasingly recognising the value of employing more sophisticated environmental and social management techniques to minimise risk and to ensure that their projects are far more attractive to project lenders. As more banks adopt the principles, and as the capacity of project sponsors is developed in response, we can expect further innovation and increased sustainability through the comprehensive management of environmental and social risk.

Rachael Bailey, Tracey Ryan and Nicky Hodges are London-based consultants at Scott Wilson, an international multi-disciplinary consultancy group. The company was one of four selected by the IFC as approved trainers for implementation of the new IFC Performance Standards, to provide training to financial institutions, project sponsors and other consultancies.
E-mail: rachael.bailey@scottwilson.com