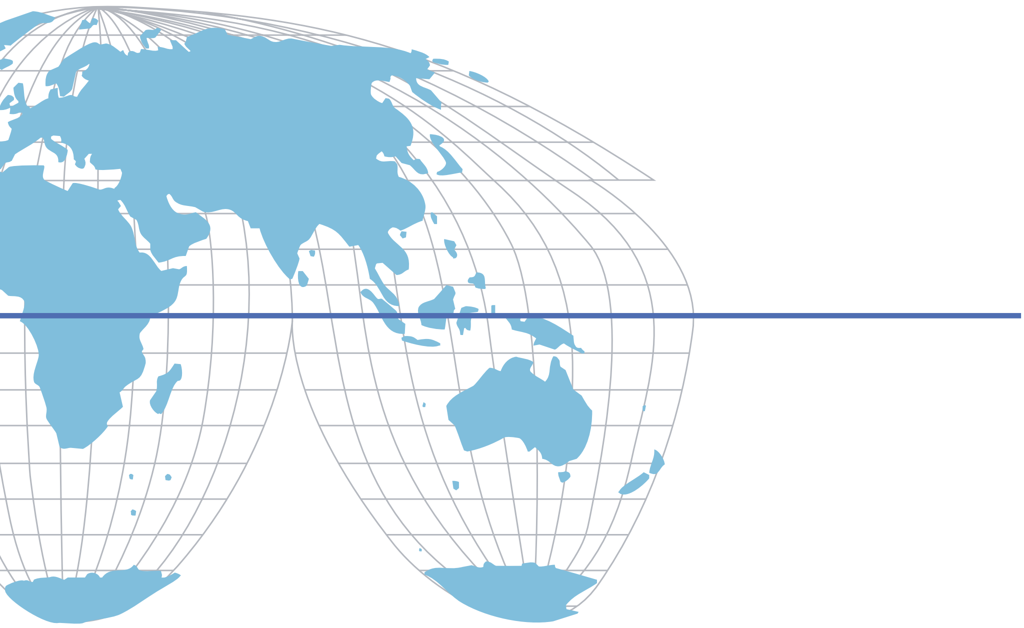
FRESHFIELDS BRUCKHAUS DERINGER

Banking on responsibility

Part 1 of Freshfields Bruckhaus Deringer Equator Principles Survey 2005: The Banks

July 2005



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Banco Bradesco
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Barclays Bank
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Eksport Kredit Fonden
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Standard Chartered
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Royal Bank of Scotland
Scotiabank
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WestLB
Westpac

'Congratulations on writing the definitive piece on the Equator Principles. An excellent report. You capture all the issues and all the arguments for and against each. You also offer perceptive commentary.'

Christopher Beale, Managing Director, Citigroup

'Overall I think this really is very good indeed and should be regarded as a definitive reference work on the Principles.'

Chris Bray, Head of Environmental Risk Policy Management, Barclays

'Very good report: we learned a lot from it.'

Johan Frijns, Co-ordinator, BankTrack

'First, let me congratulate you on an excellent piece of work. The breadth of coverage and depth of analysis is superb.'

Reed Huppman, Partner, Environmental Resources Management

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Preface

> ‘Our understanding about environmental issues is much broader as it involves the whole sustainability of the process, such as lower credit risk, less risk collateral and better overall perceived risk. Thus for us, environment is not just about turtles.’
>
> Roberto Dumas Damas, Project Finance Co-ordinator, Banco Itaú BBA

The Equator Principles are a shining beacon for responsible banking. Their impact on the financial market generally and their success in redefining banking considerations has been far greater than anyone could have predicted.

The Equator Principles are a set of voluntary guidelines that were originally adopted in June 2003 by 10 banks and which, by the beginning of June 2005, had been adopted by 31 financial institutions (30 banks and one export credit agency (ECA)). The Equator Principles apply to all industry sectors and to projects with a total capital cost of over $US50m ($50m). They provide a framework, based on the IFC (International Finance Corporation) Safeguard Policies, which commit each of the Equator Banks to develop its individual policies, practices and procedures to ensure that projects are assessed according to specific social and environmental considerations and are carried out in a socially and environmentally responsible manner. We discuss the IFC Safeguard Policies and the effect of the current IFC review of its Safeguard Policies later in the report.

The motives of each Equator Bank for adopting the Equator Principles differ substantially. For some, adopting the Equator Principles was seen as little more than an extension of existing social and environmental risk assessment practices that formed part of their overall credit risk assessment procedures for project financing. For others, the process was far from an evolutionary development but represented a fundamental change in their risk management methodologies. Equally, some Equator Banks regarded the adoption of the Equator Principles as a means of protecting the reputation or market share of the bank, while others saw it as an opportunity to create an industry standard or to enhance their competitive position.

The motives of non-Equator Banks for not adopting the Equator Principles are also varied, ranging from scepticism to a reluctance to be perceived as hypocrites given that the Equator Principles were nothing more than a continuation of business as usual.

Views differ on the success and impact of the Equator Principles. For some, but by no means all, of the Equator Banks, the Equator Principles are regarded as a paradigm shift in the assessment of social and environmental risks and the importance given by commercial lenders to social and environmental considerations.

For supporters of the Equator Principles, they have been a catalyst for change, not only in project finance but also in other areas of lending activity. A number of leading banks have already developed and adopted a wide range of policies to address social and environmental concerns, such as the impact of climate change, deforestation and the exploitation of natural resources. Those who support the Equator Principles claim that their adoption creates a 'virtuous circle', where sponsors are obliged to develop more socially and environmentally robust projects.

For some commentators, however, the real test for the Equator Banks lies in ensuring that the Equator Banks apply the Equator Principles fully and consistently. Some stakeholders, including non-governmental organisations (NGOs)[1], point to the limitations of the Equator Principles and their inconsistent interpretation and implementation by the Equator Banks. They question whether the Equator Principles really do deliver the benefits that others trumpet or are merely another example of 'greenwash'[2] by financial institutions.

Notwithstanding the different views of the Equator Principles, it is very clear that the Equator Banks have come a long way in a relatively short period. Few who work in areas where social and environmental considerations intersect with project finance will have failed to notice that much greater importance is now being placed by banks on ensuring that social and environmental considerations are addressed much earlier in the process and in a much more meaningful way.

> 'A few years ago if you spoke to an investment banker about environmental and social issues, they would have thought you a hippie.'
>
> Chris Bray, Head of Environmental Risk Policy Management, Barclays[3]

Our survey suggests that social and environmental experts continue to be treated with scepticism and that those driving forward projects continue to delay addressing social and environmental issues adequately until they risk derailing the project. However, though these potentially harmful tendencies

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1 'NGO' is a generic term that applies to a very wide number of organisations with different agendas. We have tried to attribute views expressed by NGOs as specifically as possible. We consider a number of issues relating to NGOs at Annex 4.

2 'Greenwash' is like whitewash, but is a spurious attempt to cloak a company or matter with green credentials in order to claim environmental responsibility.

3 'A matter of Principles', *Global Finance*, 1 December 2004.

are still present they are no longer prevalent among sponsors, banks or project financiers.

The objectives of our survey into the impact and implementation of the Equator Principles in the project finance market are:

- to examine claims and counterclaims made by supporters and critics of the Equator Principles;
- to provide an objective assessment of what is happening on the ground, including assessing general awareness of the Equator Principles;
- to assess what is best industry practice;
- to suggest where improvements might be achieved; and
- to equip ourselves to advise our clients fully on the Equator Principles.

A description of our methodology is set out in detail below. We do not intend our survey to be a user's guide to the Equator Principles and so we have not included case studies showing how we think they should be implemented. This report is based on a survey of banks and other entities about their experience in implementing the Equator Principles. It is not a complex social study of the financial sector, a history of the evolution of the Equator Principles or a legal treatise on social and environmental assessment of projects in the context of project finance. The object of this simple survey is to provide information to enable informed debate to take place on an important development.

Throughout our discussion of the Equator Principles and Equator Banks, it may be helpful to underline a number of points that Roberto Dumas Damas of Banco Itaú alludes to at the beginning of this preface. We believe that a better understanding of the Equator Banks and the value of the Equator Principles may be achieved if four basic premises are kept in mind:

- commercial banks are not state entities, public bodies or multilateral or bilateral lenders and as such are accountable to their shareholders and not to governments, governmental bodies or the electorate in the same way as public bodies;
- commercial banks do not hold a social development brief and are not a substitute for the IFC or social and environmental regulators;
- an essential aim of commercial banks is to make money for their shareholders; and
- commercial banks are in competition with each other.

Acknowledgements

We thank all those participants and other contributors who gave up their time to help us to understand the impact that the Equator Principles have had on the way in which banks carry out environmental and social credit assessment, not only in project finance but also in other forms of lending.

Those who participated in or contributed to our survey include Equator Banks; non-Equator Banks; project sponsors; NGOs; socially responsible investment funds; law firms; accountancy firms; engineering and environmental consultants; trade associations; public bodies; and multilateral and bilateral lenders.

We have not listed all participants as some, while willing to share their views of these matters, preferred not to be identified.

Disclosed contributors to the survey

ABN AMRO	Richard Burrett, Head of Sustainable Development Business Group
Amec	Dr Jim Wright, Director O&G Co-ordinator Europe
Banco Itaú and Banco Itaú BBA	Roberto Dumas Damas, Project Finance Co-ordinator
Bayerische Hypo und Vereinsbank	Kai Henkel, Head of Global Project and Structured Finance
BankTrack	Johan Frijns, Co-ordinator
Barclays	Chris Bray, Head of Environmental Risk Policy Management
BP	Melissa Solomon, Legal Adviser
British Gas Group	Craig Cowley, Head of Structured Finance
Butterworths Journal of International Banking and Financial Law	Roger McCormick, Editor
Citigroup	Christopher Beale, Managing Director
Consultant	Margaret Wachenfeld
Co-operative Insurance Society	Simon Cramer, Responsible Shareholding Analyst
Environmental Resources Management	Reed Huppman, Partner William Butterworth, Principal Consultant
F&C Asset Management	Kirsty Jenkinson, Senior Analyst
GE Capital	Deborah Lloyd, European Environmental Counsel

Acknowledgements (continued)

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Lloyds TSB	Richard Cooper, Head of Corporate Responsibility
Mott MacDonald	Simon Robinson, Associate Director
National Australia Bank	Richard Speak, General Counsel
Platform	Greg Muttitt, Researcher
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Scott Wilson	Tracey Ryan, Senior Consultant Edda Ivan-Smith, Principal Consultant Nicky Hodges, Social Expert Rachel Bailey, Environmental policy
Société Générale	Matthew Vickerstaff, Regional Head of Project Finance for Europe, Middle East and Africa
Sustainable Finance	Glen Armstrong, Co-founder Leo Johnson, Co-founder
University of Cardiff Faculty of Law	Professor Bob Lee
URS Corp	Freya Phillips, Principal Consultant Mark Mackintosh, Principal-in-Charge, Audit Group
WestLB	Foster Deibert, Head of Sustainability Management
Westpac	Martin Hancock, Chief Operating Officer

Executive summary

Our survey concludes that the Equator Principles are a shining beacon for responsible banking and generally have had a positive effect not only on the attitude of lenders to social and environmental considerations in project finance, but also in other areas of banking[4].

The Equator Principles are, or are rapidly becoming, an industry standard in international project finance, but perhaps more than that they have promoted the trend towards responsible banking. There is some evidence of banks adopting the Equator Principles or applying an 'Equator-Lite'[5] approach to banking activities other than project finance, and that the initial resistance within some Equator Banks to a more general application of the Equator Principles is eroding. Some of the Equator Banks believe that the Equator Principles may be applied usefully to areas such as export finance or general lending. However, senior figures among the leading Equator Banks, such as Chris Bray at Barclays, are clearly worried that by over-extending the application of the Equator Principles to areas other than project finance, they may become tainted by inadequately performing a function, such as general financial risk assessment, for which they were never designed and where banks apply less structured approaches than project finance.

There is also some evidence, albeit circumstantial, that the Equator Principles have begun to exert a positive effect on non-Equator Banks and project sponsors, largely through competitive pressures. In addition, the Equator Principles, arguably, have provided a catalyst for banks and other financial institutions to develop their thinking further on their role in the 21st Century. Whether this represents a fundamental or merely superficial change, only time will tell.

The Equator Banks are entitled to take pride in what they have achieved in a relatively short time. The NGOs may be disappointed by the lack of visible progress made by Equator Banks, but they should recognise that for the Equator Banks to have come so far in less than two years is for these banks as a group of competitors the equivalent of travelling at light speed.

However, it would be wrong to suggest that there was some inevitability to this process or that the banks would have reached their present position

4 We discuss our methodology later in the report after setting out our findings and recommendations.

5 'Equator-Lite' describes a less comprehensive version of the Equator Principles that takes account of some environmental and social impacts but is not agreed among a wide number of financial institutions and does not necessarily go as far as the Equator Principles in the comprehensiveness of its approach to environmental and/or social matters.

entirely of their own volition. Although the Equator Principles may be voluntary, their genesis is not due to voluntarism. There were undoubtedly a number of important internal drivers, such as the commitment of many Equator Bank chairmen and chief executives to sustainable development and responsible banking. The influence on commercial banks of the policies of international and transnational agencies, sovereign states and multilateral lenders, to be more discerning in choosing projects they are willing to fund, has also been important. The banks that adopted the Equator Principles did so in response to external, as well as internal, pressure for greater corporate and social responsibility on their part. Special mention should be made of the sustained pressure exerted on the financial sector by stakeholders for sustainable and responsible banking, led by some prominent socially responsible investors such as Isis (now F&C Asset Management) and Insight Investment in the UK and many other entities such as CALPERS and the Calvert group of funds in the US[6]. In addition, a number of civil society organisations and NGOs, like BankTrack (an international network of major environmental NGOs including the World Wide Fund for Nature (WWF) and Friends of the Earth (FoE)), which focus on the activities of the banking sector, have also played leading roles.

The principal motives of Equator Banks for adopting the Equator Principles differ. Some can trace a proud and impressive lineage of social and corporate responsibility. These Equator Banks see the Equator Principles as no more than a continuation of their established commitment to sustainable and responsible banking or ‘business as usual’. Others, however, would find it difficult to make such claims.

A number of Equator Banks have learned from their mistakes and now seek to embrace sustainability. Yet others, if only from enlightened self-interest or a respect for neo-classical economics, recognise that something had to be done to deliver projects which better address social and environmental impacts.

It is not all good news, though. Equator Banks are at the beginning rather the end of a journey. In the words of Sir John Bond of HSBC, they are ‘in the foothills looking up at the mountains’[7]. Whether the enterprise will succeed depends on two things: first, whether it can be demonstrated as a matter of fact that the Equator Principles really do make a difference in practice; and, second, on the IFC review of its Safeguard Policies not creating a schism between the Equator Banks.

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6 There are a number of drivers behind ‘responsible’ investment decisions. These include the Turnbull Guidelines, ASB standards and a move towards more detailed operating and financial review of companies.

7 HSBC Climate Group Launch, 27 April 2004.

The Equator Principles will be no more than a laudable aspiration unless the Equator Banks practise what they preach by refusing to finance projects that cause demonstrable and significant environmental or social harm.

From our survey, it is clear that the Equator Banks must address a number of important issues urgently if they are to claim success. They must satisfy a pressing need to embed the Equator Principles in the daily practices of bankers working with project sponsors in the front line. The application of the Equator Principles must not be damaged by the ignorance of those who are primarily responsible for their implementation. Equally, it is our view that middle ground must be found sooner rather than later with stakeholders and NGOs on important issues such as transparency and accountability in decision-making.

Although our survey findings are generally positive, not all are so. We therefore offer a number of recommendations for the Equator Banks to consider. These fall into two main categories. The first group of recommendations is ‘good housekeeping’ or ‘good industry practice’ recommendations. The second group consists of technical and legal recommendations that the Equator Banks might consider as part of a legal, technical or document review or a review of bank procedures and protocols.

Finally, we pose a number of questions for the Equator Banks that aim to stimulate debate about the future shape and direction of the Equator Principles.

Positive findings identified by survey participants

Major step
The adoption of the Equator Principles is a major step in the development of sustainable and responsible banking.

Lender considerations
The Equator Principles have promoted the importance of social and environmental issues in lending decisions but they have not displaced all other considerations to any significant extent. They are unlikely to be the most important considerations for lenders, as in every case credit considerations will prevail.

Industry standard
The Equator Principles are becoming an industry standard in international project finance and a major influence on lending decisions beyond project finance through the adoption of 'Equator-Lite' variants.

Implementation
The majority of the Equator Banks have made substantial investment in implementing the Equator Principles.

Training
This investment has included recruitment of expert advisers and the development and rollout of staff awareness and training programmes using internal and external resources.

Chairmen and CEOs
Critically, senior bank officers, such as chairmen; chief executive officers; heads and deputy heads of global project finance; and general counsel and senior lawyers in legal departments have invested significant time and effort in attending internal and external training courses and programmes and by holding meetings with NGOs and sponsors. Co-ordinating the diaries of senior officials at a large number of Equator Banks, in order to make them available for Equator Bank and NGO meetings, evidences the commitment to the success of the Equator Principles.

Sharing knowledge
The Equator Principles have fostered co-operation and the sharing of knowhow and best practice among the Equator Banks. This is a major breakthrough. As Richard Burrett of ABN AMRO remarked, the idea that Barclays should share something with Citigroup and ABN AMRO is unprecedented.

Virtuous circle
Another aspect of enhanced co-operation has been the beginning of the 'virtuous circle', where mature sponsors are designing more

robust projects to comply with the Equator Principles; Equator Banks have required non-Equator Banks to undertake to comply with the Equator Principles in the administration of the project financing as a pre-condition for their participation in a facility arranged by the Equator Banks; and non-Equator Banks have arranged facilities to ensure compliance with the Equator Principles in order to secure the widest possible participation in a syndication.

Holistic approach

The Equator Principles encourage sponsors and lenders to take a much more holistic approach to project assessment – looking at social as well as environmental reports and at the cumulative effects of these impacts.

Robust and early analysis

Knowledge that failure to satisfy the Equator Principles' requirements may seriously limit the chance of syndication should have the salutary effect of prompting both arranging or lead banks and the sponsor to test the robustness of projects against the Equator Principles thoroughly. One of the effects of the Equator Principles is the growing realisation among arranging or lead banks and sponsors that environmental and social concerns need to be addressed at an earlier stage in projects than before.

Additional protection

Mature sponsors are increasingly seeing the Equator Principles and Equator Banks as an additional layer of protection for projects against political risk.

Dialogue

The Equator Principles have led the Equator Banks into a structured dialogue with stakeholders, NGOs and multilateral organisations around the important social and environmental issues that the Equator Principles address, which is a good thing even if a limited number of NGOs are not yet convinced that the dialogue has meaning[8].

Ripple effect

The Equator Principles have had a ripple effect in the financial sector. Technical consultants reported that non-Equator Banks and sponsors have required consultants to advise if their projects comply with the Equator Principles in cases which clearly are not covered by the Equator Principles because of the nature or value of the project or in cases where the method of financing was other than project finance.

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8 BankTrack considers the dialogue with Equator Banks useful and welcomes its continuation.

Negative findings identified by survey participants

$50m threshold
The $50m threshold means that the Equator Principles do not apply to about three per cent by value of project finance lending. This is a very small percentage but it is difficult to justify assessing projects according to their monetary value alone rather than their potential social and environmental impacts. Small projects in sensitive areas or in developing countries are quite capable of inflicting significant adverse impacts, notwithstanding the fact that they fall below the $50m threshold.

