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The Equator Principles – Consultation, Assessment and Accountability

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At the heart of the Equator Principles lie the issues of implementation and accountability, how strictly do the EPs bind signatories to act and should a voluntary framework have the legal 'teeth' to penalise institutions falling below their commitments?

Alongside Infrastructure Journal's second review of the Principles, Paul Q. Watchman, Bruce Johnston and Tim Baines of LeBoeuf Lamb's Environment, Health, and Safety practice pass a critical eye over the legal basis of the EP framework.

The Equator Principles (EP) are voluntary social and environmental guidelines that 45 banks and financial institutions (together the Equator Principles Financial Institutions or EPFI) have agreed to be bound by¹. They are not a detailed set of enforceable legal norms but a general framework of ten broad principles² which are underpinned by International Finance Corporation (IFC) Performance Standards and the application of local and national law.

The EP comprise two sets of principles. The first set of EP (EP1), conceived with the help of the IFC in 2002, was launched in 2003. The second revised set of EP (EP2)³ has been open for adoption by EPFI from July 2006. Under the EP, EPFI undertake not to provide loans to a project unless sponsors can demonstrate that the project will be constructed and operated in accordance with sound social and environmental management practices.

Our aim is not to provide a comprehensive analysis of the EP but to discuss some of the more challenging issues that they raise, particularly in relation to some of the 'new' obligations imposed by EP2 and the effects that these may have on the accountability of EPFI. This necessitates a basic analysis of how the EP work.

Implementation of EP

Categorisation of Projects

The EP require projects to be categorised as Category A, B or C projects in accordance with the degree of risk which the project presents to society or the environment.

Category A	High Risk	Projects with potential significant adverse social or environmental impacts that are diverse, irreversible, or unprecedented
Category B	Medium Risk	Projects with potential limited adverse social and environmental impacts that are few in number, generally site specific, largely reversible, and readily addressed through mitigation measures
Category C	Low/No Risk	Projects with minimal or no social or environmental impacts

Category A and C projects are relatively straightforward to identify. If a project is categorised as a Category B project, the applicable requirements differ depending upon whether the project is located in a non-OECD country or a non High-Income OECD country.⁴ Regardless of this distinction, it may be considered appropriate to subject certain projects to a particular requirement (see below).

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Requirements of EPFI for Category A and Category B projects

Requirement	Category A	Category B
Environmental and Social Impact Assessment	All Category A	All Category B
Action Plan and Management System	All Category A	Category B*
Public Consultation	All Category A	Category B*#
Grievance Procedures	All Category A	Category B*#
Independent Expert Review	All Category A	Category B#
Independent Monitoring	All Category A	Category B#
Annual Reporting Obligations	All Category A	All Category B
Loan Covenants: — Materially comply with applicable social and environmental laws, regulations, and permits — Materially comply with the Action Plan and Monitoring/Management Systems — Compliance and enforcement mechanisms — Decommissioning Plan — Compliance with Decommissioning Plan	All Category A	Category B*#

Key

* Non-OECD countries and non High-Income OECD countries.

Considered appropriate to subject the Category B project to the requirement.

Advisory activities

Under EP2, in addition to lending activities alone (as is the case under EP1) the EP apply to 'advisory' activities. This change should mean that EPFI become involved with projects at an earlier stage, better enabling them to influence the categorisation of the project, choice of consultants and other advisors, and the scope of due diligence of the project. Involvement of EPFI when these matters have been largely determined limits their ability to influence the project and the application of EP⁵ This should also allow EPFI to better guide sponsors through the key issues, such as human rights, biodiversity, or involuntary displacement of local people or indigenous tribes.⁶

Consultation

EP2 state that for all Category A projects and, as appropriate, Category B projects located in non-OECD countries and non High-Income OECD countries, there is an obligation on the borrower or third party expert to consult with 'project affected communities' in a 'structured and culturally appropriate manner'. This requirement is of great importance as many projects are located in pre-literate non-High-Income OECD or non-OECD countries.

Consultation must be in a manner which is appropriate to the location of the project and the local communities. The objectives of the consultation are to ensure that project-affected communities⁷ have the opportunity to express their views on project risks, impacts, and mitigation measures and that the sponsor may consider and respond to them. Effective consultation should:

1. Be based on the prior disclosure of relevant and adequate information (including draft documents and plans)
2. Begin early in the SEA process

3. Focus on the social and environmental risks and adverse impacts and the proposed measures and actions to address these
4. Be carried out on an ongoing basis as risks and impacts arise. Cultural appreciation appears to imply that a borrower or expert considers which form of communication may be necessary, what language or languages should be adopted, what the affected communities' decision process is, and where meetings should be held.