Scope
Project finance represents only part of the lending portfolios of Equator Banks. By confining the Equator Principles to project finance, other activities, which tend not to be funded through project finance mechanisms (such as balance sheet lending to companies engaged in the mining, forestry and offshore energy sector) but which may have significant negative social and environmental impacts, may not be subject to the robust assessment required by the Equator Principles.

Stringency
BankTrack criticises the Equator Principles as not being as stringent in their approach as the principles of the Collevecchio Declaration or the policies of the IFC and is concerned that the Equator Principles are weak on social issues. By way of contrast, the WWF criticises the emphasis of the Equator Principles on social considerations that it believes detracts from environmental considerations which are more important.

Voluntary nature
The Equator Principles are general, voluntary guidelines. In order to reduce unnecessary or unjustifiable inconsistencies in interpretation and implementation that have inevitably developed among the Equator Banks, it is suggested by a number of participants that the Equator Banks agree and articulate more detailed guidelines. The defence of the Equator Banks to charges of inconsistent application of the Equator Principles is that they do not act collectively but are only a very loose alliance of individual banks. Even if this is true at present, it is expected that the Equator Banks will come under increasing pressure from NGOs and other stakeholders to harmonise their application of the Equator Principles in the medium-term or long run. However, as made clear by Reed Huppman of Environmental Resources Management, it would be impossible to create guidelines that would entirely eradicate disagreement over conflicting views or alliances.

Early involvement
There are important limitations on the ability of an Equator Bank (even when it is the arranging bank) to influence a project, because of the tendency of sponsors to involve banks at quite a late stage of the

development of a project (although this does not apply to financial advisory mandates which are awarded much earlier in the life of a project). This perceived lack of power or influence (traction) of the Equator Banks is especially evident in multi-staged projects, where the earlier phases have already been completed without any assessment under the Equator Principles having been undertaken, but where a later stage or stages are subject to such assessment. In such circumstances, the Equator Banks must refuse to either fund the later stages of the project or adapt the Equator Principles by accepting the partly completed project as the baseline from which impacts are to be measured.

In most circumstances, a pragmatic solution is preferred to rigid application of the Equator Principles, because it would be implausible to expect a major project for which a number of stages have already been completed to simply be abandoned. Nonetheless, there is a need to be careful with the idea of working from a ‘new baseline’ for multi-stage projects. Reputational risk will follow a project from all stages (and will often accumulate over time) to include subsequent lenders. A bad project is a bad project and sometimes cannot be fixed. Further, a part-finished project is unlikely to simply be abandoned; it is more likely that another bank would step in and accept lower environmental and/or management standards.

Fear of damage to reputation may also lead to Equator Banks declining financial advisory mandates for non-compliant projects even where they do not seek a funding role subsequently.

Lack of awareness

Despite the best efforts of a large number of the Equator Banks to raise staff awareness and to provide training, general awareness among bankers of the Equator Principles remains low. Remarkably, some of the most profound examples of ignorance of the Equator Principles were found among leading project finance lawyers and some banks. There is even some evidence that project sponsors are not aware of the additional requirements imposed by Equator Principles on projects and/or that they are not informed of such requirements until late in lifecycles of projects.

Circumvention

The Equator Principles can be circumvented easily. For example, a powerful sponsor may decide to self-finance a project vehicle using shareholder funds, re-financing using limited recourse debt once the project is completed or in operation. Equally, a sponsor may seek (or a bank may offer to arrange) alternative sources of funds, such as a project bond or similar capital markets product, or an alternative form of bank financing, such as a straightforward corporate loan to the project company guaranteed by the sponsor. Circumstantial evidence suggests that some sponsors and some banks discuss attempts to bypass the Equator Principles but that, with a few notable exceptions, neither circumvent the Equator Principles very often.

Sinner or saint

Some NGOs and other stakeholders originally formed a negative perception of the Equator Banks. These stakeholders viewed the 'lobbying' of the World Bank Group by Equator Banks, the general resistance of a number of influential Equator Banks to the recommendations of the World Bank Extractive Industries Review and the doubts expressed by the Equator Banks about the IFC review of its Safeguard Policies as demonstrating that the Equator Principles are in reality a device to limit or prevent positive change, rather than a force for good. However, attitudes may have changed. BankTrack, for example, sees the Equator Banks more as an ally than an opponent in trying to get a set of clear performance standards and believes that its co-operation with the Equator Banks on commenting to the IFC was very useful.

Equally, some NGOs originally expressed concern that the Equator Principles would be a brake on the development of best sector policies[9]. That fear does not appear to have been justified with the Equator Banks producing sector policies by the armful. Equator Banks, on the other hand, see a certain irony in the focus by stakeholders on their activities, to the exclusion of the activities of those banks that have a poor social and environmental record and have not adopted the Equator Principles or even an 'Equator-Lite' approach to lending decision-making.

Funding

It has been suggested that it is becoming more difficult to fund Category A projects[10], as few Equator Banks are willing to risk being criticised for funding such projects, however important those Category A projects may be. We believe that suggestion to be unfounded, but that there is some truth in the view that Equator Banks are thinking longer and harder before giving financial support to headline projects, such as Sakhalin II.

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9 Examples of current best sector policies would be ABN AMRO forestry policy, HSBC climate change and forestry policies and the wide range of social and environmental policies adopted by Citigroup.

10 Category A projects are high environment and social risk projects.

Recommendations

Introduction to recommendations

Some of our recommendations go beyond simply ‘good housekeeping’ and ‘best industry practice’ and as such may be considered aspirational. However, we believe that it is important for us to indicate where Equator Banks should look beyond current practice and where there is a need to strive for higher and better standards in the future.

Good housekeeping and best industry practice recommendations

Consolidation and specialisation

Equator Banks should continue to work together to consolidate their approach to the Equator Principles and to achieve best practice in implementing the Equator Principles. In addition, specialists within the Equator Banks ought to extend their collaboration with specialists in other institutions (such as other Equator Banks, ECAs, multilateral lending agencies (MLAs) such as the EBRD and similar regional development banks and other public bodies), whether or not involved in the same transaction. This would help share workload and experience and lead quickly to a common understanding of the Equator Principles and the associated IFC Safeguard Policies.

Expansion

Whereas we acknowledge the danger of ‘free riders’ bringing the Equator Principles into disrepute, this risk must be balanced against the need to encourage the adoption of the Equator Principles by as many financial institutions as possible. We do not therefore consider that the Equator Banks should abandon their policy of open membership at this stage. We have no doubt, however, that membership criteria will be adopted at a later stage after a critical mass of Equator Banks has been achieved in order to ensure that the Equator Principles are accepted as the industry standard for social and environmental assessment.

ECAs and MLAs

Use should be made of the expertise and experience of the ECAs and MLAs on social and environmental issues who should be encouraged to share such expertise and experience with the wider financial community. ECAs and MLAs should consider following the example of the Danish ECA, EKF, and sign up to the Equator Principles. This will help the Equator Principles to become a truly international social and environmental standard, which, in turn, it is hoped, would promote wider social and environmental responsibility.

Raising awareness and training

Equator Banks should learn from the best practices of mature sponsors, such as BP, Shell and BHP Billiton, particularly regarding stakeholder dialogue and communication and, where appropriate, setting up independent panels of experts to advise on policy and procedural matters. Equator Banks should develop greater internal awareness of the Equator Principles through awareness raising strategies and training programmes for their staff, and the professionals with whom they work, relating to the application, interpretation and implementation of the Equator Principles. To this end, the Equator Banks need to continue to roll out their initial training for new or reassigned staff and offer ongoing refresher and advanced courses as appropriate, including the use of online training based on case studies.

Sharing knowledge
Within the limits imposed by client confidentiality, Equator Banks should continue to develop the existing practice of sharing precedents, knowhow systems and materials.

Working group
A working group should be established, comprising a number of leading Equator Banks, project sponsors and professional advisers, to review policy, produce a best practice manual and to share knowhow. There will be some initial resistance to this, as it undermines the independent choice of each Equator Bank on how to implement the Equator Principles, but it will contribute towards a uniform application of the Equator Principles and should be done.

Dialogue with sponsors
Arranging banks and banks acting as financial advisers should enter into dialogue with sponsors on Equator Principles issues as early as possible in the project cycle, in particular where syndication to other banks is likely. It may be that even more radical solutions need to be developed in order to inform project sponsors about the implications of the Equator Principles and how to effectively implement them.

Dialogue with stakeholders
Equator Banks should continue to develop dialogue with NGOs and other stakeholders and sponsors by meeting them on a regular basis to discuss general issues and specific concerns relating to the Equator Principles and their implementation. There is also a need to proactively identify relevant stakeholders as soon as possible in the project finance cycle to identify any potential problems with projects.

Education of stakeholders
Equator Banks should not assume that stakeholders understand perfectly the nature of their business. Equator Banks therefore should explain to stakeholders (in particular NGOs) key matters, such as:

- the nature of limited recourse project financing;
- the use of special purpose vehicles as borrowers;
- the requirement of sponsors to achieve off-balance sheet treatment of the project financing;
- the relationship between the arranging banks, the sponsors and the syndicate banks;
- the mechanics of syndication; and
- the process of enforcement of loan covenants,

by publishing guidance on these matters on the Equator Principles and Equator Banks' websites.

General disclosure
Consideration should be given to disclosing, subject to client confidentiality, in the annual Corporate and Social Responsibility (CSR) reports of the Equator Banks:

- the number of Equator Principles projects actively considered in the course of the year (as financial adviser, lead arranger and as a lending bank);
- the number of projects considered in each sector;
- the number of projects considered in each category;
- the number of applications accepted by lenders (whether modified or not as a result of the application of the Equator Principles) and rejected; and
- the occasions on which, and reasons why, the bank had chosen to deviate from strict application of the IFC Safeguard Policies[11].

Equator Banks have much to gain and little to lose from such general disclosure. In addition, Equator Principles requirements for Category A projects could include a sponsor public consultation and disclosure plan.

[11] Simon Cramer of the Co-operative Insurance Society is working with NGOs and the Equator Banks on the appropriate limits for disclosure.

EMP disclosure
Equator Banks should consider disclosing Environmental Management Plans (EMPs) on their websites for a minimum period and insisting project sponsors do likewise.

Transparency
The Equator Banks should encourage sponsors to be as transparent as practicable about their projects, particularly with EMPs, and should encourage sponsors to meet with NGOs and other stakeholders.

Public consultation
Equator Banks should treat public consultation requirements more comprehensively, including their use as a planning and management tool.

Environment Bank
An Equator Bank ought to be appointed as the bank responsible for environmental and social compliance during both the construction and operational phases of a project. The IFC is also able to take on this role. The role of this lead Technical Bank or Environment Bank should rarely (if ever) be delegated by participating Equator Banks to a non-Equator Bank as it appears strange that Equator Banks would entrust compliance with the Equator Principles to a bank which has not adopted them and by implication will not have detailed knowledge of the Equator Principles.

Experience
Wherever possible, the lead Technical Bank or Environment Bank should have prior experience of funding projects of the type in question and, as time passes, of the application of the Equator Principles to such projects.

External advisers
Equator Banks should follow the example of Japan Bank for International Co-operation (JBIC) and appoint external advisers to review the rules, policy and procedures that underpin the Equator Principles. Such advisers should be familiar with the Equator Principles and should be given consistent guidance on good practice and minimum standards for consultants in terms of disclosure and consultation. The Equator Banks' consultants should be independent of any consultants working for the project sponsor, have proven track records and knowledge of environment and social issues.

Internal screening
Equator Banks should rely on their own screening process and the advice of their own legal and technical experts to assess the appropriate category of an Equator Principles project rather than relying only, or to a larger degree than is appropriate, upon a categorisation adopted by sponsors or others.

Auditing
The Equator Banks should internally audit compliance with the Equator Principles but should also bring in external consultants to independently audit a sample of Equator Principles projects to identify any shortcomings in, or possible improvements necessary for the implementation of, the Equator Principles.

Consistent implementation
In consultation with stakeholders (including NGOs) and sponsors, the Equator Banks should work towards consistent implementation of the Equator Principles by, where appropriate, developing consensus on the interpretation of the Equator Principles and on the exercise of any discretion open to the Equator Banks in implementing the Equator Principles.

Categorisation
Equator Banks should adopt a precautionary or conservative approach to categorising a project with its sponsors and the legal, financial and technical advisers of its sponsors. They should avoid benchmarking subjectively against the first projects they apply the Equator Principles to or alternatively against vastly complex and difficult projects, such as the Baku-Tbilisi-Ceyhan (BTC) pipeline. By doing so, they will set such low standards for Category A projects that it will be unlikely that any other projects will be so categorised. External advisers should be involved in the categorisation of projects, particularly the evaluation of social risk and impact. Though mature sponsors may have come to appreciate through experience the cost of failing to address social and environmental concerns adequately at the right time, this is unlikely to always be the case with all sponsors and even among mature sponsors, memories can be short.

Rounding up
A public lending body suggested to us that a precautionary approach should be adopted to project categorisation. Though Category A and Category C projects may be identified easily, it is suggested that Category B projects be subjected to the higher level of assessment and monitoring requirements of Category A, except in cases of Category B projects which are borderline Category C projects. Where there is any doubt as to which category an Equator Principles project falls, Equator Banks should apply a presumption that the project falls into the higher or more onerous of the two categories. We have adopted this recommendation.

Staged projects
Equator Banks should develop a consistent approach for applying the Equator Principles to staged projects.

$50m threshold
Consideration should be given to lowering or abolishing the $50m threshold.

Best practice guidelines
Best practice guidelines should be developed with a view to providing a model for how project managers should address the Equator Principles as part of the project life cycle.

Technical recommendations

Environmental and social due diligence
As part of their due diligence prior to funding, Equator Banks, acting on the advice of their *own* technical advisers, need to satisfy themselves as to:

- the adequacy (both as to the scope, findings, degree of public consultation and recommendations as well as the methodology adopted) of all material social and environmental reports produced or commissioned by the borrower, the sponsors or any relevant third party in relation to the project;
- that all such reports have been disclosed to the lenders or their technical advisers in full; and
- that the persons who prepared or reviewed such reports on behalf of the borrower were suitably qualified and experienced having regard to the location and nature of the project.

Lenders should also seek the right to interrogate the borrowers' advisers on how the requirements for implementing the Equator Principles were met. Equator Banks should agree criteria for deciding when they should commission their own environmental and social studies and consultation processes in situations where their technical advisers have identified that those commissioned by sponsors are inadequate.

Compliance
Equator Banks should require loan documentation to include:

- representations and warranties regarding disclosure of available environmental information and reports; adequacy of the methodology adopted in preparing environmental assessments and other such reports (including, where applicable, the required degree of public consultation); compliance with stipulated national, transnational and international environmental and social protection laws and treaties (not necessarily limited to those of the jurisdiction of the project); and the agreed environmental and social guidelines and policies applicable to the project (these could be the IFC Safeguard Policies and World Bank and IFC Specific Guidelines that underpin the Equator Principles) as of the date of the agreement (and repetition of the representations and warranties). The accuracy of these representations and warranties will be conditions precedent to initial and subsequent draw downs under the facility;

- covenants to observe and comply with environmental laws and the environmental and social guidelines and policies applicable as of the date of the agreement in all material respects; as well as
- periodic reporting obligations based on the requirements of the applicable environmental management plan (EMP) or similar document.

The documentation should include a separate event of default for breach of these social protection or environmental obligations, possibly without further materiality qualifications, and with rectification periods sufficient to demonstrate the requirement of the Equator Principles that the Equator Banks have engaged with the borrower to encourage compliance.

Standard terms and conditions
Equator Banks should agree standard terms and conditions with consultants and other professional advisers acting for them. These standard terms and conditions should cover the duration of liability of the consultant to the Equator Banks; professional indemnity insurance; duty of care to other lenders and future lenders who will rely on their reports in deciding to participate in the loan; collateral warranties; and assignment of interests. There may be a need for a number of standard form contracts for different types of projects and differences in value of projects.

Appointment of consultants
In order to ensure the required degree of independence and credibility of the environmental and social consultants and their work, it would be preferable if the Equator Banks' legal representatives were closely involved in the process of engagement, including the preparation of the scope of services to be provided and the reporting process. This is because it is often necessary to test the assumptions, methodology and findings of consultants forensically so that sponsors can prepare projects that enable them to withstand potentially hostile cross-examination in a court, administrative tribunal or public inquiry.

Information handling procedures
Equator Banks should review information handling procedures to ensure that reports from borrowers required by an EMP are reviewed adequately on a periodic basis at an appropriate level within the bank.

Control over environmental provisions
Equator Banks should (where applicable) review intercreditor arrangements to ensure that they have: an appropriate degree of negative control over any proposed amendments to or waiver of, the environmental provisions of the loan documentation; and, possibly through the step-down process, ultimately positive control over the enforcement of social and environmental covenants and declaration of environmental events of default if a majority of non-Equator Banks is reluctant to enforce the lenders' rights.

Documentary mismatches
Equator Banks should review loan documentation to ensure that there is no mismatch between the requirements to report on environmental issues under an EMP, any equivalent covenant under the loan agreement and/or the ability of the Equator Banks to take action against the borrower to rectify any breach.

Preserving the power to act
Equator Banks should review loan documentation to avoid being put in a position of receiving information about environmental issues but being powerless to act under the loan agreement in order to ensure rectification (to minimise the bank's potential liability for environmental breaches of which they had knowledge).

Client confidential information
Equator Banks should review the legal liability of the bank and its officers for disclosure of client confidential information and the extent that this can be relaxed through exceptions to confidentiality undertakings.

Disclosure to regulators
Equator Banks should review the legal liability of the bank and its officers for non-disclosure of social and environmental information to regulatory agencies.

Constructive liability
Equator Banks should review the potential for legal liability of the bank and its officers where failure to take enforcement action as provided for in the loan documentation for known pollution or the likelihood of pollution occurring, results in pollution occurring or continuing.

Independent panels
Equator Banks should consider encouraging sponsors to appoint independent panels to assess and monitor projects, having regard to the scale, complexity and/or impact of the project.

Composition of independent panels
Equator Banks should consider encouraging sponsors to appoint leading experts in the field that any independent panels are to address and, where it is possible to do so, members of the community affected by the project and local NGO members.

Dealing with negative allegations
Equator Banks should consider the development of an independent commission that would investigate alleged breaches of human rights, environmental standards and press complaints relating to projects. In addition, Equator Banks should put robust PR departments in place that understand the nature and implications of project finance transactions and which are equipped to fully investigate and explain relevant issues or, if relevant, refute accusations[12].

Security, human rights and anti-corruption and bribery protocols
Where appropriate, Equator Banks should suggest to sponsors that they follow the best practice of leading sponsors, such as BP, in entering into agreements to regulate and enforce security and human rights and to provide for transparency in respect of the payment of money to governments, agents and other third parties.

Ombudsman
There is a need for an ombudsman to provide redress and to enable third parties to complain when the Equator Principles are breached. The ombudsman should also promote transparency and accountability.

12 Additional guidance on dealing with reputational risk is included at Annex IV.

Chronological evolution of the Equator Principles

The Equator Principles can be seen as the response of financial institutions to internal and external pressures to live up to the CSR values that they espouse. External pressure – applied by stakeholders, governments and governmental agencies, MLAs, socially responsible investment funds, international advocacy groups and NGOs – has included encouraging banks or financial institutions to accept responsibility for assessing and monitoring the environmental and social impact of financing major projects. Internally, pressure exerted at board level by senior members of banks, such as chairmen and chief executives, has been of great importance.