EP2 provide that for projects with 'significant adverse impacts' on affected communities, there should be 'free, prior, and informed consultation'. This is an interesting procedural concept developed in the context of the review of the World Bank Group's activities in the extractive industries sector,⁸ and is now a key part of EP such that the borrower must satisfy the EPFI that the informed participation of the affected communities has been adequately incorporated into the project. However, under EP there is no requirement to establish that broad community support has been obtained for the project.⁹

Streamlining Assessment

In drafting EP2, there has been a conscious decision to 'streamline' the environmental and social assessment process for High-Income OECD countries. This accords with current practice in countries such as the United Kingdom where the EP are effectively ignored in Private Finance Initiative financing.

In the case of High-Income OECD countries, the baseline requirement for an Environmental and Social Impact Assessment of a Category A or Category B project differs from that for non-OECD or non-High-Income OECD countries. The baseline standard for a non-OECD country or a non-High-Income OECD country is that the IFC Performance Standards plus any applicable industry IFC Environmental, Health, and Safety (EHS) Guidelines should be applied. In the case of High-Income OECD countries, the baseline is compliance with local or national law alone. The basis for this distinction is that in High-Income OECD countries, laws relating to environmental protection and safeguarding of social matters tend to be more stringent and robust than the IFC Performance Standards and the EHS Guidelines.

This distinction may be an oversimplification of a complex situation. It does not show an appreciation of the very different OECD High-Income country environmental, social, and governance standards and their diverse enforcement regimes and practices. Germany, Greece, Italy, Spain, the Netherlands, and the United Kingdom are all European Union Member States and High-Income OECD countries but some of these countries are known to have less impressive records than others in transposing and implementing social and environmental directives and regulations.¹⁰ Similarly, there is divergence in the approach of these Member States to the enforcement of local environmental and labour laws.¹¹

Loan Documentation Issues

Covenants

Since the adoption of EP1, EPFI have been required to review loan documentation¹² in light of the wider social and environmental assessment, monitoring, and enforcement obligations by which they have agreed to be bound. EP2 has introduced four borrower covenants that must be incorporated into loan documentation. These covenants are that borrowers must comply with:

- Local, state and host country social and environmental laws, regulations, and permits in all material respects
- The Action Plan in all material respects
- A duty to provide regular reports on compliance with the Action Plan and laws, regulations, and permits
- The Decommissioning Plan

The introduction of these covenants, far from being a 'sea change' represents a 'codification' of existing practice. Most loan documents will already have a covenant requiring the borrower to comply with local laws. That covenant is usually subject to a materiality threshold so that loans do not go into default as a result of a 'major' breach of a 'minor' law or a 'minor' breach of a 'major' law.¹³ The threshold is usually qualified with reference to the breach having a 'Material Adverse Effect'. The definition of 'Material Adverse Effect' is extensively negotiated in each transaction.

It is also usual for loan documentation to contain a separate covenant in relation to compliance with environmental laws. This is usually required by the compliance team at the EPFI, though it usually adds nothing to the general covenant about compliance with law, because it will also be qualified by 'Material Adverse Effect'. However, because of the stringency of the specific environmental covenant, it can be problematic to include compliance with 'social' laws within this covenant. 'Social' laws, as envisaged by the EP, are difficult to match up with the reality of laws in many project countries. They are also difficult to define.¹⁴

Experience has also shown that compliance with the social aspects of the EP can be more difficult to document and implement than the environmental aspects of the EP. In some countries, consultation (and compensation) which can be seen as a 'foreign' interference in the political arena, are actively resisted by local governments.

Breaches of The EP

Many different reasons have been advanced by EPFI for adopting the EP. These include the protection of reputation, a defence against civil society activism, and matching sector 'best practice'. As the EP are voluntary standards, there are no prescribed remedies for their 'breach'. However, EPFI are likely to be cautious about reneging on the commitments to which they have signed up and sacrificing the many factors that lead to them to adopt the EP in the first place.