The processes described above may have resulted in major changes for the Equator Banks, but pressure has not all been in one direction. It is equally clear that some of the NGOs have sought to better understand the technical drivers behind commercial bank and capital markets decision-making. This is no bad thing, as it is more effective for NGOs to pursue achievable objectives from a sound base of knowledge, even if this entails some ideological sacrifices.

However, to understand the Equator Principles, and the response of NGOs and others to them, it is necessary to understand their historical development. In trying to describe our understanding of the key development phases of the Equator Principles, we may have inadvertently omitted some meetings or discussions because we were not part of the process and depended on information from a number of sources. In October 2002, ABN AMRO and the IFC convened a London meeting of nine commercial banks to discuss 'environmental and social issues in project finance'[13]. ABN AMRO, Barclays, WestLB and the IFC presented case studies on past projects which had attracted controversy because of environmental or social issues, after which Citigroup proposed that the banks try to develop a framework to deal with these issues. ABN AMRO, Barclays, Citigroup and WestLB agreed to form a task force to draft a framework for consideration by other banks.

In subsequent meetings conducted by telephone, the four banks decided to produce a set of guidelines on environmental and social risks in project financing to be based on IFC policies, most notably the IFC's Safeguard Policies.

These four 'founder' Equator Banks assumed the burden of drafting what was later to become the Equator Principles. Christopher Beale (Global Head of Project and Structured Trade Finance, Citigroup) and Richard Burrett (Head of Sustainable Development Business Group, ABN AMRO) are described as key players in the creation of the Equator Principles. It

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13 *Environmental & social leadership through the Equator Principles*, IFC.

would be wrong, however, not to acknowledge the huge contribution to the development of the Equator Principles made by Chris Bray (Head of Environmental Risk Policy Management, Barclays) and Foster Deibert (Head of Sustainability Management, WestLB).

By way of background information, note that in January 2003, the NGO-sponsored Collevecchio Declaration on Financial Institutions and Sustainability outlined six principles to which the NGOs wished financial institutions to commit.

Six principles of the Collevecchio Declaration

- sustainability;
- 'do no harm';
- responsibility;
- accountability;
- transparency; and
- sustainable markets and governance.

Ten major banks adopted the Equator Principles in June 2003. These included the four 'founding fathers' plus Calyon, Credit Suisse First Boston, HVB Group, Rabobank, Royal Bank of Scotland and Westpac.

Other meetings were held afterwards, including two more key Equator Bank meetings that took place in 2004. The first was held on 1 July 2004, when 16 of the institutions that had adopted the Equator Principles met with representatives of 13 NGOs[14] in London to review the progress in the implementation of the Equator Principles and to address some of the concerns of NGOs. An additional meeting also took place in London, on 28 October 2004, when financial institutions met with project sponsors from the oil and gas, mining, metals and power industries to discuss proposed changes to the IFC policies on which the Equator Principles are based. Attending the meeting from the project sponsors' side were representatives of the International Petroleum Industry Environmental Conservation Association (IPIECA), the International Association of Oil &

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14 The NGOs represented at the meeting were WWF (UK), Berne Declaration, Campagna per la Riforma della Banca Mondiale, Friends of the Earth (UK), Friends of the Earth (US), Milieudefensie, Platform, Rainforest Action Network (RAN), Urgewald (all members of BankTrack) and in addition, The Nature Conservancy, Environmental Defense, Friends of the Earth (Japan), World Resources Institute (UK) and World Resources Institute (US).

Gas Producers (OGP), and the International Council on Mining & Metals (ICMM). The financial institutions were interested in learning industry views of the proposed IFC Performance Standards, which change the policies currently addressed by IFC Safeguard Policies[15].

By June 2005, 30 banks and one ECA had adopted the Equator Principles. Together, the Equator Banks now account for about 80 per cent of global project financing business[16].

Table 1 – Equator Banks

Australia	Westpac
Belgium	Dexia KBC KBC
Brazil	Banco Bradesco Banco do Brasil Banco Itaú Banco Itaú BBA Unibanco
Canada	CIBC Manulife Royal Bank of Canada Scotiabank
France	Calyon
Denmark	Eksport Kredit Fonden (ECA)
Germany	Dresdner Bank HVB Group WestLB
Italy	MCC
Japan	Mizuho
The Netherlands	ABN AMRO ING Rabobank
Spain	BBVA
Switzerland	Credit Suisse First Boston

15 www.equator-principles.com.

16 ‘Putting Principles into practice’, *Environmental Finance*, June 2004.

Chronological evolution of the Equator Principles (continued)

UK	Barclays HSBC Group Standard Chartered Royal Bank of Scotland
US	Bank of America Citigroup JPMorgan Chase

Other meetings are scheduled for 2005 between the Equator Banks themselves and between the Equator Banks, sponsors and NGOs.

Given the uncertainty about the outcome of the ongoing review of IFC Safeguard Policies, and the short period of time before the IFC review was intended to be completed, it appeared unlikely to us that many more banks would adopt the Equator Principles during the course of early 2005. However, this has proven not to be the case with the adoption of the Equator Principles by Scotiabank on 18 January 2005, Banco do Brasil on 3 March 2005, JPMorgan Chase on 25 April 2005 and Manulife on 11 May 2005.

The Equator Principles

By adopting the Equator Principles[17], an Equator Bank undertakes to provide loans only to projects whose sponsors can demonstrate ability and willingness to comply with comprehensive processes to ensure that the projects with a total capital cost of $50m or more are developed and operated in a socially responsible manner and according to sound environmental management practices.

The Equator Principles provide a framework for environmental and social assessment of projects, based on the IFC environmental and social screening model. Projects are categorised as Category A, B or C (high, medium or low environmental or social risk), using the criteria explained below. For all Category A and appropriate Category B projects (high and medium risk), a borrower must carry out a properly scoped environmental assessment (EA)[18], which addresses the environmental and social issues identified in the categorisation process.

The EA must demonstrate that the project complies with:

- host country laws;
- regulations and permits applicable to the project;
- World Bank and IFC Specific Guidelines;
- the IFC's Safeguard Policies; and
- IFC Pollution Prevention and Abatement Guidelines for the relevant industry sector.

For projects in 'low and middle income countries' only[19], the EA must also take into account IFC Safeguard Polices on issues such as natural habitats, indigenous peoples, involuntary resettlement, safety of dams, forestry and cultural property.

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17 The Equator Principles are reproduced in full at Annex III.

18 See Table 2 – Scope of the Equator Principles: environmental assessment.

19 The World Bank Development Indicators Database www.worldbank.org/data/countryclass/classgroups.htm.

Table 2 – scope of the Equator Principles: environmental assessment

Baseline environmental and social conditions
What local laws and any applicable international treaties require
Sustainable development and use of renewable natural resources
Protection of human health, cultural properties and biodiversity, including endangered species and sensitive ecosystems
Use of dangerous substances
Major hazards
Occupational health and safety
Fire prevention and life safety
Socio-economic impacts
Land acquisition and land use
Involuntary resettlement
Impacts on indigenous peoples and communities
Cumulative impacts of existing projects, the proposed project, and anticipated future projects
Public participation of affected parties in the design, review and implementation of the project
Consideration of environmentally and socially preferable alternatives
Efficient production, delivery and use of energy
Pollution prevention and waste minimisation, pollution controls (liquid effluents and air emissions) and solid and chemical waste management

For all Category A and appropriate Category B projects, the borrower or a third party expert must prepare an EMP, which draws on the conclusions of the EA and which addresses mitigation, monitoring of environmental and social impacts, action plans and management of risks. For all Category A projects and appropriate Category B projects, the bank must be satisfied that the borrower or a third party expert has carried out appropriate public consultation among groups affected by the project. Further, all Category A projects are subject to independent review.

The IFC Safeguard Policies

The Equator Principles are not a 'standalone' set of principles and as outlined above, incorporate other sets of standards. EAs relating to projects in 'low and middle income countries' must take account of the IFC's Safeguard Policies. The IFC's Safeguard Policies cover the following areas[20]:

- environmental assessment;
- natural habitats;
- pest management;
- forestry;
- safety of dams;
- indigenous peoples;
- involuntary resettlement;
- cultural property;
- child and forced labour; and
- international waterways.

The IFC is currently undertaking a review of these Safeguard Polices. This review has serious implications for the Equator Principles themselves. The background to the IFC review and its effect on both adoption of the Equator Principles and the scope and future success of the Equator Principles are discussed in detail below.

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[20] As of 4 June 2003 and are available at www.equatorprinciples.com.

Table 3 – project categories
Category A

Classification criteria	Environmental assessment required?	EMP required?	Consultation required?	Applicable guidelines	Additional policies (projects in low and middle income countries only)
Likely to have significant adverse environmental impacts that are sensitive, diverse, or unprecedented. A potential impact is considered 'sensitive' if it may be irreversible (eg lead to loss of a major natural habitat); or affects vulnerable groups or ethnic minorities; involve involuntary displacement or resettlement; or affect significant cultural heritage sites. These impacts may affect an area broader than the sites or facilities subject to physical works.	EA for a Category A project examines the project's potential negative and positive environmental impacts, compares them with those of feasible alternatives (including, the 'without project' situation), and recommends any measures needed to prevent, minimise, mitigate, or compensate for adverse impacts and improve environmental performance. A full EA is required which is normally an Environmental Impact Assessment (EIA).	Yes	Yes	1) World Bank Pollution Prevention and Abatement Guidelines (which include numerical targets for reducing pollution, as well as maximum emission levels achievable through cleaner production and end-of-pipe treatment); and 2) IFC Environmental, Health and Safety Guidelines for such project sectors as airports, oil and gas development, healthcare facilities etc).	IFC Safeguard Policies. There are currently 10 policies, including ones on environmental assessment, natural habitats, pest management, forestry etc.

Category B

Classification criteria	Environmental assessment required?	EMP required?	Consultation required?	Applicable guidelines	Additional policies (projects in low and middle income countries only)
Proposed project is classified as Category B if its potential adverse environmental impacts on human populations or environmentally important areas – including wetlands, forests, grasslands, and other natural habitats – are less adverse than those of Category A projects. These impacts are site-specific; few if any of them are irreversible; and in most cases mitigatory measures can be designed more readily than for Category A projects.	See Category A. The scope of EA for a Category B project may vary from project to project, but it is narrower than that of Category A EA. Like Category A EA, it examines the project's potential negative and positive environmental impacts and recommends any measures needed to prevent, minimise, mitigate, or compensate for adverse impacts and improve environmental performance.	No	No	Same as for Category A projects.	Same as for Category A projects.

Category C

Classification criteria	Environmental assessment required?	EMP required?	Consultation required?	Applicable guidelines	Additional policies (projects in low and middle income countries only)
A proposed project is classified as Category C if it is likely to have minimal or no adverse environmental impacts.	Not beyond screening	No	No	None	None

Advantages of the Equator Principles

> 'The Principles have proven more successful than anyone could have imagined.'
>
> Peter Woicke, former Executive Vice-President of the IFC and Managing Director, World Bank[21]

> '[The Equator Principles are] one of the most important things that the banking industry has done in the past couple of years.'
>
> Charles Prince, Chief Executive, Citigroup[22]

> 'The Principles are playing a critical role in developing best practice in socio-environmental impact assessment and mitigation for major international projects.'
>
> Robert Evans, Parsons Brinckerhoff [23]

As might be expected, it is not difficult to find praise for the Equator Principles from the World Bank, the IFC or the Equator Banks as, in a sense, they have ownership of the Equator Principles, having facilitated their development, drafted or adopted them. It is reasonable, however, to ask if there are any other groups who believe the Equator Principles have delivered and continue to deliver very real benefits, or whether there is an unacceptable degree of self-congratulation on the part of the owners of the Equator Principles.

It is also clear that sponsors, technical consultants and trade associations see very real advantages to the Equator Principles in creating a level playing field, developing an industry standard or bringing social and environmental issues to the fore in project assessment. However, some see the Equator Principles simply as a means of avoiding potential reputational risks or gaining green credentials that translate into a competitive advantage.

Praise from some stakeholders, including NGOs, for the Equator Principles and the Equator Banks has been cautious. There appears to be a view among (at least some) NGOs that the Equator Banks need watching, and more specifically, that their actions should be monitored very closely to

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21 *Equator Principles celebrate first anniversary*, www.equatorprinciples.com.

22 *Equator Principles celebrate first anniversary*, www.equatorprinciples.com.

23 *Business leaders' initiative on human rights report 2*: *work in progress* (London, December 2004).

ensure that the reality of the Equator Principles meets the rhetoric of the Equator Banks. BankTrack, for example, while applauding the Equator Banks' efforts to engage with social and environmental issues, adds: 'the Equator Principles are only as good as the commitment behind them'[24]. FoE states that while it is 'pleased that banks are responding to public pressure and are trying to address the environmental and social impact of their transactions', lack of accountability for implementation 'may be a fatal flaw of the Equator Principles'[25].

The Equator Principles require increased due diligence by sponsors, particularly at the front end of projects, and by the Equator Banks. This is likely to mean that projects will attract less adverse criticism from stakeholders (including local governments or sovereign states). As such, political risk of projects may be diminished, and environmental and social sustainability safeguarded. It is clear that the Equator Principles are different from anything that has gone before and even those banks that had well-developed social and environmental risk assessment processes and procedures should recognise that there is something inherently different about the holistic approach of the Equator Principles. It is in this sense that they are a 'shining beacon' in social and environmental assessment by banks.

Disadvantages of the Equator Principles

> 'We do not wish the Amazon filled with Category A pipelines. We simply want these projects to not go ahead.'
>
> Johan Frijns, Co-ordinator, BankTrack

> 'If the possible extinction of an entire whale species [by the Sakhalin II oil and gas project] falls within the range of normal risks the Equator Banks want to 'determine', 'assess' and 'manage' with the Principles, what good are such Principles then?'
>
> Campaigner quoted by BankTrack[26]

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[24] *Principles, profits or just PR – triple P investments under the Principles*, BankTrack, June 2004.

[25] *Financial Times*, 4 June 2003.

[26] *Principles, profits or just PR – triple P investments under the Principles*, BankTrack, June 2004.

> 'Unlimited investment in fossil fuels is not compatible with socially responsible lending due to the fundamentally unsustainable nature of these activities and the serious threat of climate change. Lenders should be looking to reduce their exposure and, longer term, ceasing to invest in fossil fuels entirely.'
>
> Greg Muttitt, Researcher, Platform

> 'Some of these groups [NGOs] fundamentally believe that the oil and gas industry should not exist.'
>
> Richard Burrett, ABN AMRO[27]

Some NGOs start from a very different philosophical basis to those of banks or sponsors. For the Equator Banks, the Equator Principles represent an opportunity to create better technical projects rather than barring projects altogether. However, some NGOs wish financial institutions to declare 'no-go' areas for financing projects (for example, in rain forests or countries such as Burma) and even no-go industries (oil and gas and nuclear, for example). Some NGOs also want the Equator Banks to cease to fund any 'unsustainable' development, which they would argue includes the extractive and paper and pulp industries as well as fossil fuel, hydro-energy and nuclear energy projects.

The idea of such 'no go' zones has already started to make its way into bank policy. For example, JPMorgan Chase adopted a new environmental policy that 'includes a pledge to set up one of the largest "No Go Zones", or sensitive regions where it won't finance commercial logging or underwrite projects that pose an environmental threat'[28]. Citigroup, Bank of America and HSBC have also adopted certain 'no-go' policies.

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[27] 'A matter of Principles', *Global Finance*, 1 December 2004.

[28] 'JPMorgan adopts 'green' lending policies', *The Wall Street Journal*, April 25, 2005.

NGOs' principal criticism of the Equator Principles

As illustrated by the quotes above, some NGOs consider some projects so environmentally or socially sensitive, in the sense that such harm may be irreversible, that they are not capable of being adequately addressed by the application of the Equator Principles. For example, subjecting the Sakhalin II project to the Equator Principles would not be regarded as a comprehensive success if, regardless of the rigour of assessment methodology, the project led to the extinction of the grey whale.

NGO criticism, it should be said, has focused on not only the substance and form of the Equator Principles, but also on what they see as the failure of the Equator Banks to apply them, or to apply them consistently.

Nonetheless, their main reactions to the Equator Principles, as opposed to the application by the Equator Banks of the Equator Principles, are:

- inconsistency with the Collevecchio Declaration;
- narrowness of scope;
- lack of accountability;
- looseness and opacity of guidelines;
- weakness on social issues; and
- brake on development of good practice and policies[29].

Inconsistency with the Collevecchio Declaration

NGOs see the Equator Principles as falling short of the Collevecchio Declaration objectives outlined in the chronology of the Equator Principles above. In particular NGOs complain that the Equator Principles do not refer to the Declaration's 'do no harm' principle, which they see as implying categorical prohibitions on certain kinds of projects. In addition, whereas the Collevecchio Declaration emphasises a precautionary approach, NGOs point out that the Equator Principles are concerned not with taking a precautionary approach but with mitigation of harm. The difference between these two approaches is that while a 'precautionary approach' would involve avoiding projects which create a risk of causing harm, a 'mitigation of harm' approach involves accepting, to a certain extent, that harm will be caused but developing ways in which this will be reduced and managed.

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29 www.ran.org.

Narrowness of scope of the Equator Principles

The NGO community has reservations about the scope of the Equator Principles. It is said, for example, that they ignore climate change. This view is incorrect. Certainly, there is no express mention of climate change in the text of the Equator Principles, but it is addressed in the underlying IFC Safeguard Policy[30] and in relevant sector guidelines. There are other environmental and social issues that the Equator Principles do not specifically draw to the attention of the banks.

Socially responsible fund mangers such as Kirsty Jenkinson at F&C Asset Management and Steve Waygood of Insight Investment, have identified the failure of the Equator Principles to address human rights abuses, corruption and bribery as major flaws and recommend that they should address these important matters explicitly. They both add, however, that as a starting point they regard the Equator Principles as a very worthwhile development.

The restriction of the Equator Principles to project finance is seen by NGOs as ignoring social and environmental impacts of activities funded by general corporate lending to companies in the mining and forestry sectors as well as upstream oil and gas development, where project finance is less common. NGOs also fear that some projects valued under the $50m threshold may be as harmful to society and the environment as projects of a greater value. Depending on the location of the project, there is no doubt that the NGOs are right to point to the potential disjunction between the value of a project and its social or environmental impacts.

Lack of transparency and accountability in the Equator Principles

Notwithstanding the professional requirements of banks to maintain client confidentiality and the consequent perceived secrecy of the circumstances surrounding commercial lending, some NGOs consider that there is a lack of transparency in Equator Bank decision-making, compounded by the absence of any remedy or mechanism to ensure that financial institutions actually implement the Equator Principles. While in part modelled on IFC policy, the Equator Principles do not, for example, reproduce other key IFC accountability policies and procedures, such as procedures on disclosure, as these are regarded as being inappropriate to apply to commercial banks.

Furthermore, affected communities have no recourse to the financial institutions, through, for example, a dispute resolution mechanism for third parties (such as the IFC Compliance Advisor/Ombudsman [31]) in cases

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30 OP 4.01, footnote 4.

31 The office of IFC Compliance Advisor Ombudsman has as its objective 'to provide an accessible and effective mechanism for handling complaints

where standards are allegedly not being met or implemented. As loan documentation places responsibility for this on the borrower, it is arguable that the NGOs are shooting at the wrong target. However, setting up such a mechanism could be a requirement imposed by loan documentation.

Looseness and opacity of the drafting of the Equator Principles

> 'The loopholes are wide open enough for bulldozers to move through.'
>
> Illyse Hogue, Global Finance Campaign Director, Rainforest Action Network[32]

The Equator Principles are not legal rules that require compliance. They are assessment criteria that address a project's overall compliance with (or justified deviations from) the IFC Safeguard Policies and the referenced Guidelines[33]. They use language like 'reasonable minimum period', which some NGOs argue is vague, and could lead to poor implementation. Again, there is a mismatch between the functions of the Equator Principles as tools of assessment and some of the criticisms levelled at them by some of the NGOs. The Equator Principles are a framework of principles agreed between the Equator Banks on the back of which each Equator Bank develops its own policies and procedures.

Weak on social issues

Our survey indicated that the current Equator Principles provide particularly weak guidance on social impact assessment. Primarily social impact consultants raised this concern. It is hoped that social assessment is an area in which the IFC review will provide particularly helpful additional guidance.

Brake on development of good practice and policies

Notwithstanding the rapid growth of sector policies by leading Equator Banks, such as ABN AMRO, Barclays and Citigroup and the late flowering of JPMorgan Chase as a champion of environmental enlightenment, some NGOs fear that the Equator Principles will have a limiting effect, preventing or delaying the adoption of best practice standards for individual

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from persons who are affected (or are likely to be affected) by the social and environmental impacts of IFC […] sponsored projects'. Any individual or community directly impacted by an IFC project or likely to be affected by it can complain – www.cao-ombudsman.org.

32 *The Wall Street Journal*, 4 June 2003, www.equator-principles.com.

33 Although, as has been mentioned above, for low/middle income countries, IFC Safeguard Policies must be taken into account when carrying out the environmental assessment.

sectors[34]. BankTrack sees the Equator Principles as the 'floor' and would oppose them being used as a 'ceiling' for development of social and environmental standards, but it has already been proved to BankTrack's satisfaction that initial concern that this would be the case is unjustified.

If the ongoing adoption of comprehensive environmental policies by a number of Equator Banks, including Citigroup, HSBC, Bank of America, ABN AMRO, Barclays, JPMorgan Chase and WestLB shows that this concern is not valid, it may nevertheless be worth considering whether the Equator Banks should take the radical step of cutting their ties to the IFC (which is not regarded by a number of NGOs who participated in the survey as being in the vanguard of enlightened social standards) and IFC Safeguard Policies, to enable them to develop more bespoke policies which better enable them to respond to the challenges that environmental and social issues raise. This would also reduce their dependence on external standards subject to changes that are out of their control.

Criticism of Equator Banks' application of the Equator Principles

NGO criticism of the application of the Equator Principles ranges far and wide but can perhaps be reduced to three main areas:

- 'greenwash';
- opposing progressive policy developments; and
- lack of accountability and transparency.

'Greenwash'

> 'We recently signed up to the Principles which govern ethical long-term lending principles. We now have to manage the consequences of that with our customers, perhaps there is some business that we would have done once that we now cannot do. Sometimes there are tough decisions to be made.'
>
> Stephen Green, Group Chief Executive, HSBC Group[35]

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34 Please see 'Beyond the Equator Principles' below. For example, the HSBC's forestry policy, the Bank of America's environmental guidelines for reduction of greenhouse gas emissions or ABN AMRO's lending policies in the oil, gas and mining sectors.

35 Stephen K. Green, *Windsor Leadership Trust: creating a business that builds a cultural and economic diversity*, 5 December 2003.

> 'Projects that, although they would have been prime candidates for rejection or major mitigation because of their negative environmental or social impact, nevertheless got funded by Equator Banks. In fact, none of the projects considered highly controversial by NGOs at the time of the adoption of the Principles were put on hold or cancelled.'
>
> BankTrack[36]

BankTrack and other NGOs focus on the failure of the Equator Banks to live up to their commitments, arguing that the Equator Banks are using the Equator Principles simply as 'greenwash'. BankTrack, for example, in its study *Principles, profits or just PR*[37], reports on banks which it regards as continuing to lend to environmentally or socially unsound projects, notwithstanding their adoption of the Equator Principles. It is accepted that there are a number of projects and project types that BankTrack, and other NGOs, oppose in principle. The BTC pipeline is a prime example of this tendency. Despite the BP consortium having published thousands of pages on a dedicated website about the project, set up advisory panels on development, implemented a human rights protocol and a transparency initiative and having had aspects of the project reviewed in detail by the IFC and some of the lenders, some NGOs still opposed this project vehemently.

NGOs also argue that financial institutions must prove that they are serious about implementing the Equator Principles by rejecting unsuitable projects, increasing staff resources and by clearly demonstrating how they apply the Equator Principles to their decision-making process. It is clear that the Equator Banks have done this and have increased staff resources and embarked on ambitious awareness raising and training with their staff. What is much less clear to Oil Change and other NGOs is the decision-making process employed by banks to accept or reject projects because of what they see as an unjustifiable reluctance on the part of the Equator Banks to be transparent about these matters.

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36 *Principles, profits or just PR – triple P investments under the Principles*, BankTrack, June 2004.

37 *Principles, profits or just PR – triple P investments under the Principles*, BankTrack, June 2004.

Opposing progressive policy developments

> 'It's outrageous that the Equator Banks are lobbying against proposals that would make emerging market investments better benefit the poor ... we and other NGOs are calling on the Equator Banks … to honour the spirit of the Principles and to publicly support the EIR[38] recommendations.'
>
> Friends of the Earth[39]

> 'The fear among civil society is that the Equator Banks will drag the IFC down.'
>
> World Resources Institute[40]

One of the great ironies for the Equator Banks is that, despite having taken the major step of adopting the Equator Principles while other banks have been content to avoid environmental and social issues, NGOs have not portrayed them as a force for good or as demonstrating good environmental stewardship. In fact, the Equator Banks are seen as opponents of social and environmental progress and as a pressure group of powerful financial institutions. This pressure group, it is said, lobbies the IFC and World Bank in order to limit or prevent positive social and environmental change[41]. This unfortunate perception of some NGOs of the Equator Banks is perhaps changing and does not reflect the view of, for example, BankTrack.

Nonetheless, according to some NGOs, the fact is that the Equator Banks are wedded to profits, rather than being enlightened and principled financial institutions seeking better ways to protect the environment and society. This is clearly demonstrated, according to the NGOs, by both the collective opposition of a number of influential Equator Banks to the Extractive Industry Review and by the approach which the Equator Banks as a whole have adopted towards the review of its IFC Safeguard Policies (although the involvement of the Equator Banks in the review contrasts with the attitude of several NGOs which have boycotted the process altogether under

[38] The Extractive Industry Review, which recommends cessation of lending on mineral and oil and gas projects.

[39] 'Equator Banks oppose strengthening World Bank environmental, social protections' – 5 April 2004; www.foe.org/new/releases.

[40] This is in respect of the opposition by Equator Banks to changes to the review of the IFC's Safeguard Policies – see below; as cited in *Environmental Finance*, 'Putting Principles into practice', June 2004.

[41] This criticism, however, is limited to projects reliant on IFC funding; clearly, the Equator Principles have far wider application and are not confined to IFC-funded projects.

the vain principle that their failure to participate in the process will somehow destroy or change its legitimacy)[42].

However, it is important not to see making profits and protecting society as well as the environment as diametrically opposed. Progress can be made by agreeing on how to balance the need to generate profits against the need to protect the environment and society.

In addition, care should be taken in attaching too much importance to opposition to the Extractive Industry Review. It should be noted that over 300 NGOs decided to boycott the IFC process for a wide range of reasons[43]. Furthermore, NGOs have different interests at stake to the Equator Banks who are adopting the policies themselves and at a later stage of the consultation period this boycott was 'called off' and NGOs submitted a long analysis of shortcomings of the IFC's proposed Performance Standards. It is difficult to know what the boycott actually achieved, as it is surely more important for the NGOs to shape and influence policy than remain out in the cold.

Lack of transparency and accountability in the application of the Equator Principles

> 'While Equator Banks, in informal conversation, continue to stress that projects indeed get rejected, they refuse to provide concrete examples, for fear of jeopardising future business opportunities with prospective clients. This makes it difficult for outside observers to judge how rigidly the Principles are being applied.'
>
> BankTrack[44]

> 'There is no way to monitor whether they're applying the Principles to projects.'
>
> Jon Sohn, Friends of the Earth, Washington[45]

One of the principal concerns of NGOs is that they are unable to monitor the performance of the Equator Banks or understand their decision-making process partly because of the relative looseness and opacity of the Equator

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42 On 11 April 2004, the Equator Banks signed a letter to the president of the World Bank Group giving their opinions on a number of issues in the review and opposing its adoption.

43 More details of this opposition can be found at www.grrr-now.org.

44 *Principles, profits or just PR – triple P investments under the Principles*, BankTrack, June 2004.

45 *Environmental Finance*, June 2004.

Principles and partly because Equator Banks will not disclose to them how and for which projects the Equator Banks make financing decisions.

Some NGOs, therefore, have called on the Equator Banks to be more transparent and to make public which projects they have considered, which projects they have rejected, and to what extent social and environmental considerations led to their decision. The Equator Banks have so far (with the notable exception of the Baku-Tbilisi-Ceyhan (BTC) pipeline[46], where a number of the Equator Banks that participated in the financing could rely on the disclosure procedures adopted by the IFC and participating public bodies) resisted this call. In doing so, the Equator Banks cited their absolute duty to protect client confidentiality (since such disclosure would not fall within permissible exceptions under, for example, the *Tournier*[47] principles in English law) but also questioned whether it is for banks rather than project sponsors to make public disclosure about projects.

The Equator Banks also express doubts as to whether the NGOs are asking the right questions in relation to disclosure. However, this argument may be circular, as the NGOs may argue that without more information, they do not necessarily know what questions they should be asking. Further, projects may be rejected or not be supported for many reasons other than unacceptable social and environmental impacts and this, the Equator Banks consider, simply undermines the simple question posed by NGOs.

Nevertheless, BankTrack argues that banks should go further than just providing information about projects. They should be transparent about all other management systems they may have adopted to ensure Equator Principles implementation. For example, in its report *No U Turn*[48], it questions whether the Equator Banks have developed mechanisms for assessing the ability of their consultants to handle social issues.

In the eyes of some NGOs such as Oil Change, closely interlinked with this perceived lack of transparency is a lack of accountability to stakeholders. NGOs would like the Equator Banks to set up mechanisms for the redress of individual grievances, perhaps of a similar nature to the procedure for complaints to the IFC Compliance Advisor/Ombudsman whose mandate

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46 For examples of bank reports on their involvement in the BTC project, please see ABN AMRO's Sustainability Report 2003 and Citigroup Citizenship Report 2003.

47 *Tournier v National Provincial and Union Bank of England* [1924] 1KB 461 (CA 1923).

48 www.banktrack.org/fileadmin/user_upload/documents/E_Publications_and_Reports/BankTrack_publications/No_U_turn_allowed.pdf.

covers IFC and Multilateral Investment Guarantee Agency (MIGA), but not the World Bank[49].

BankTrack study

Some projects and banks were subject to scrutiny in the BankTrack report, *Principles, profits or just PR*. These projects with supporting banks are set out in Table 4.

Table 4 – BankTrack list of projects considered 'unacceptable'

Project	Banks
BTC pipeline	ABN AMRO, Citigroup, Mizuho, Société Générale, Banca Intesa, Dexia, HVB, ING, KBC, Royal Bank of Scotland and WestLB
Kárahnjúkar Hydroelectric Project in Iceland	Barclays
Kainantu Gold Project in Papua New Guinea	ABN AMRO
Lukoil D6 Oil Project in the Baltic Sea [50]	ABN AMRO, Citigroup, Calyon, Dresdner Bank, Barclays, KBC, HVB, Dexia
Maggi soybean farming expansion in Brazil	Rabobank, Crédit Suisse, HSBC, ING Bank, WestLB
Mindanao power plant in the Philippines	HVB and Dresdner Bank
Trans Thai-Malaysia pipeline in Thailand	Barclays, Calyon, Dresdner Bank, HSBC, ING Bank, KBC Bank, Mizuho Corporate Bank, Standard Chartered
Transredes network expansion in Bolivia	ABN AMRO and BBVA

Often NGO criticism is focused on banks with significant retail practices such as RBS, HBOS, Barclays and Citigroup whose customers can be persuaded to cut up credit cards, boycott branches or close accounts and so put pressure on the banks[51]. However, BankTrack points out that the criteria for selection was whether they were in touch with local NGOs that waged campaigns on these projects, so that highlighting them would help their cause further. Furthermore, they stated that the 'retail' argument played no role in the report but might be a strategic consideration when planning campaigns.

49 BankTrack proposes the introduction of an Independent Accountability Mechanism, not only to include an Ombudsman, but also to oversee other governance issues such as collecting annual Equator Principles disclosure and identifying weaknesses.

50 We understand that this project has not been funded by any banks.

51 For a discussion of NGO campaigns targeting retail banks, please see the section on Stakeholder and NGO Activism.

Issues and methodology

We undertook part 1 of our survey to explore the reality behind the rhetoric of the Equator Banks and the NGOs and to try to gauge the real impact of the Equator Principles on the financial sector. We did this because of significant differences of opinion about the impact and benefits of the Equator Principles between NGOs and stakeholders on the one hand and the Equator Banks and sponsors on the other, together with a need to respond to a growing demand from our own clients for advice on the Equator Principles.

Methodology

Part 1 of our survey mainly focused on:

- the Equator Banks; and
- non-Equator Banks that have leading project finance practices.

Part 2 of our survey will focus on the role of:

- project sponsors; and
- professional consultants.

To get a more balanced picture for part 1 of our survey, we also sought the views of other interested parties, and not just banks, including sponsors, NGOs, engineering and environmental consultants, public bodies, rating agencies, socially responsible funds, law firms, accountancy firms, multilateral and bilateral lending agencies and trade and industry associations.

Sets of different open-ended questionnaires were prepared for Equator Banks, non-Equator Banks, sponsors, consultants and other groups to reflect the different interests in and emphasis placed by each group on the various aspects of the Equator Principles, as well as to enable each group to put forward its own concerns about implementation[52]. We sent out over 80 questionnaires.

Responses to questionnaires were, in a number of cases, supplemented by structured face-to-face or telephone interviews where we considered that this would be useful, based on the information provided by respondents in the questionnaires or if the participant preferred to respond by way of interview rather than completing the questionnaire. In some cases, where there remained points to be clarified, follow-up interviews were held with participants.

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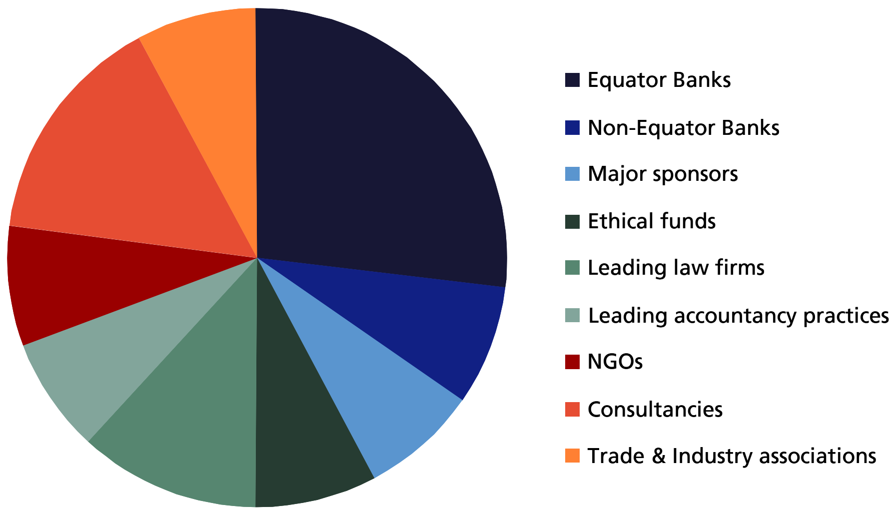
[52] A copy of our Equator Bank questionnaire is included at Annex V.

Over 40 interviews were held in person or by telephone. Individuals interviewed included senior bankers and officials in Equator Banks and non-Equator Banks and senior officers in public bodies and rating agencies, together with prominent NGO officials, technical consultants, accountants and lawyers.

Figure 1 – survey interviewees



As would be expected, the largest groups of respondents and interviewees were the Equator Banks with roughly equal representation from the eight remaining groups of respondents and interviewees. In some cases, however, a respondent would speak in a representative capacity: for example, BankTrack responded on behalf of a number of NGOs. Other participants responded in a personal capacity rather than as a representative of their trade, political organisation or law firm.

All participants who took part in the survey were promised anonymity. Participants and contributors identified or quoted in this report have given their permission to be named or quoted in the report. Not all participants wished to be identified in the report so the full extent of those participating in the survey cannot be described. While it is not possible, therefore, to show the full extent of consultation, we are satisfied that the contributors and participants comprised a representative sample of leading players with hands-on experience of the impact of the Equator Principles.

The survey however, has practical limitations:

- the Equator Principles are relatively new, having been in effect for just over two years; and

- during that period, project finance market, particularly in emerging markets has been 'in the doldrums', as one of the project finance bankers interviewed confessed. Opportunities for testing the effectiveness of the Equator Principles have therefore been limited by a relatively low volume of Equator Principles transactions.

Not all banks have had the same level of experience of implementing the Equator Principles. Therefore it is important, in the context of the survey, to appreciate that the market profile and practices of leading banks in terms of value, volume and types of project supported, have differed widely over time.

As can be seen from table 5 below[53], while just over half of the top-tier project finance banks have adopted the Equator Principles, there are a number of notable absences – including many of the Japanese banks and the two leading French project finance banks, BNP Paribas and Société Générale. With about half the number of the leading project finance banks not having adopted the Equator Principles, it appears that the need to protect market share cannot wholly explain why banks adopt or decline to adopt them.

Table 5 also highlights wide disparities in the value of transactions closed by the Equator Banks. Thus, while Citigroup invested nearly $5bn in projects in the year 2004 (thus securing for itself a leading position among the Equator Banks), ABN AMRO's share of the project finance market, although large, was less, just in excess of $2.6bn. However, it must be said that ABN AMRO is recognised as a market leader in financing successfully complex and difficult projects in developing countries, particularly in South America.

Equally, significant disparities in volume appear in the wider community of project finance banks. For example, whereas project financing by BNP Paribas was in excess of $5bn in the year 2004, Brazilian Equator Banks (Banco Bradesco or Banco Itaú) do not even make it to the top of the table for Latin American regional project finance arrangers, let alone the international leagues[54]. Clearly, therefore, the experience of Equator Banks in implementing the Equator Principles is not the same in breadth or depth.

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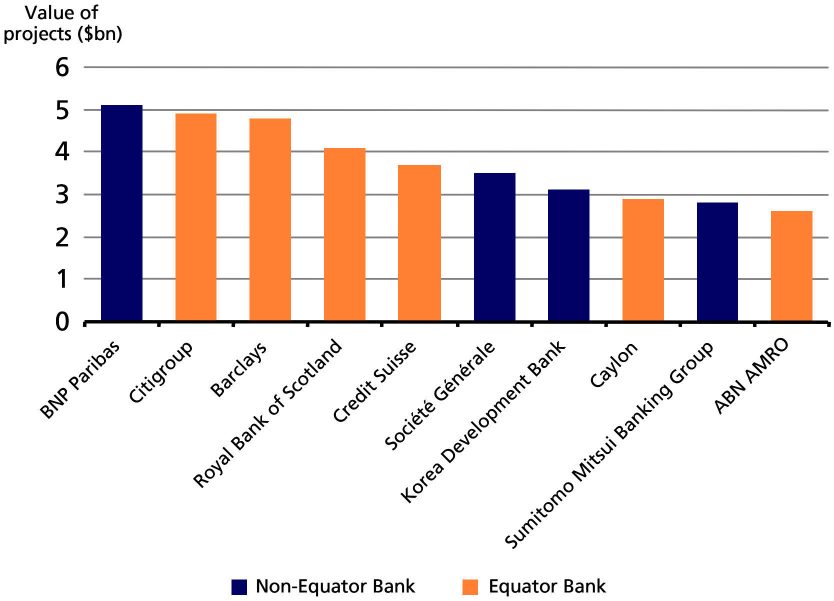
53 *Dealogic*, Global Mandated Arrangers League Table 2004 (deals signed and closed).