Reputation

EPFI have sought reputational protection by adopting the EP. The EP allow EPFI to hold themselves out as responsible lenders complying with widely adopted 'best practice' standards. This reputational advantage is underlined by the fact that the EP are underpinned by the IFC's Safeguard Policies. Banks and financial institutions continue to suffer damage to their reputations from perceived 'irresponsible' lending practices and EP adoption helps protect against this.

The tendency of civil society to monitor and report back on performance, especially against the obligations set out by the EP, can only mean that EPFI are under increasing reputational pressure to comply with the EP. That said, there are currently no formal provisions in the EP to sanction entities that engage in 'greenwash' by adopting the EPs but failing to properly implement them. This contrasts with other voluntary standards such as the UN Global Compact.¹⁵ We have long argued the case for the usefulness of a compliance advi-

sor and 'ombudsman' to advise third parties on issues relating to a project and to monitor and regulate EP implementation.¹⁶ EPFI are also likely to be concerned with how they are perceived by industry regulators and the increasing number of fund and asset managers who monitor social and environmental impacts.

High-level commitment

Many leading figures in the banking community have demonstrated a commitment to social and environmental responsibility. Project finance is particularly sensitive to such considerations. It is clear that the pressure to live up to this commitment is driven 'from the top', and that many bankers will be concerned that financing a project without properly complying with the EP risks the wrath of senior management. The need to match up to institutional pressure to comply with social and environmental standards is an important factor in encouraging EP compliance.

Protection of market share and differentiation

As the number of EPFI increases, it becomes less easy for EPFI to differentiate themselves by way of adopting the EP. However, it is still likely that the increased due diligence required by the EP means that projects will attract less adverse criticism from stakeholders. EPFI are likely to want to properly implement the EP in order to more successfully manage projects by reducing costly delays caused by poor social planning and ill-considered environmental consequences.

Another helpful aspect of the EP for EPFI is that for the first time a 'uniform' standard has been introduced against which they can measure environmental and social compliance. This also helps EPFI to differentiate themselves from other banks and financial institutions who may adopt a less rigorous approach. As well as a 'moral' argument for EP compliance, reputable global players are likely to resist being seen as one of a diminishing group of entities who do not apply widely adopted social and environmental standards.

Syndication

Sponsors are likely to encourage banks to adopt the EP if it becomes the case that EP compliance leads to a more successful syndication of projects. Syndication difficulties can increase project costs, have a negative effect on reputation and will make it harder to attract finance for future projects. The length of time and cost of syndication might also increase if arrangers invoke provisions in their mandate letters that allow them to withdraw from arranging finance if there is insufficient take-up from the market as a result of the project not being EP compliant.

Increasing formality of sanction

The factors outlined above can be seen as informal mechanisms of sanction for breach of the requirements of the EP. The use of formal sanctions in relation to non-observance of the EP has not been adopted. However, EP2 has introduced three additional methods of sanction which have more 'formal' hallmarks and which it is hoped will encourage EP compliance and accountability. These are the obligation to put in place independent review, grievance procedures, and annual reporting obligations.

(i) Independent Review

For all Category A projects and, where appropriate, Category B projects, EPFI can require independent review by a social or environmental expert not directly associated with the borrower. The scope of the review which the independent expert may be requested to carry out includes the Environmental and Social Impact Assessment, Action Plan, and consultation process documentation. The purpose of the review is to assist EPFI in their due diligence of the development and operation of the project and in respect of compliance with the EP.

(ii) Grievance Procedures

In the light of several recent well-publicised projects there has been a call for sponsors and EPFI to become more transparent and accountable to both the communities affected directly by such projects and to civil society generally. EP2 requires a grievance procedure to be put in place during a project's lifetime for the benefit of project-affected communities. This reform acknowledges criticism of the need for sponsors to provide effective grievance procedures. It nevertheless falls far short of fully addressing lack of accountability in implementation of the EP.

(iii) Annual Reporting Obligations

EP2 requires EPFI to provide periodic public reports at least annually. The report must cover implementation of the EP processes and the experience of the EPFI, subject to the requirements of client confidentiality. At a minimum, the report should address the number of transactions screened by the EPFI and the categorisation of each transaction as well as information on the implementation of the EP. In addition, the EPFI report may include a breakdown of transactions and categorisations by sector or region.

Towards accountability?