54 *Dealogic*, Global Mandated Arrangers, November 2004.

Table 5 – top 10 project finance banks 2004



With a few notable exceptions, it has been possible to obtain adequate information from the banks and other parties on the implementation of the Equator Principles. However, constraints of time and the sensitivity of sponsors to discussing their projects prevented us from obtaining a detailed insight into what leading sponsors think about the Equator Principles and their impact on the sponsors' businesses. We intend to address this omission in part 2 of our Equator Principles survey.

Finally, the objectives of the survey can be summarised as follows:

- to examine claims and counterclaims made by supporters and critics of the Equator Principles;
- to provide an objective assessment of what is happening on the ground;
- to assess what is best industry practice;
- to suggest where improvements might be achieved; and
- to equip ourselves to advise our clients fully on the Equator Principles.

We examined some of the key issues about the Equator Principles and Equator Banks raised by interviewees or that emerged during our survey:

- reasons given by some banks for adopting the Equator Principles;

- reasons why some banks have chosen not to adopt the Equator Principles;
- scope of the Equator Principles;
- awareness of the Equator Principles;
- assessment of Equator Principles projects;
- transparency and accountability of the Equator Banks; and
- loan documentation for Equator Principles projects.

Reasons for adopting the Equator Principles

The main reasons advanced by Equator Banks for adopting the Equator Principles were:

- reputation;
- business as usual;
- high-level commitment;
- stakeholder and NGO activism;
- protection of market share;
- level playing field;
- industry standard;
- virtuous circle;
- sustainable development; and
- financial risk rating.

Not all of these reasons were accorded equal importance by each Equator Bank and for some Equator Banks there was, clearly, a combination of reasons for adopting the Equator Principles.

Many other reasons given by the Equator Banks that do not appear on the list of key reasons given for adopting the Equator Principles above could be cited as well, including:

- business ethics;
- corporate governance;
- international norms;
- need for greater transparency;
- accountability to stakeholders;
- credit risk;
- access to cheaper funds;
- desire to address social and environmental issues in a more robust way; and
- reduction of political risk to projects.

We have focused only on the reasons most frequently quoted by the Equator Banks as having motivated their adoption of the Equator Principles. In any case, there will be some degree of overlap, for example, between good business ethics and protection of the reputation of the bank.

Whatever the reasons given, it is important to recognise from the outset the nature of the 'club' the Equator Banks have joined. The vanguard of Equator Banks (ABN AMRO, Barclays, Citigroup and WestLB) did not want to create an elite of banks or an exclusive club, but wanted to attract 'as broad a church as possible'[55]. Rather than setting a high barrier for entry and making sure that only banks (such as the founding four Equator Banks and other international banks such as HSBC) that are able to achieve the highest standards of social and environmental responsibility are admitted, they opted for a policy of actively encouraging participation by banks with less developed social and environmental policies and procedures.

Thus, for the vanguard Equator Banks, the complaints of NGOs that some of the Equator Banks are not setting themselves the highest desirable standards in terms of fully developed social and environmental assessment are misplaced. By allowing banks to adopt the Equator Principles with the view to 'catching up' with the vanguard later, it was thought that the speed of development would be increased significantly. The idea that banks which fund relatively few projects are somehow 'lightweight' or have adopted the Equator Principles merely for PR reasons is regarded by some Equator Banks as risible and based on a misconception on the part of the NGOs as to the objectives of the Equator Principles. Whether the Equator Banks will be able to or should develop the Equator Principles without imposing minimum membership requirements and rules of membership, or whether the Equator Principles will be tainted by free riders (Equator Banks who do not contribute to the development of the Equator Principles but who take credit for them) are questions that continue to be raised by NGOs such as BankTrack and FoE, and socially responsible funds such as Insight Investment.

Reputation

> 'Reputation, reputation, reputation! O! I have lost my reputation. I have lost the immortal part of myself, and what remains is bestial.'
>
> Othello[56]

55 Richard Burrett, Head of Sustainable Development Business Group, ABN AMRO.

56 Act II, Scene 3, 262-265.

> ‘The reputation of the Bank is linked to the reputation of its clients. No one client and no one piece of business is worth risking the reputation of the Bank.’
>
> Jon Williams, Head of Environmental Risk Management, HSBC Holdings

> ‘The turning point for us came with one large pipeline project, where as a result of pressure from a number of NGOs, we came to fully appreciate the extent to which issues relating to environmental and social aspects can affect a bank’s reputation. It was a crucial eye opening experience and we know that other banks have been similarly affected.’
>
> Foster Deibert, Head of Sustainability Management, WestLB

> ‘Over the last few years, it has become increasingly clear that environmental performance has significant implications for financial institutions. The key issues now for banks, investment funds and other financial institutions include financial, reputation and political risks associated with the environmental status and impact of their portfolios.’
>
> Silvio de Carvalho, Executive Director, Banco Itaú

During the survey, banks and sponsors returned repeatedly to the value and importance of reputation, the need to protect a good reputation and the difficulty in regaining a good reputation, if tarnished. In this context, banks used ‘reputation’ in two different senses. First, the need to protect the public image of the institution regarding internal decisions such as what projects to finance and, second, the vulnerability of the reputation of the bank to what the bank’s customers or clients do, such as what project sponsors do in areas which are out of the control of the bank. Examples of this include the targeting of CSFB over its role as lending bank to Shell in Sakhalin II, or the Equator Banks, such as RBS, over their role in providing finance to the BP consortium to construct and operate the BTC pipeline. The capacity of sponsors to adopt and implement high environmental, social and human rights standards was therefore seen as critical to the ability of the banks to protect their reputation.

Conversely, it was recognised that stains on reputation are particularly stubborn and difficult to remove. For example, discussing the long-term effect of the student boycott of Barclays over apartheid in South Africa in the 1970s and 1980s, Chris Lendrum, Group Vice-Chairman, remarked in February 2004 that ‘even today we are dogged by the perceptions about South Africa’[57]. In addition, the funding of totalitarian regimes in South America, the funding of armaments and seizure of Nazi gold held by certain Swiss banks still rightly haunt the imagination of many senior bankers.

[57] *Financial Times*, 19 February 2004.

It was also clear that financial institutions and sponsors viewed the approval of socially responsible funds such as F&C and Insight Investment as being important and inclusion in FTSE 4 Good and the Dow Jones Sustainability Index to be beneficial to their reputation. For the Equator Banks, adoption of the Equator Principles facilitates this inclusion[58].

Financial regulators, such as the SEC and FSA also recognise that it is not only high-profile cases like Enron, WorldCom and Parmalat that may endanger the reputations of commercial banks and, by implication, the financial industry. Reputations, financial regulators recognise, may be damaged notwithstanding that transactions comply with current legal, accounting or regulatory requirements[59]. The fact that the summary eviction of land owners is lawful and permitted in a developing country is not necessarily the best defence against the charge of human rights abuse which may be levelled at a bank by its retail clients. As BankTrack points out, simply doing the legal minimum can be insufficient in that sense. Some socially responsible investors call this ‘moral liability’ where a company breaches stakeholder expectations of what is expected ethical behaviour[60].

Indeed, the actions of sponsors funded by the banks that bring public criticism of their clients (and, therefore, by implication, of the bank(s)) may be actions in which the bank is not directly involved, has no power to prevent, or, if it had the required knowledge, is not in any position to prevent.

Leading banks and mature sponsors have long been conscious of the symbiotic nature of their relationship and importance of reputation to their businesses, but awareness of the importance of risk to reputation and the need to address it are only now becoming recognised by less experienced sponsors and banks; in particular, some of those operating in less developed countries.

Contrary to what some NGOs believe, fear of damage to reputation has led to certain of the Equator Banks declining, or resigning from, advisory mandates when sponsors have demonstrated an unwillingness to ensure that a project will be structured so as to be compliant with the Equator Principles, irrespective of whether the bank intended to arrange financing for the project. Nonetheless, the international planning and environmental

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58 ERM report – *Credit risk management – banking industry integrating environmental and social issues – how much and how fast?*, 2004.

59 FSA letter to chief executives of major investment banks, 27 September 2004.

60 ‘Sustainability, Changing Landscape of Liability’, 2004, www.sustainability.com.

consultancy Scott Wilson suggested that Equator Banks leave themselves open to such attacks because they do not always take sufficient measures to protect themselves or impose appropriate control measures on clients through loan covenants and monitoring requirements, including performing adequate 'on the ground' analysis of the social and environmental effect of projects.

Business as usual

'The guidelines laid down in the Principles are another important step in ensuring we *continue* to set and maintain ever higher standards.'

Johnny Cameron, Chief Executive, Corporate Banking and Financial Markets, Royal Bank of Scotland

'At Barclays we take our social and environmental responsibilities seriously. We have long been aware of the sensitivities surrounding project financing and only lend when we are satisfied that environmental impacts are being managed in accordance with stringent environmental criteria. We have been pleased to work alongside other leading banks to adopt the Principles, which gives us the opportunity to *formalise further* our commitment.'

Chris Lendrum, Vice-Chairman with responsibility for CSR, Barclays Bank[61]

'The Bank is committed to minimising the environmental and social impacts associated with its operations, and that adopting the Principles will *reinforce* the Bank's established environmental and social risk evaluation process.'

Mervyn Davies, Group Chief Executive, Standard Chartered Bank[62]

'It is *logical and natural* that Dexia, the bank for sustainable development, would enthusiastically adopt the Principles.'

Pierre Richard, Chairman and Chief Executive Officer, Dexia

'The adoption of the Principles *enhances* our *existing* environmental risk management policies and commitment to sustainable development.'

Suzanne Labarge, Vice-Chairman and Chief Risk Officer, Royal Bank of Canada

'For Westpac, the adoption of the Principles was a *natural extension to our existing environmental risk management policies and procedures*.'

ERM Report[63]

61 *CSR News*, 4 June 2004, Barclays website, www.barclays.co.uk.

62 Standard Chartered Bank, *Environmental Report for 2003*.

A large number of the Equator Banks believe that the adoption of the Equator Principles was not a radical change for them, but a continuation of 'business as usual'. These banks told us that, before adopting the Equator Principles, they already had sound internal policies and procedures on which to build.

Barclays, Lloyds TSB, Standard Chartered, Banco Itaú and ABN AMRO, among many other Equator Banks and non-Equator Banks, clearly had well-established principles, standards and policies to assess environmental risk and (to a degree) the social and environmental impacts of projects. Some (such as Barclays), however, openly acknowledged that, while they had good environmental assessment practices, they were not quite so confident about social assessment.

> 'Adopting the [Equator] Principles was seen as a logical, incremental step in the development of the existing policies and procedures which Barclays has had in place for a number of years. Nonetheless, we have had to incorporate more explicit and significant recognition of social considerations to match the IFC's more stringent guidelines on social issues, such as construction site health and safety.'
>
> Chris Bray, Head of Environmental Risk Policy Management, Barclays

The 'business as usual' approach has been criticised by NGOs, which believe that it can lead to Equator Principles being embraced as a mere PR exercise.

> 'As a test case, the BTC pipeline would seem to expose the signing of these banks to the [Equator] Principles as a public relations exercise which allows them to continue with business as usual whatever the risks to people and nature.'
>
> Jules Pecks, WWF[64]

Undoubtedly there is a paradox and perhaps even naivety about the belief that a 'business as usual' approach can accommodate the Equator Principles. The Equator Principles are meant to be different from anything that has gone before and even those banks which had well-developed social and environmental risk assessment processes and procedures should recognise that there is something inherently different about the holistic approach of the Equator Principles to what was done before. This is not to deny that there was not an element of building on existing foundations provided by the Equator Banks, but to suggest that the Equator Principles

[63] ERM Report, *Credit risk management – banking industry integrating environmental and social issues – how much and how fast?*, 2004.

[64] Green Consumer Guide.com, 6 February 2004.

require ongoing and in some cases, quite extensive, development and reinforcement by the equivalent of deep piling of those foundations.

High-level commitment

> 'This is about good business practice, it is about leadership and it is about doing the right thing. We are extremely proud to be part of this voluntary, private-sector initiative and we are confident that we will see more and more banks active in project finance adopt these principles in the coming months.'
>
> Charles Prince, Chairman and Chief Executive, Global Corporate and Investment Bank, Citigroup[65]

> 'The Principles are appropriately becoming the reference standard for financial institutions to ensure that the principles of responsible environmental stewardship and socially responsible development are embedded within our project finance activities.'
>
> Herman Mulder, Senior Executive Vice President, ABN AMRO[66]

For several Equator Banks, adopting the Equator Principles was a top-down initiative, driven by chairmen, chief executives and senior bankers.

This issue was made real to us when we were invited to make a presentation to an Equator Bank on the Equator Principles in 2004. At that training seminar, it was made clear to the very senior bankers assembled from all over the world that the Equator Bank in question had adopted the Equator Principles. It was also emphasised that the Chairman, CEO and Deputy CEO of Project and Export Finance as well as the joint heads of the Global Project Finance Practice were committed to the Equator Principles and that it would be a seriously career limiting move for anyone at that Equator Bank to fail to appreciate the importance that the bank attached to the Equator Principles.

Two other examples of commitment from the top may be cited. Sir Fred Goodwin, Chief Executive of Royal Bank of Scotland, stated in Royal Bank of Scotland's first full report on corporate responsibility in 2003[67] that he is the designated board member for the group's corporate responsibility policy and that the Directorate of Public Policy and government reports directly to him on these issues, including the Equator Principles. Similarly, Stephen Green and Sir John Bond, respectively Chief Executive and Chairman of

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65 '10 global banks endorse socially responsible "Equator Principles"', 5 June 2003, www.equator-principles.com.

66 'Principles celebrate first anniversary', 4 June 2004, www.equator-principles.com.

67 Royal Bank of Scotland, *Corporate Responsibility Report 2003*.

HSBC, have repeatedly made clear their full commitment to sustainable development and their recognition of the importance of the impact that the Equator Principles will have on lending by HSBC.

NGO and stakeholder activism

> 'No matter how strong a bank's official policies may be, communities and the public ultimately judge a bank's sustainability by the on-the-ground environmental/social impacts of its portfolio.'
>
> BankTrack[68]

Unsurprisingly, many banks see the Equator Principles as a way of demonstrating their sensitivity to widespread public concern over environmental and human rights issues. Many shareholders now reference these issues in making investment decisions, a trend which is most visible in 'socially responsible' funds but is not confined to them. Similarly, the feeling that the bank is a socially responsible business may influence employee satisfaction and retention.

The banking sector has also come under sustained pressure from environmental and human rights NGOs that see sponsor funding by banks as the oxygen of allegedly unsustainable projects. There are even groups that focus specifically on banking activities. For example, BankTrack[69] is a network of 14 'civil society organisations' that tracks the operations of the private financial sector and its effect on people and the environment. In addition, Bankwatch monitors public money in the central and eastern European region[70].

Stakeholder activism is the catalyst for increasing realisation by financial institutions that failure to deal with environmental and social issues arising from project financing may threaten their businesses.

The Rainforest Action Network (RAN) campaign against the alleged financing by Citigroup of the destruction of tropical rainforests offers a most striking example of stakeholder pressure influencing a leading bank's social and environmental performance, although it is difficult to obtain an accurate account from parties that can be reported. We can do no more than report what we have heard. However, there is some difference between what we have been told by a number of parties who should know the facts and what has been reported in the press.

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68 BankTrack, *Principles, profits or just PR – triple P investments under the Principles*, June 2004.

69 www.banktrack.org.

70 www.bankwatch.org.

As part of their anti-Citigroup campaign, RAN made an advertisement which was broadcast on cable television in New York in which film celebrities such as Susan Sarandon and Daryl Hannah urged Citigroup credit card holders to destroy their cards in protest against the bank's alleged involvement in the destruction of tropical rainforests. It is alleged that the next day the Chairman of Citigroup received between 20,000 and 100,000 cut up credit cards from its clients. Some NGOs believe the cumulative effect of this broadcast and of demonstrations, petitions and negative advertising by RAN is what forced Citigroup executives to approach RAN. Following this meeting, NGOs claim that Citigroup committed itself to enhancing due diligence for projects in 'high-caution zones'; to implementing new lending practices for areas occupied by indigenous peoples; and to report greenhouse gas emissions from all power-sector projects it finances[71]. This example, even if widely exaggerated for publicity purposes, shows that no institution, not even a global bank of the stature of Citigroup or JPMorgan Chase is immune from adverse public opinion. It is also a message that is proving to be an important catalyst for a more pro-active approach on the part of banks towards sustainability, human rights and social impacts.

To be fair to Citigroup, (who would, we are sure, dispute the accuracy of this account) many other examples of increased stakeholder and NGO activism against financial institutions could have been included in the examples of 'campaigns' against financial instructions discussed above. These include:

- animal rights movements targeting Royal Bank of Scotland over its financial support for Huntington Life Science – a campaign that has been criticised by NGOs and civil society alike as crossing the line between acceptable and unacceptable 'lobbying' and resorting to the violent intimidation of the innocent families of senior members and staff of Royal Bank of Scotland[72]; and
- gay rights groups, trade union and student associations urging a boycott of the Bank of Scotland online banking operation which was supported by an American TV evangelist who in the past had taken anti-gay and misogynist stances[73].

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71 Paul West, RAN spokesperson, *Banking on the environment: a model campaign against financing eco-destruction*, April 2004.

72 news.bbc.co.uk/1/hi/business/1123732.stm.

73 news.bbc.co.uk/1/hi/business/621123.stm.

Protection of market share

> 'Unibanco is concerned that only projects that effectively contribute to the country's development and, at the same time, help preserve the communities and protect the environment, should meet with approval. Few institutions share this vision today, but we envisage social and environmental concerns becoming a primordial factor in the decision to approve any project in the future.'
>
> Tomas Zinner, Chairman of the Board of Instituto Unibanco, Unibanco[74]

Some Equator Banks have adopted the Equator Principles in order to differentiate themselves from their competitors or to protect or increase their market share. These banks believe that, in future, an increasing number of mature sponsors will choose an Equator Bank because the increased due diligence required by the Equator Principles is likely to mean that the project will attract less adverse criticism from stakeholders (including local governments or sovereign states), political risk will be diminished and environmental sustainability safeguarded. There are obvious parallels here with the practice of some powerful sponsors borrowing money from multilateral lenders or ECAs. In some cases, the sponsor does not really need to finance a project but by borrowing money from such bodies, they obtain a greater degree of protection against political risk.

During our survey, a number of Equator Banks stated that major sponsors had begun to show a preference for Equator Banks for these reasons. While there is no hard evidence yet, in general, we believe that a 'virtuous circle' of better projects underpinned by rigorous social and environmental assessment and better risk assessment in lending decisions is forming between Equator Banks and major sponsors, as very good circumstantial evidence suggests that this is the case.

Level playing field

> 'We did not think that environmental due diligence should be grounds on which we should compete.'
>
> Richard Burrett, Head of Sustainable Development Business Group, ABN AMRO

> 'Consensus among bankers on a common standard for sustainable performance is a major step for the mining industry.'
>
> Paul Mitchell, Secretary General, ICMM[75]

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74 *Equator news*, IFC website (www.ifc.org), 1 June 2004.

75 As cited in S. Lazarus' 'A matter of Principle', *Project Finance Magazine*, 3 March 2004.

> 'This is a huge step forward for the private sector. There is a global framework, with common language about how we identify [social and environmental] risks and best practice standards.'
>
> Christopher Beale, Global Head of Projects and Structured Trade Finance, Citigroup

> 'As a financial institution we have a huge responsibility to influence emerging markets and to draw on our experiences in this field when we finance projects. It is important that international financial institutions adopt the Equator Principles, boosting the importance of environmental and social issues.'
>
> Lars Kolte, Managing Director of Eksport Kredit Fonden[76]

A number of sponsors have recognised that creating a more consistent basis for social and environmental assessment of projects has a number of advantages. Each Equator Bank may differ to a degree in how they implement the Equator Principles but their differences in approach are not radical. In addition, if by satisfying the requirements of one Equator Bank, other Equator Banks accept their findings and recommendations, this may produce a wider syndication market. Equally, it is recognised that levelling the playing field may raise the standard generally, therefore squeezing players not applying such rigorous standards of assessment out of the market. There is, as Richard Burrett of ABN AMRO makes clear, also a moral basis for what may ultimately result in a uniform approach, as it appears unseemly for commercial banks to be in competition over environmental and social impact assessments rather than social and environmental impacts. Kim Brand of Scotiabank (a recent addition to the list of Equator Banks) confirmed this unprecedented approach of co-operation among Equator Banks, praising a number of Equator Banks for assisting Scotiabank to get up to speed quickly on understanding the requirements of the Equator Principles.

Industry standard

> 'This will become the de facto standard for the industry.'
>
> Christopher Beale, Global Head of Projects and Structured Trade Finance, Citigroup[77]

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76 'Export Kredit Fonden adopts international "Equator Principles" guidelines', www.equator-principles.com.

77 'Leading banks sign up to project finance principles', *Environmental Finance*, 4 June 2004, www.equator-principles.com.

> 'The Principles have become the project finance industry standard for addressing environmental and social issues in project financing globally.'
>
> Equator Principles website[78]

> 'It is our fundamental belief that the Principles are appropriately becoming the reference standard for financial institutions to ensure that the principles of responsible environmental stewardship and socially responsible development are embedded within our project finance activities.'
>
> Herman Mulder, Vice-President, ABN AMRO[79]

> 'The Principles have become the new market standard, thus transforming project finance.'
>
> Suellen Lazarus, formerly of the IFC[80]

> 'We believe our adoption of the Principles supports an industry standard that recognizes environmental responsibility.'
>
> Chan Martin, Enterprise Market Risk Executive, Bank of America[81]

> 'This is a major step forward in trying to achieve environmental standards for the global economy.'
>
> Fred Krupp, Executive Director, Environmental Defence

Some non-Equator Banks recognise the Equator Principles as 'the only game in town'. Other non-Equator Banks (and the majority of the Equator Banks) are sceptical about the willingness, sagacity and capacity of sponsors to see any virtue in subjecting their projects to a more robust and expensive assessment process[82]. Sponsors are more likely to appreciate the benefits of a project being Equator Principles-compliant if this had a

78 Website www.equator-principles.com.

79 'Principles celebrate first anniversary', 4 June 2004, www.equator-principles.com.

80 S. Lazarus, 'A matter of Principle', *Project Finance Magazine*, 3 March 2004.

81 'Bank of America adopts the Principles', www.equator-principles.com, April 2004.

82 Admittedly, however, their profile is much lower in deals where they are part of a consortium using a special purpose vehicle as the project vehicle.

positive effect on syndication, as a difficult or failed syndication has 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 being non-compliant.

Sustainable development

> 'The adoption of these Principles by the private sector marks a profound victory for sustainable development.'
>
> Peter Woicke, former Executive Vice-President of the IFC and Managing Director, World Bank[83]

Few of the Equator Banks took the view that the Equator Principles in themselves opened a new chapter on sustainable development. This is because they apply not only in jurisdictions where environmental laws may be weak, non-existent or poorly enforced (and where the IFC/World Bank policies and guidelines often become a substitute for the local legal regime), but also in jurisdictions that already have well developed and adequately enforced environmental laws, and where the requirements set out in the Equator Principles are applied as a matter of course already. The majority of Equator Banks saw the Equator Principles as a milestone rather than the end of the road towards the attainment of sustainable development goals.

Virtuous circle

> 'While the Principles were mainly consistent with our values and existing practice, we have found that formalising the daily practice through these principles has created a virtuous circle.'
>
> Calyon[84]

> 'The Equator Banks believe this [the Principles] will lead to more secure investments on the part of our customers and safer loans on the part of the banks. Because if you finance something that's dirty or something that harms people, there is likelihood that the host government or local people will interfere with it or even take it away from you.'
>
> Christopher Beale, Global Head of Projects and Structured Trade Finance, Citigroup[85]

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83 'Banks sign up for responsible lending accord', *Financial Times*, 4 June 2003, www.equator-principles.com.

84 'Putting Principles into practice', *Environmental Finance*, June 2004.

85 *The Wall Street Journal*, 4 June 2003.

> 'Banks face both credit and reputation risk when they finance development around the world. If sponsors adopt and follow the Equator Principles for sensitive projects, they might well enjoy a faster implementation period, with the result being that the project starts generating a revenue scheme earlier, avoiding the spectre of costly interruptions, delays and retrenchments. Equator will lead to more secure investments on the part of our customers and safer loans on the part of the banks.'
>
> Christopher Beale, Global Head of Project and Structured Trade Finance, Citigroup[86]

> 'The nexus between financial services, investment and sustainable development is steadily becoming evident. The Principles reflect a growing awareness of this nexus and could lead to projects that are better not only for the financial sector, but also for the environment and human health and welfare.'
>
> William L Thomas, Pilsbury Winthrop[87]

As mentioned above, there is a growing belief among the Equator Banks that a virtuous circle is beginning to develop where sponsors, aware of the stringent requirements of the Equator Principles, are bringing more robustly assessed projects to the Equator Banks. Similarly, it is believed that non-Equator Banks are compelled to apply the Equator Principles as a prerequisite to successful syndication. These claims may be premature, but it is clear from interviews during our survey that some mature sponsors and non-Equator Banks have adopted more rigorous social and environment assessment practices. Equally, however, we have recently been informed of a matter, which if true, would place a cancer at the very heart of the Equator Principles and Equator Banks.

Financial risk rating

> 'Many banks like ourselves have been integrating environmental issues into their credit risk management process for over a decade. A significant development is how this fits in with capital requirements related to Basel II. The sentiment proposed in the Accord clearly indicates that environmental risk issues are now positioned as mainstream business considerations for the sector, challenging institutions to ensure their policies and procedures reflect this expectation.'
>
> Chris Bray, Head of Environmental Risk Policy Management, Barclays[88]

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86 *Global Finance Magazine*, July 2003.

87 *Project Finance International Yearbook 2004.*

88 ERM Report, *Credit risk management – banking industry integrating environmental and social issues – how much and how fast?*, 2004.

> 'The biggest legacy of the Equator Principles is that they will have acted as a catalyst for broader areas.'
>
> Richard Burrett, Head of Sustainable Development Business Group, ABN AMRO

Under the Basel II Framework Agreement, as incorporated under the forthcoming EU Capital Requirements Directive, internationally active banks have to satisfy minimum capital requirements against credit risks and operational risks. The amount of capital reserved for credit risk can, however, be reduced if a bank can demonstrate to its banking supervisor that it qualifies for the Internal Ratings Based (IRB) approach by having acceptable internal risk assessment and management procedures which have been in operation for a minimum period of three years. Equator Banks may regard compliance with the Equator Principles as a discipline that will improve their internal risk assessment and management procedures and thus contribute to their qualifying for the entry criteria for the IRB approach.

To the extent that a bank has historical experience based on its internal data that projects that are Equator Principles-compliant have lower default rates and loss estimates than similar projects that are not compliant, it may allocate its own lower risk weighting to the relevant risk component when financing these projects. This could mean that it could offer more competitive pricing for Equator Principles-compliant projects.

Where banks have insufficiently developed internal risk assessment procedures to satisfy fully the entry criteria for the IRB approach, they will be obliged to follow a supervisory category for risk weighting for project finance. The supervisory categories are based upon certain 'slotting' criteria that rate the exposure of a project finance transaction to various grades of risk (such as political and legal environment, including government support). It will be interesting to see whether banking supervisors will treat compliance with the Equator Principles as contributing towards a higher supervisory rating grade (and thus a reduced risk weighting) than non-compliant projects because compliance mitigates political risk.

Reasons for staying out of the Equator Principles regime

The main reasons advanced by non-Equator Banks for not adopting the Principles were:

- scepticism;
- necessary internal systems not in place;
- similar procedures already in place;
- increase market share;
- fear of contagion; and
- review of Safeguard Policies.

The perception of Equator Banks is that NGOs focus on the Equator Principles to the exclusion of non-Equator Banks with less developed social and environmental polices. This, they argue, compares to a teacher marking a pupil's report card 'could do better' while ignoring completely that most of the pupils in the school are truants. In these circumstances, it is reasonable for Equator Banks to ask, as did Sandra Odendahl, Senior Manager of Environment Risk Management at the Royal Bank of Canada, what NGOs are doing about the banks that remain in the shadows, have not signed the Equator Principles and do not have as strong environmental or social policies as the Equator Banks[89].

On the other hand, some organisations such as BankTrack argue that it and others have spread their net more widely. CRBM[90], for example, focuses on Banca Intesa, and in the US, BankTrack has focused on JPMorgan Chase (which only recently became and Equator Bank) and others, while Netwerk Vlaanderen has targeted Belgian banks such as Fortis. It is therefore not entirely true to say that NGOs focus only on Equator Banks. Nonetheless, keeping a sharp eye on the Equator Banks, as BankTrack admits, does 'make sense' as they cover over 80 per cent of the project finance market.

Given the perceived advantages of adopting the Equator Principles claimed by the Equator Banks, why have a number of major banks, such as Lloyds TSB (which is widely recognised to be among those banks with the most advanced environmental credit risk assessment systems and procedures)[91], Deutsche Bank, Bank of Scotland, Société Générale and BNP Paribas (the

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89 Ethical Corporation Online, 2 May 2004.

90 Campagna per la riforma della Banca Mondiale.

91 F&C Asset Management, *A benchmarking study: environmental credit risk factors in the pan-European banking sector*, September 2002.

last three are recognised as having leading project finance practices), not adopted the Equator Principles?

The reluctance of these banks to adopt the Equator Principles, we would suggest, is not necessarily attributable to any lack of concern on their part about environmental or human rights issues, but to more sophisticated doubts that they share to a greater or lesser extent about the value of the Equator Principles process. The motivation of some (at least) of the non-Equator Banks in not adopting the Equator Principles may be usefully compared to the motives attributed by NGOs to 'the PR Equator Banks' (those Equator Banks which have adopted the Equator Principles but are alleged to have done little more than emblazon the Equator Principles on their websites[92]).

A number of plausible reasons for staying out of the Equator Principles group were advanced in answers to the survey. The main reasons given by non-Equator Banks for not adopting the Equator Principles (see list above) are subject to the same caveats as the list of reasons for the Equator Banks adopting the Equator Principles. The list of key reasons for not adopting the Equator Banks could have been much longer, but those listed above are the core reasons given. Other reasons given included the high cost of implementation.

Scepticism

Some non-Equator Banks expressed scepticism about the true value of the Equator Principles and whether the Equator Banks had in fact the capacity to implement them. If the Equator Principles are seen by sceptics as 'not being worth the paper they are written on' or if the Equator Banks themselves see them as merely 'business as usual' rather than a radical reform, then promoting the Equator Principles as a new or important development may be regarded as disingenuous or dishonest. For the non-Equator Banks, however, it is equally clear that the Equator Banks are viewed as having provided NGOs and stakeholders with a convenient and useful diversion. The Equator Principles give stakeholders and NGOs a larger target to aim at, while the non-Equator Banks are left relatively undisturbed and undetected below the NGO radar. However, as stated above, this is a view with which BankTrack takes issue, at least as a bold statement of fact if not a question of strategy.

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92 *Unproven principles; the Equator Principles at year two*, BankTrack.

Necessary internal systems not in place

> 'We recognise that the Principles are the only game in town because of the dominance of the Equator Banks as a source of project finance and the need for syndication. Nevertheless, we do not wish to be hypocritical and say one thing whilst doing another. We propose adopting the Principles only when we are confident that we can keep our word and deliver on our commitment.'
>
> Senior representative of a non-Equator Bank

Whereas some of the Equator Banks, such as Citigroup and WestLB, used adoption of the Equator Principles as a driver for internal changes in bank policies and procedures, a number of non-Equator Banks are more cautious in their approach and are trying to get internal procedures and policies in place before adopting the Equator Principles. This is driven in part by fear of being criticised for hypocrisy if they fail to deliver what the Equator Principles promise. This was the case for Bank of Scotland (a leading project finance bank that comes 11th in the Global Mandated Arrangers League Table 2004[93] but which has not adopted the Equator Principles), which did not wish to be regarded as hypocritical or indulging in 'greenwash' by adopting the Equator Principles until there was a degree of confidence that it could adhere to them.

Similar procedures already in place

> 'Most of our project financing for developing countries takes the form of a co-financing alongside a loan from the JBIC[94]. JBIC's own standards ensure that we give sufficient consideration to environmental factors.'
>
> International Japanese banker[95]

Only one Japanese bank, Mizuho, has adopted the Equator Principles, notwithstanding the importance of Japanese banks in the project finance market, particularly in developing countries. A reason for this given during the survey is that Japan Bank for International Co-operation (JBIC) has its own Guidelines for Confirmation of Environmental and Social Considerations (April 2002). It may be that some Japanese banks feel that the JBIC guidelines are as adequate as the Equator Principles as they cover the same issues, albeit in a different way or that there is a question of loyalty to JBIC, which has been at the forefront of promoting social and environmental responsibility in banking in developing countries.

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93 *Dealogic*, Global Mandated Arrangers League Table 2004 (deals signed and closed).

94 Syndicated loan covered by a NEXI insurance policy.

95 *Nikkei*, Tokyo, 5 September 2003.

It was not clear whether Japanese banks, when lending on an uncovered basis (ie where JBIC is not involved), continued to apply the JBIC guidelines. If they do, presumably this position may change as and when the Equator Principles become a truly global industry standard. If they do not, it will be interesting to see what the Japanese banks do.

Increase market share

> 'It is rumoured that some non-Equator Banks have proudly advertised their lack of environmental and social standards as a way of attracting less scrupulous clients. Although the [Equator] Banks have tried to avoid this practice by gathering a critical mass of endorsers, such 'bottom feeding' is a weakness of practically all voluntary initiatives.'
>
> BankTrack[96]

While some NGOs have commented that there is an opportunity for non-Equator Banks to win business from sponsors, our survey revealed no hard evidence that this practice is widespread or even frequent. In practice, the international nature of the financial centres from which project financings are typically sourced would make this strategy impracticable except in the narrowest of circumstances where a project can be financed purely from a local financial market.

Fear of contagion

Some banks are dissuaded from adopting the Equator Principles, as they fear that it is not possible to predict where it would all end. One Equator Bank suggested the reason for the absence of major French project finance banks was that they were very concerned that the Equator Principles carried a virus that in turn would infect other limbs of banking, such as export credit finance or general lending. The Equator Banks recognise that it would be good to have major project finance players like BNP Paribas and Société Générale on board, but think this fear means this is unlikely to happen until the outcome of the IFC review of Safeguard Policies is known and may not happen in the short to medium term.

IFC review of Safeguard Policies

> 'Giving the Equator Banks a preferential or even decisive say in the actual drafting process would completely ruin the legitimacy of the policies in the eyes of those whose interests and rights they are supposed to protect'.
>
> BankTrack[97]

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96 *Principles, profits or just PR – triple P investments under the Principles*, BankTrack, June 2004.

97 *Principles, profits or just PR – triple P investments under the Principles*, BankTrack, June 2004.

The IFC review is in many ways the key to the future success of the Equator Principles. It is not only the Equator Banks that are unhappy about the uncertainty surrounding the review of the IFC Safeguard Policies. Many Equator Banks and non-Equator Banks fear that the IFC review may lead to the adoption of vague, aspirational or, in particular, new standards, altering the Equator Principles accordingly. This, in turn, may lead to a situation where some Equator Banks could either choose to withdraw from the revised Equator Principles, as they did not originally subscribe to them, or agree to implement the Equator Principles at different levels, thus undermining the object of a level playing field. The concerns and difficulties surrounding the IFC review are discussed in more detail in the section below which discusses the scope of the Equator Principles. However, while at one time it appeared that these concerns would prevent non-Equator Banks from adopting the Equator Principles, the adoption of the Equator Principles by four additional Equator Banks in early to mid 2005[98] has largely dispelled this fear.

[98] Scotiabank on 18 January 2005, Banco do Brasil on 3 March 2005, JPMorgan Chase on 25 April 2005 and Manulife on 11 May 2005.

Scope of the Equator Principles

The matters most often mentioned in criticism of the scope of the Equator Principles were:

- the restriction of the Equator Principles to project finance;
- the $50m financial threshold;
- the potentially harmful impact of the IFC review on the nascent Equator Principles and an associated risk of schism between the Equator Banks; and
- rumours that banks and sponsors were colluding to circumvent the requirements of the Equator Principles.

Project finance only

> 'Perhaps one of the Principles' greatest weaknesses is that the scope is limited to project finance. The ambit should extend across the board of financing activities. While project finance may have the biggest single impact, the cumulative effect of financing should not be disregarded.'
>
> Justin Smith & Lisa Plit[99]

The most obvious limitation of the Equator Principles is that they are limited to project finance. There are good reasons for applying the Equator Principles to project finance. Repayments under financing arrangements in project finance transactions are dependent on good project performance. Banks therefore have a greater influence on the structuring of such projects. Consequently, the loan documentation includes covenants, events of default and enforcement powers that give them much more control over the business of the borrower than is the case for other types of lending transaction. These covenants, events of default and enforcement powers allow the banks to exert sufficient influence over projects to satisfy themselves that standards such as the Equator Principles are being adhered to. Other methods of finance, such as internal funding by sponsors and general corporate lending are widely used to finance projects, but these methods of financing do not provide the opportunities for assessment, monitoring and control by lenders that project finance makes available. They may however be subject to other EA requirements because of, for example, national law.

The Equator Banks have justified the limitation of the Equator Principles to the project finance market on various grounds:

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99 *Business Day*, South Africa, 14 July 2003.

- the Equator Banks were responding directly to specific criticism of funding of allegedly unsustainable, large-scale projects, such as Three Gorges Dam, the OCP Ecuador Pipeline and the BTC Pipeline;
- the Equator Banks simply had to start somewhere. Project finance was an obvious starting place, not only because of the criticism levelled at project funding but also because, as a relatively discrete area, it could be used as a test-bed for socially responsible banking;
- due to the limited recourse nature of project financing, banks are far more aware of the detail of the projects they are asked to finance, which makes implementing the requirements of the Equator Principles easier; and
- the limitation was seen by a number of Equator Banks as a milestone rather than a final destination. A number of Equator Banks have now applied the Equator Principles to other areas of banking activity or have adopted an 'Equator-Lite' approach to other forms of lending or have applied policies which are more stringent than the Equator Principles to some activities.