When taken together, it is clear that the introduction of grievance procedures and the requirement for independent expert appraisal and community consultation have created a more powerful arsenal of weapons with which EPFI themselves and civil society can more effectively monitor compliance with the EP. This reinforces the significance of the less autocratic but equally important 'sanctions' of loss of reputation and falling behind internal and external market expectations. It remains to be seen whether future developments in the EP will lead to the introduction of more formal methods of holding EPFI to account.

Notes

1. An up-to-date list of EPFI can be found at www.equator-principles.com.
2. The Equator Principles can be viewed at www.equator-principles.com.
3. A summary of the primary differences between EP1 and EP2 is available at www.llgm.com (follow "client alerts" hyperlink; then follow 'associates' hyperlink; then search for "Equator Principles").
4. High-Income OECD countries are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Republic of Korea, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States of America (www.worldbank.org; following hyperlink to 'Data'; follow hyperlink to 'Country Groups').
5. See *Banking on Responsibility: Part 1 of the Equator Principles Survey 2005: The Banks*, (London: Freshfields Bruckhaus Deringer, July 2005) pp. 10-12, 92-95.
6. *Ibid.*, at pp. 95-104.
7. 'Project affected communities' are communities of the local population within the project's area of influence who are likely to be adversely affected by the project (see note 4 to Principle 5 of the EP2).
8. In 2000, the World Bank Group announced that it would carry out a comprehensive review of its activities in oil, gas, and mining production (the extractive industries sector), prompted largely by concerns expressed by a variety of stakeholders, primarily environmental and human rights organisations. The review included an independent stakeholder consultation process and report prepared by Dr. Emil Salim (former Indonesian State Minister for Population and Environment). The report made various recommendations to which the World Bank Group Management responded. The World Bank Group concluded it would only support extractive industry projects where there has been a process of free, prior, and informed consultation with affected communities that leads to the affected community's broad support for the project (see World Bank Group, *Striking a Better Balance - The World Bank Group and Extractive Industries: The Final Report of the Extractive Industries Review*; World Bank Group Management Response, 17 September, 2004, pp. v, 7, 9, 21, 22, 23 and 31 (available at www.ifc.org).
9. Contrast with the World Bank Group's position (see *ibid.*).
10. For instance: Council Directive 85/337/EEC of 27 June, 1985 on the assessment of the effects of certain public and private projects on the environment, OJ L 175, 05.07.1985 pp.40-48 (the EU Environmental Impact Assessment); Council Directive 96/34/EC of 3 June, 1996 on the framework agreement on parental leave concluded by UNICE, CEEP, and the ETUC, OJ L 145, 19.6.1996, pp. 4-9 (the EC Parental Leave Directive); Council Directive 93/104/EC of 23 November, 1993 concerning certain aspects of the organisation of working time OJ L 307, 13.12.1993, pp. 18-24 (the Working Time Directive); and Directive 2003/87/EC of the European Parliament and of the Council establishing a scheme for greenhouse gas emission allowance trading within the Community, OJ L 275, 25.10.2003, pp.32-46 as amended by Directive 2004/101/EC, OJ L 338, 13.11.2004, p.1816.
11. A comprehensive overview of the evolution and enforcement of labour laws in the EU can be found in the European Commission's *Labour Laws (1992-2003)*. Volume 1 can be found at: http://ec.europa.eu/employment_social/labour_law/docs/generalreport_en.pdf. Volume 2 is available at: http://ec.europa.eu/employment_social/emplweb/publications/publication_en.cfm?id=59. See also European Commission Green Paper, *Modernising labour law to meet the challenges of the 21st century*, COM (2006) 708 final, for a summary of the current and complex challenges facing labour law and its enforcement.
12. *Banking on Responsibility: Part 1 (2005)*, see *supra* at note 5, pp. 112-117.
13. *Ibid.*, see *supra* at note 5, pp. 113-116.
14. See Paul Q. Watchman, "The Equator Principles: Raising the Bar on Social Impact Assessments", *Human Rights, Trade and Investment Matters*, Amnesty International, 2006.
15. Under the UN Global Compact, signatory companies must submit a Communication on Progress (COP) annually. This must describe the ways in which they are implementing the 10 principles. If a company misses two consecutive deadlines it is delisted and the delisting will be noted on a website. A company can regain its status by submitting a COP. 335 companies were delisted on 2 October 2006.
16. On the need for an ombudsman or external expert advisors see *Banking on Responsibility: Part 1 (2005)*, see *supra* at note 5, p. 22.