The forestry policies of ABN AMRO and HSBC; Barclays' general commitment to 'follow the money' (as evidenced by the application of the Equator Principles to general lending on the Karahnjukar hydro project in Iceland); and the wider emphasis on sustainability in lending placed by ABN AMRO, Bank of America, Citigroup, JPMorgan Chase and WestLB each illustrate this tendency to apply the Equator Principles to other areas. However, leading Equator Banks such as Barclays are concerned that by seeking to stretch the Equator Principles too far beyond project finance, their credibility may snap. Against this argument is Scott Wilson's view that the current limited application of the Equator Principles reduces the ability of lenders to properly consider the effects of developments funded by other means of finance in extremely sensitive locations, a point perhaps underlined by Barclays' experience on the Karahnjukar Dam in Iceland.

The $50m threshold

'The Principles apply only to projects which cost $50m or more. The question now arises: How many projects fall below $50m and what about them? According to the IFC, a cut off point and some level of materiality are necessary. Most of the sensitive project developments involve much larger sums. While the league tables for project loans do not necessarily record all small project loans, they indicate that projects costing less than $50m represent only 3 per cent of the market.'

The Hindu, July 25, 2003

The Equator Principles only apply to projects with a total capital cost of

$50m or more. The $50m threshold was a concession made to a number of Equator Banks to encourage them to adopt the Equator Principles, but the threshold requirement attracts criticism because projects below the threshold may seriously or irreparably damage the environment or present social and cultural risks. The limitation is said to be particularly damaging to developing countries where the capital costs of quite significant projects may be less than $50m and local laws may not require stringent environmental and social impact assessment. A notable example is provided by the Kainantu Gold Project in Papua New Guinea, which received harsh public criticism for its adverse social and environmental impacts but fell below the threshold: the loan amounting to $30m and project costs to $40m. However, against this view, a number of participants mentioned that they did not think that the $50m threshold was important but instead the Equator Banks should develop specific policies to deal with project development in countries that are particularly vulnerable such as Sudan, Angola, Zimbabwe, Indonesia and Myanmar.

A number of banks indicated that they were not interested in becoming involved in projects below this threshold. They feel their investment and the cost to a sponsor of carrying out an Equator Principles-compliant environmental and social impact assessment would not be commercially viable at this level. Indeed, it was said that this could force a sharp increase in the upfront costs to comply with the Equator Principles, leaving the sponsors to seek alternative forms of financing, which would undermine the objectives of the Equator Principles.

Another issue relating to the $50m threshold is the possibility of sponsors and banks agreeing to ‘salami-slice’ projects[100] so that each part of the project falls below the $50m threshold. For many banks, however, this clearly is impractical and simply does not make financial sense. It is doubtful whether many of the Equator Banks would have any interest in this threshold circumvention device, although that is not to say that we have evidence that it is not used.

It could be argued that, if the Equator Banks do not want to form part of the bottom end of the project finance market, they should either formally withdraw from it or do away with the financial threshold to remove the risk of potential social and environmental abuses. This view, however, ignores the fact that banks have ongoing relationships with clients who may seek smaller loans for projects from time to time and that banks arduously seek to protect and enhance their client networks. Nonetheless, the $50m

[100] Dividing a project into smaller pieces to avoid the project assessment threshold being applied to the whole project rather than every part of the project.

threshold does mean that a number of projects with worrying social and environmental effects are not subject to the Equator Principles.

Whatever the merits of any case, we were informed that the threshold is being quietly abandoned by a number of Equator Banks. ABN AMRO, for example, has dropped the threshold from its mining policy on the basis that it was difficult to justify this restriction to NGOs (among others). JPMorgan Chase has reduced the $50m threshold to $10m and Citigroup has extended Equator-like categorisation to equity and underwriting transactions (outside project finance) where the use of the proceeds is unknown. Against this trend, one major Equator Bank suggested that most projects that have serious environmental and social impacts are large ones and, from a process point of view, there needs to be a cut-off point to avoid small loans being swamped in unnecessary procedural problems. However, it was also pointed out by the same Equator Bank that in practice, a sophisticated bank would apply an Equator Principles-like process to small loans that raise Equator Principles issues.

IFC review

The scope of the Equator Principles as a direct consequence of the IFC review is now the subject of a major re-examination. The IFC embarked on an integrated review of its Safeguard Policies, its Policy on Disclosure of Information and its Environmental, Health & Safety (EHS) Guidelines with a view to comprehensively updating them, including stakeholder consultation and expert input. The revised policies should be presented to IFC's management and Board for approval in autumn of 2005.

There is general concern among the Equator Banks, not only about the review process, but also about the lack of information to enable them to assess the merits of the proposed reforms. Some Equator Banks may be forgiven for expressing surprise that the IFC should suggest such far-reaching reforms so soon after negotiating the Equator Principles with them (although one Equator Bank conceded that it was aware that a policy review by the IFC was a real prospect when it adopted the Equator Principles and by the time of launch of Equator Principles, it was clear the a review would take place).

Other Equator Banks, while acknowledging that the IFC policies and guidelines were always part of the Equator Principles, are concerned that the review is taking place so soon after adoption of the Equator Principles and feel that reform is premature and unhelpful. Yet another group of Equator Banks do not object to review of the IFC policy, but argue that they do not have sufficient information to participate constructively in negotiations or consultation with the IFC.

Partly in response to requests from NGOs, 17 financial institutions met representatives of IFC in New York on 7 December 2004 in the second consultation on the IFC review. The financial institutions requested the IFC to extend the timetable for the review by at least six months from the original 17 December 2004 deadline for Phase I of the Public Consultation and Comment Period. This was to ensure all stakeholders, including the financial institutions that have adopted the Equator Principles, had adequate time for full consideration of the implications of the proposed new policies. The institutions took the view that it was difficult to understand fully the proposed new policies, known as Performance Standards, without the interpretation notes that had not been released. They stated that it is critical to ensure that there is sufficient time to develop a set of Performance Standards that are broadly accepted and appropriate to stand the test of time. 16 Equator Banks met with representatives of IFC in Paris on 20 April 2005. The Equator Banks discussed their comments on the proposed Performance Standards that are intended to replace the Safeguard Policies and the IFC has embarked on a redrafting of the Performance Standards.

The Performance Standards may, when finalised, require the revision of the Equator Principles and financial institutions expressed the need for their own consultation process with their stakeholders on the revised Equator Principles before the new principles are implemented[101].

It is suggested by participants in our survey, including NGOs, Equator Banks and a number of sponsors, that the IFC review may cause a schism between the Equator Banks. While some of them may accept the Performance Standards, particularly if the IFC takes on board the views of the Equator Banks lobby, other Equator Banks may seek to draw the line at the IFC Safeguard Policies as they existed at the date on which the bank in question adopted the Equator Principles. This is partly because of the different purposes served by the IFC Safeguard Policies and the Equator Principles. While IFC and World Bank lending is limited to emerging markets, Equator Bank lending is far more widespread. The changes to Safeguard Policies that are valid for protecting fragile environments where local laws and law enforcement capabilities are weak may not be equally valid – or, indeed, necessary– in jurisdictions which have adequate legal and enforcement frameworks for tackling environmental and social impacts. This is why the Equator Principles only require that the Safeguard Polices are applied in developing not developed countries.

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[101] www.equatorprinciples.com.

The differences and difficulties in negotiating and drafting the Equator Principles in 2003 will no doubt re-emerge, unless consensus develops among the Equator Banks concerning the proposed changes to policy.

Avoidance of schism is a challenge that the IFC and Equator Banks have faced since 2003 but it will become more daunting as they go forward. Alternatively, Equator Banks may begin to select Performance Standards they choose to apply and in what circumstances they may require additional assurances from sponsors.

Nonetheless, if there is a schism between the Equator Banks, the impact and value of the Equator Principles may be damaged beyond repair.

On a more positive note, it is hoped that the IFC review will bring about more explicit and practical standards. This would level the playing field by reducing the scope for different interpretation of the Equator Principles by the Equator Banks. Vagueness is a particular issue in relation to social issues given the paucity of international best practice and lack of existing standards. As such, the IFC review could lead to significant improvements in this area.

A more fundamental issue is whether the Equator Principles should be decoupled from IFC policy altogether. This may seem heretical as the ability to found the Equator Principles on available IFC policy has been the bedrock of the success of the Equator Principles in some ways. Yet, it must now be asked if arguably IFC policy is not appropriate for the Equator Banks and, in fact, prevents development of more bespoke policies.

Circumvention of Equator Principles requirements

Our research does not confirm that banks and sponsors have on occasion sought to circumvent the requirements of the Equator Principles. On the other hand, some questionable practices that have been reported to us as part of ‘coffee house gossip’ include the following:

- sponsors suggesting to banks that they will self-finance the project from general borrowing, take the NGO and stakeholder flak for the banks, and later re-finance with the banks (because the Equator Principles do not apply to re-financing of existing projects or general borrowing);
- non-Equator Banks holding out to sponsors that there are advantages of banking with them, as this will avoid the formal requirements of Equator Principles assessment; and
- sponsors changing the source of financing to the capital markets or other forms of finance to avoid the Equator Principles.

Examples of borrowers circumventing environmental and social standards in the past were passed on to us in the course of our survey but we have not been given proof of such activities. It must be said that the majority of banks and sponsors were sceptical about the occurrence or the effectiveness of such practices, because of the dominant position of the Equator Banks in the project finance and other markets. In addition, sponsors who cut themselves off from about 80 per cent of the project finance market by adopting such means were seen as foolish and such behaviour therefore was unlikely to be common practice among banks and sponsors.

Awareness of the Equator Principles

> ‘A senior project finance banker at an Equator Bank actually told us recently that the Principles only applied to developing countries, not Europe. Because the decision-making process is part of the project finance world, mistakes often happen. So there is a general lack of awareness of the substance of the Principles, though not the title.’
>
> An environmental consultant

Other examples of general ignorance within Equator Banks and non-Equator Banks of the Equator Principles have included beliefs that they were the ‘Curator Principles’ rather than Equator Principles and that the Equator Principles apply only to:

- ‘developing’ countries, such as Australia;
- onshore projects; and
- the Equatorial regions[102].

Banks are not alone in their ignorance of the Equator Principles. Remarkably, leading finance and environmental lawyers, some NGOs (though all campaigners working on projects now appear to be aware of the Equator Principles) and rating agencies also did not know the Equator Principles existed or knew little more than the name or that they existed.

With the notable exception of specialist environmental risk and CSR advisers, we found that the general level of awareness of the Equator Principles among bankers and project finance and environmental lawyers was low. This was despite the fact that at the time of the survey, a series of articles on the Equator Principles appeared in legal and financial journals, written by us and by other law firms such as Sullivan & Cromwell and, to a lesser extent, Norton Rose. This tendency may decrease as more articles about the Equator Principles are published and seminars and training programmes are run.

This low level of general awareness may be explained by the fact that the application of the Equator Principles is limited at present to project finance and by the very short period of time that has elapsed since they were adopted. Professor Bob Lee adds that it would also tend to suggest that if the Equator Principles amount only to ‘greenwash’ then attempts to demonstrate sound environmental credentials have been unsuccessful.

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[102] Some participants have expressed doubts as to the authenticity of these comments but senior banking officers made each one directly to us.

Vanguard of Equator Banks

> 'We are sharing best practice, which is unusual, but this isn't an area where we are competing.'
>
> Richard Burrett, Head of Sustainable Development Business Group, ABN AMRO

There are material disparities in the levels of resources devoted by the Equator Banks to Equator Principles issues.

Our survey revealed (as confirmed by both NGOs and certain Equator Banks) that there is a vanguard of leading Equator Banks, in terms of their commitment to and development of the Equator Principles. This vanguard comprises ABN AMRO, Barclays, Citigroup and WestLB, which assumed responsibility voluntarily for drafting and negotiating the Equator Principles, and HSBC. These banks show the most commitment to the Equator Principles; they liaise with each other on a regular basis and are at the forefront of development of policies and procedures.

Behind the vanguard follows a chasing pack of banks, which includes Royal Bank of Scotland, which has demonstrated very real commitment to the Equator Principles from the top down. Behind the chasing pack are some 'solid citizens' who, while not leading the way on the Equator Principles, nevertheless contribute fully to their development.

There is, however, said to be a fourth group of Equator Banks about which less positive views are expressed by NGOs, socially responsible funds and even by some, but by no means all, of the Equator Banks and leading non-Equator Banks. It is said that members of this group of 'PR Equator Banks' or 'free riders' do little project finance work or have done little more than put their adoption of the Equator Principles on their websites, free riding on the efforts of the other Equator Banks.

It became clear during our survey that while the large majority of Equator Banks were fully committed (by attending all the Equator Banks' meetings and the series of meetings held in 2004 with the IFC, NGOs and major sponsors and contributing fully to the development of Equator Banks' policies and practices), a small minority of Equator Banks were perceived as not being prepared to do so.

Steve Waygood of Insight Investment said that such 'free riding' could bring the Equator Principles and the Equator Banks into disrepute. He suggested that there is a need for the Equator Banks to redefine rules for membership and to require a minimum compliance and commitment from banks that adopt the Equator Principles. Waygood also observed that while it was quite common for a body like the Equator Banks to seek to achieve critical mass in the early stages of development by having open membership, other bodies had later developed formal membership criteria. These included the UN Global Compact and the United Nations Environment Programme (UNEP), as well as other groups that had adopted marine and forestry standards.

We were not able to establish whether this unwillingness to participate and contribute fully with the other Equator Banks was because the project finance market had been slow for the PR Equator Banks or whether there was some other reason for their relative lack of enthusiasm and commitment. However, the clear enthusiasm and commitment of a body like BankTrack to participate in Equator Principles meetings notwithstanding its relative lack of means compared to the Equator Banks, does speak volumes about the efforts of 'free riders'.

Raising awareness within the Equator Banks

Despite some ignorance of the Equator Principles and what they stand for, the Equator Banks have made an impressive effort in raising awareness among their staff and, through that effort, in bringing the bankers working in project finance and other areas of banking to a more informed perspective on the impact of their activities in social and environmental terms.

Raising awareness and training

Training by Sustainable Finance[103] comprises three course models tailored to the needs of the banks and professionals in the banks responsible for implementation of the Equator Principles. Sustainable Finance runs two modules[104] for the IFC:

- a short, half-day course for bankers whose awareness needs to be raised on risks and issues and how the process works, but who will not be responsible for day-to-day implementation; and
- a two-day course geared to project finance professionals to provide them with tools to identify risks, categorise projects, apply the policies and procedures and to implement monitoring measures. Interactive case studies use the banks' own projects.

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103 Sustainable Finance was established in 2003 to provide training, consultancy and decision-making support in environmental and social risk management to the financial sector. Its consultants – among them, notably, Glen Armstrong and Leo Johnson – have trained a number of project finance staff as well as won a number of IFC corporate support awards for their work on the Equator Principles – www.sustainablefinance.co.uk.

104 www.sustainablefinance.com.

In addition, a five-day masterclass that provides in-depth knowledge and application for professional gatekeepers has been developed but not yet run.

Sustainable Finance, which is headed by Glen Armstrong and Leo Johnson, had trained over 900 banking professionals from 17 major banks on issues related to the Equator Principles by May 2005.

Even if one assumes that Sustainable Finance has cornered the market, the training of this number of senior and other banking officers (including several global heads of practice areas) is plainly very impressive.

Banco Itaú, one of many banks that have participated in the training programme run by Sustainable Finance, reports that 50 employees from both Banco Itaú and Banco Itaú BBA participated in a two-day workshop. The participants were selected based on their involvement with the key Equator Principles issue areas, and therefore included representatives of credit, legal, project finance, commercial and mergers and acquisitions departments. The workshop embraced several topics to which the Equator Principles are of relevance (namely, improved credit risk, improved return and overall improvement in the perceived risk); the advantages and disadvantages of the Equator Principles; environmental and social risk screening; dealing with sponsor resistance; and evolution of best practice. Banco Itaú intends to hold similar workshops every year for the foreseeable future in order to ensure adequate training at all levels of banking personnel.

HSBC also reports extensive Equator Principles training. As part of implementing the Equator Principles, which HSBC adopted in September 2003, all teams globally involved in financing projects – 155 managers and 24 senior executives – underwent special training during 2004, with courses delivered in London, New York and Hong Kong. HSBC will be undertaking further awareness training in 2005, covering non-project finance teams in their corporate and institutional banking departments who are involved in sectors where environmental factors are a consideration. BankTrack accepts that by May 2003, 365 professionals at 13 Equator Banks had attended IFC courses, but admits that it had no knowledge of what was being done at grassroots level.

Although Sustainable Finance has provided direct training to Equator Banks, this is not the end of the story. A number of Equator Banks (such as HSBC) have bought and run the self-standing training programme devised by the IFC to train other bankers and lawyers in project finance, corporate finance and export credit finance in the application, interpretation and implementation of the Equator Principles. Usually the training begins with senior people such as specialists and frontline bankers, reflecting how the Equator Principles are being driven from the top. A number of banks have emphasised the need to ensure that the frontline bankers are committed and knowledgeable, as it is they who will retain responsibility for supervising and monitoring the project on behalf of the bank. In the future, some Equator Banks are committed to providing all relevant staff with online training on the Equator Principles.

However, some disparity exists in the approach banks have adopted in training staff about the Equator Principles. Some have trained only a few key staff members (externally by the IFC or Sustainable Finance); others have taken training to the bank's frontline troops. For example, by the end of 2003, Citigroup had trained 100 project finance bankers whose business is most impacted by the Equator Principles, as well as training 375 risk management and marketing personnel, and new analysts and associates. Calyon, too, invested heavily in an extensive training scheme involving the IFC. 120 individuals worldwide had been trained by October 2004[105].

However, a distinction must also be drawn between general awareness raising, and training. While increasing levels of awareness among those involved in project finance might be achieved more easily, functional training should be included on banks' long-term agenda[106]. Furthermore, some social and environmental consultants have suggested that although training has been rolled out at the majority of banks, it is apparent that only selected members of staff have been trained, and not always the most appropriate ones.

Although the internal divisions in banks for deal evaluation, assessment of credit and environmental risk differ, there was a clear consensus that the project finance dealmakers had to be trained. The Equator Principles had to be embedded in the minds of people who manage projects, rather than being the exclusive reserve of environmentalists or risk assessment committees whose function was divorced from project finance. A number of banks had also begun the process of spinning out the Equator Principles in other areas, such as export credit and commodity finance.

Recruitment

Part of the effort Equator Banks have put into implementing and raising awareness of the Equator Principles is reflected in recruitment. Not all banks started from the same position, as some had already developed significant in-house expertise and resources on risk assessment, at least for

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105 'Putting Principles into practice', *Environmental Finance*, June 2004.

106 Note, for example, the following comments by those who received training (from www.sustainablefinance.co.uk/quotes.htm): 'First class knowledge of the Equator Principles and the bank'; 'Brought the material alive and forced me to re-think environmental risk'.

the environmental as opposed to the social risk. They achieved this both through internal and external recruitment. According to Glen Armstrong, for example, ‘some banks have chosen to recruit external specialists with specific expertise, others have felt that an understanding of the bank is paramount and have therefore diverted existing personnel’.

Some banks allocate responsibility to only two to three people. We are aware of only one bank (Citigroup) that has recruited a senior expert on the Equator Principles and project assessment from the IFC to lead its team on social impact issues. In general, however, Equator Banks have not recruited many people from bodies (such as the IFC, Export Credit Agencies, public bodies or the European Bank for Reconstruction and Development (EBRD)) who could supply the requisite expertise.

Choosing consultants and professional advisers

> ‘Banks have limited experience in monitoring environmental and social compliance and will rely on outside experts. Getting high quality, consistent and independent advice will be one of the major challenges for the banks and for borrowers.’
>
> Paul Mitchell, Secretary General, ICMM[107]

Some mature sponsors have a good record of carrying out difficult projects in an environmentally and socially responsible manner. Over many years, mature sponsors have become aware of the unpalatable truth that you get what you pay for in terms of quality. Mature sponsors and other repeat players, such as lenders and public bodies, therefore try to surround themselves with the best, not necessarily the cheapest, advisers.

There are a number of national and international engineering and environmental consultants and law firms which have worked closely with sponsors and banks on project design and construction over a number of years and have established a good track record as advisers of choice on major project work. Some banks are very aware which advisers are the best experts to engage to deal with engineering, environmental and legal matters. Not all banks, however, have that knowledge.

Equally, whereas it is sometimes possible to have a one-stop shop consultancy, major projects tend to require a number of discrete and diverse skills. Best practice is to have a team of consultants reporting to a project manager who has a proven record in running teams of experts and who can take an overview of trade-offs between economic, environmental and social

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107 As cited in S. Lazarus’ ‘A Matter of Principle’, *Project Finance Magazine*, 3 March 2004.

benefits and disadvantages and decide whether any such trade-off is justifiable or supportable.

There was uniform concern over social impact assessment, in spite of the fact that bilateral and multilateral lenders and public bodies have been carrying out such assessments for some time. Even more markedly than in the field of environmental impacts, there does not seem to be awareness among the banks of the existence of a body of experts, knowledge of social science, agreed methodology or common approach as is evident in EA where there is 30 years of project-related experience and evaluation of the assessment process.

Panels of experts

> 'There is a wide variety of experience in the Equator Banks in dealing with the Principles. Some resources are better than others. And usually they use one-stop solutions. So it's worrying to see that some banks don't have panels of experts.'
>
> Leading technical expert

> 'There is a need for external panels to be made up of real experts and not just the former great and good. There is less need for retired ambassadors than for knowledgeable professionals.'
>
> Steve Waygood, Insight Investment

As indicated, few Equator Banks have panels of experts or strong relationships with leaders in environmental and social impact risk assessment (including lawyers, social scientists, economists and environmental consultants). In fact, the most common request we received from participants during the survey was for a list of experts we could recommend to both Equator Banks and non-Equator Banks. There are a number of Equator Banks with adequate in-house expertise in some of the areas covered by the Equator Principles, but few suggested that they presently had sufficient expertise to provide complete coverage of all Equator Principles issues.

The position is further complicated when the need to address social impacts is considered. Whereas environmental effects (the toxicity or bio-accumulation of a certain pollutant, for example) are, broadly speaking, universally applicable, this is not true for social impacts. The almost infinite variety and complexity of human social structures may vary markedly from region to region and even from case to case. While it is sound practice to employ the same environmental consultant to consider groundwater contamination in a temperate zone for one project and in the tropics for another, there are real dangers in assuming that the social impact of a project on Australian aborigines is likely to be same as, or even recognisably similar to, a comparable project on pastoral communities in semi-arid lands in west Asia. Some relatively well-established banks, for example, Barclays, have real in-house environmental assessment expertise and leading project finance practices, but have less well-developed expertise in the assessment of social impacts. Scott Wilson added that social experts will, for example, be aware that there is a huge range of expertise needed within the social science field and will therefore be able to identify the need for and source a particular person with the relevant expertise. Few in-house departments would be capable of this.

As mentioned below, where the host state does not have an adequate legal regime for the protection of the environment or human rights, it is sometimes necessary to 'import' legal rules, usually those set out in an international treaty or generally agreed by a respected international organisation (such as the World Health Organisation (WHO) or the International Labour Organisation (ILO)). Where this is the case, care will need to be taken to appoint legal and technical advisers who are sufficiently familiar with the application and interpretation of these rules to enable them both to argue persuasively for their adoption, and also to assist the parties in tailoring their application to the project and the existing legal regime of the host state.

In addition, some Equator Banks and sponsors, in our view at least, have made surprising choices when appointing external experts. For example, engineering firms (rather than environmental consultants, legal experts, anthropologists, social scientists and/or economists) appear to be charged with a wide range of tasks that are not wholly or partly within their field of expertise, qualification or knowledge.

Consultants that we regard as very well established and experienced in their field of expertise had received surprisingly few instructions from Equator Banks on Equator Principles matters. A prominent technical expert reported to us in October 2004 that the leading global environmental consultancy for which he worked had received only one set of Equator Principles-related instructions since June 2003.

Equally worrying was the discovery that some Equator Banks appear to take the view that they had discharged their obligations under the Equator Principles by merely accepting the findings of sponsors' consultants. In some cases, that may be satisfactory, particularly if the sponsor is mature and the consultancy is blue chip. Otherwise, it is prudent for the Equator Banks to engage independent consultants to review the reports provided by the sponsor or the sponsor's technical consultants or ensure a sufficient degree of control over the sponsors' consultants and vetting of their results.

Further, Scott Wilson points out that the difficulties of organising consultation and participation of communities affected by projects should not be underestimated. Equator Banks should also be aware that there is a need for ongoing involvement of reputable consultants and that it may not be appropriate for projects to be handed over to local ‘advisors’ to monitor projects after, for example, financial close. The need for effective monitoring of the development and execution stages of projects is as important as the need for good due diligence prior to financial close in order to adequately protect lenders’ and sponsors’ reputational risk as well as the environmental and social needs of the project site.

Given the breadth of issues to be addressed by the Equator Principles, Equator Banks and sponsors need to develop better knowledge of experts in their field, share views of experts and develop panels of experts.

Project assessment

> 'The idea that all ecological impacts and aspects of a company's impacts are being managed adequately through your bog-standard traditional environmental management system is largely flawed.'
>
> Insight Investment[108]

The main project assessment issues that emerged from our survey were:

- whether the Equator Banks in fact had the power to influence a major project given that generally the involvement of the banks in project development takes place at a fairly late stage;
- whether any bank but an Equator Bank should carry out the role of the Environment Bank in assessing and monitoring the implementation of an Equator Principles project;
- problems associated with categorising projects according to the Equator Principles criteria;
- the scope and form of due diligence and the dependence of the Equator Banks on reports prepared by and for sponsors;
- sponsor capacity;
- the need for effective monitoring of projects and information handling; and
- the challenge presented to the Equator Banks in assessing social issues.

Power of Equator Banks to shape projects

A problem for some projects is that the lending Equator Banks may not become involved until too late in the development of a project to influence fundamentals, such as the route of pipelines, roads or railways or the site selection of dams or airports. Where this is the case, it may be argued that the Equator Principles become window dressing or, at best, a device for dealing with political risk as the project can no longer in reality be subject to the rigours of a robust and objective social and environmental assessment in line with the requirements of the Equator Principles.

A particular problem identified by the survey relates to multi-staged projects such as motorway projects, as discussed above in the section 'Negative findings'. Complications arise where the initial stages of the project have not been the subject of an Equator Principles review, but current or future stages are so assessed. These complications obviously stem from the recent adoption of the Equator Principles and the transitional

[108] *Investor Responsibility Bulletin*, Autumn 2003.

period before full Equator Principles implementation for all relevant projects. Inevitably, at this stage of development of the Equator Principles, Equator Banks have tended to be pragmatic in their approach to staged projects. At least as far as the future stages are concerned, the difficulty of financing and syndication without some sort of framework for social and environmental review means that sponsors will probably have to adhere more closely to the letter of the Equator Principles. However, doing so may well involve a detailed assessment or cursory examination of the cumulative impact of the various stages of the project, and any possibility of complying with the Equator Principles in the future may be restricted and changed by the historical background of the project.

Similar difficulties may arise with projects that have been at the planning stage a long time before the adoption of the Equator Principles and cannot simply stop. We will see how this issue will be addressed in light of the Equator Principles.

During our survey, it was made clear to us that a number of Equator Banks had decided not to participate in loan syndication of certain projects. This was not because the bank considered the environmental or social impacts of a project to be unacceptable, but simply because the bank felt that it did not have the resources or expertise to assess the project or type of project adequately in the time given to the bank by the sponsor or arranging bank to come to a conclusion. Other Equator Banks considered that, because of their greater resources or expertise in projects of a certain type, an adequate assessment of the project could be made in the time available.

We regard these issues, however, as teething problems that will become less important or less difficult as sponsors accept that projects must be designed to comply with the requirements of the Equator Principles.

The criticism by BankTrack that the Equator Principles did not lead to the cancellation or delay of certain projects may be seen in the light of the fact that there has been a necessary bedding down period for the Equator Principles and, during that period, it was not unreasonable for the Equator Banks to be more pragmatic in their assessment of projects than they will be once the Equator Principles are fully effective. Familiarity among the legal and technical advisers in the project finance arena, the Equator Banks argue, will help overcome this concern. Whatever the case, it is clear that BankTrack regards the ‘honeymoon period’ as over.

Which bank should lead the Equator Principles due diligence?

> 'Any bank joining a loan syndication arranged by an Equator Bank will be buying into due diligence done according to the Principles. We can't force banks to adopt them, but think that the Principles are a useful way of ensuring that institutions go through the necessary steps.'
>
> Richard Burrett, Head of Sustainable Development Business Group, ABN AMRO[109]

> 'The integrity of the Environmental Credit Risk Assessment of the lead bank in cases of syndicated loans is a significant weak link.'
>
> ISIS[110]

A critical question for banks arranging finance or joining a syndication is which of them should carry out the Technical Bank or Environment Bank function[111], where the technical (including social and environmental) aspects of the project are assessed to determine the technical feasibility of the project from a construction and operational standpoint.

We believe (notwithstanding the fact that non-Equator banks have performed their role in major projects, such as the BTC pipeline), that the appointment of an Equator Bank as the Technical or Environmental Bank is critical to the successful implementation of the Equator Principles as the reputation of all participating banks is dependent on the Environment Bank, both during the project assessment stage and during the constructional and operational stages of the project.

Being appointed as the Environment Bank, we would argue, is not the same as any of the other roles (such as book runner or financial modelling bank), to which a bank may be appointed by other banks supporting a project. It is pivotal to the success of the project and to protecting the reputation of the banks supporting the project. Our argument is based on the following points.

- The Environment Bank has an important role both before and after financial close. The Environment Bank will advise the other banks whether the Equator Principles have been complied with in all pre-financial close matters. Equally, it will be the Environment Bank that monitors compliance with the EMP during the construction and operational phases of the project and assesses the information provided by the sponsors and consultants about the project.

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109 As cited in 'Principled finance?', *Project Finance Magazine*, June 2003.

110 F&C Asset Management, *A benchmarking study: environmental credit risk factors in the pan-European banking sector*, September 2002.

111 These terms are explained in Annex I.

- Whereas a bank doing financial modelling or looking at other technical aspects of a project may make mistakes, it is less likely that those mistakes will affect the reputation of the group of banks to the same extent as mistakes about whether a project complies with the Equator Principles. The reputation of the banks supporting the project is only as strong as the weakest link. Failure of the Environment Bank to report non-compliance to the other banks or a lax approach to assessments, compliance or reporting by the sponsors may result in damage to the reputation of all the banks, not only the Environment Bank.

- In time, banks may be encouraged to subscribe to syndicated deals based on the strength of the Environment Bank.

On this point, however, there is a division of opinion among lenders. Some Equator Banks feel strongly that it is inappropriate for a bank which has not committed itself to the Equator Principles to lead the Equator Principles due diligence. Other Equator Banks consider that to question the commitment of a non-Equator Bank in carrying out a thorough Equator Principles due diligence just because it has not committed itself to the Equator Principles is wrong.

While there is something in the argument that there is nothing inherently wrong in a non-Equator Bank leading an Equator Principles due diligence, we would argue that it would look distinctly odd if Equator Banks were to delegate responsibility to a bank which has not adopted the Equator Principles to test compliance with the Equator Principles. If the Equator Principles aim to provide more robust projects and to protect the reputation of banks from public criticism by stakeholders, it is difficult to understand why Equator Banks, even if they had a veto or weighted voting rights, would concede the Environment Bank role to a bank which does not share their ambitions for, belief in, knowledge of or commitment to the Equator Principles.

Categorisation of projects

Crescencia Maurer of the World Resources Institute warned of ‘categorisation creep’ where the banks, given the scope for subjectivity in categorisation, may be tempted to place projects in lower risk categories to reduce costs associated with carrying out social and environmental assessment[112].

Our own impression is that Equator Banks do not systematically downgrade projects in this way. We do accept, though, that the NGOs may have

112 ‘Putting Principles into practice’, *Environmental Finance*, June 2004, www.equator-principles.com.

grounds for suspicion and social and environmental consultants have certainly testified to overly ‘optimistic’ categorisation of projects. A possible explanation for the NGO belief that this practice of downgrading categorisation does occur is that many issues addressed by the Equator Principles involve some element of judgement as to which equally qualified leading professional advisers may legitimately hold different opinions, arising out of difficulties of interpretation or reaching a conclusion. However, a difference in professional opinion about project assessment or categorisation does not necessarily mean there was any degree of artificial manipulation of categorisation of the project in question. Furthermore, BankTrack observes that the IFC Compliance Advisor/Ombudsman’s review shows an alarming number of miscategorisations by IFC project staff. This does not prove that Equator Banks do the same but if the IFC’s experienced staff cannot apply its own policies properly then it is difficult to expect Equator Banks to be able to do so in every case.

It is natural for most sponsors and their arranging banks to seek the least onerous project categorisation as possible as this would appear, at least in the short run, to save costs, time and effort. It is clear that project categorisation is a matter of discussion, sometimes heated, and even negotiation between the arranging bank and the bank charged with social and environmental credit risk assessment, not only among the Equator Banks themselves, but also between the Equator Banks and the sponsors.

Differences of opinion are demonstrated by the fact that it is sometimes necessary for an Equator Bank to combine resources from disparate areas of the bank to form oversight committees. An Equator Bank indicated to us that sometimes disagreement between the arranging banker and the risk assessment unit about the correct categorisation of a project or the decision to fund or reject a project was referred to the board of the bank or a standing committee or to a special committee set up to deal with such disputes.

It would be unrealistic to think that the Equator Banks and non-Equator Banks are not in competition with each other for business. Sponsors and project finance bankers no doubt put pressure on those carrying out the Equator Principles assessment, but, as far as we could ascertain, this takes the form of legitimate pressure of parties with justifiably different viewpoints and agendas, rather than corruption of the aims and objectives of the Equator Principles.

By contrast, we are aware that it is the practice of some public bodies to upgrade, rather than downgrade projects where there is doubt about the correct categorisation of a project, as where there is any doubt it is useful to take a precautionary approach to categorisation. Some participants found this claim rather hard to swallow and point out that this contradicts IFC experience.

This precautionary approach to categorisation, in our view, has some merit. It underlines the Equator Banks' commitment to the spirit of the Equator Principles, as well as the letter of the Equator Principles, and should help insulate the Equator Banks against unjustified criticism from NGOs and other stakeholders. Understandably, public bodies do not have the same commercial pressures as private entities, for which the consequences of category upgrade could include increased cost for the sponsors and delay to the project. Nevertheless, erring on the side of caution would seem appropriate when carrying out project categorisation in those few cases where there is genuine confusion about the correct categorisation of projects.

Scott Wilson and Environmental Resources Management (ERM) have indicated that the categorisation of projects can rely on false distinctions and that there is evidence of a need for specialist knowledge especially for categorising social risk or impact. Where social risk is overlooked, some projects with a relatively low environmental impact but high social impact are being categorised as 'B' or even 'C' projects, even though the social impacts of such projects mean that it would be more appropriate to class them as Category A projects. Though mature sponsors may have come to appreciate through experience the cost of failing to address social and environmental concerns adequately at the right time, this is unlikely to always be the case with all sponsors and even among mature sponsors, memories can be short.

In addition, the experience of certain projects such as the Newbury bypass indicates that consultation should be carried out even on projects in high-income countries. Such consultation could take the form of a requirement for an EA, a public enquiry for land acquisition or simply notification of local people of project details.

It also appears that some Equator Banks may use controversial projects such as the BTC Pipeline in order to benchmark 'high' risk projects. This inevitably will lead to under-categorisation on the basis that few other projects will have such profound impacts and thus if the BTC pipeline is viewed as the Category A benchmark, not many other projects can be Category A projects. Projects also risk being subjectively benchmarked against Equator Banks' first Equator Principles projects rather than against industry standard norms. Such tendencies will be less prevalent as Equator Banks become more adept at categorisation and rely more on external advisers during the categorisation process.

Due diligence

Project sponsors and their advisers may work on a project for years before seeking external funding from banks or public bodies, so by the time finance is sought, many of the key decisions, such as the route of a pipeline, may have been made. The ability of lenders to alter the shape or direction of a project thereafter generally will be limited. Nevertheless, due diligence must be taken extremely seriously in light of the requirements of the Equator Principles and the potential lender liabilities[113].

A possible effect of the Equator Principles may be that appointment as financial adviser to sponsors may call for detailed knowledge of how the Equator Banks and non-Equator Banks approach due diligence. Alternatively, the sponsors may engage a shadow arranging bank earlier in the development or planning of a project to advise on whether the project is being structured in an Equator Principles-compliant manner. An Equator Bank may be keen to perform this role if it were likely to influence its subsequent appointment as an arranger. Knowledge that failure to satisfy the Equator Principles requirements may seriously limit the chance of syndication should have the salutary effect of prompting both the arrangers and the sponsor to test thoroughly the robustness of the project against the Equator Principles.

Scope of due diligence

What due diligence should the Equator Bank do? If lenders are relying on studies prepared for or by sponsors, it is crucial to examine the scope of the due diligence carefully to ensure that all relevant environmental and social issues to which the project gives rise are examined and that the consultant or company carrying out the assessment has had sufficient time and resources to carry out the assessment properly.

From our own experience and from evidence provided to our survey, it is clear that sponsors frequently expand the scope of due diligence to seek to fill in gaps in assessment as issues such as displacement of indigenous people or the watering grounds of protected species of birds, emerge through the consulting process with stakeholders and specialist committees. This ‘suck it and see’ approach may not be enough for either the sponsor or the Equator Banks. It is equally important to ensure that the scope of work of the lender’s consultant is appropriate in light of that review. Repeating a desktop study or other study that suggests the need for further or intrusive works merely compounds error and will lose the confidence of stakeholders if not addressed and may trigger political risk.

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[113] Please see Annex II.

There may be an urgent need for advice from social or environmental consultants, but work quickly commissioned without due consideration of the issues and how to address them adequately or done superficially will merely lead to problems for the project further down the line.

The lenders' technical adviser will owe a duty of care to them and perhaps to subsequent participants in the financing (at least those who participate in primary syndication). The scope of work of the lenders' technical adviser will include a detailed review of the information provided by the sponsor to the sponsors' technical adviser and the methodology adopted by it in preparing any reports and analysis on which the project relies. Information warranties in the loan documents will back this up.

Lenders may not feel comfortable in relying on the sponsors' adviser, even if the sponsors' adviser owes them an express duty of care. They will want their own adviser who is less susceptible to the pressure that an influential sponsor can exert on a sponsor. The scope of works of the lender's technical adviser should clearly spell out what the environmental and social consultants have undertaken to carry out, the works the consultant has not undertaken and explain why such works have or have not been undertaken. If further works are undertaken later (for example, a site visit to clarify an apparent problem or intrusive works carried out), this should be clearly recorded in writing and the scope of works amended accordingly.

> 'We do depend quite a lot on information that is supplied to us by the sponsors of projects and I do not think there is any way of saying otherwise. They are responsible for it, they have most of the information available, and we do rely to a large extent on what they provide us being fair and accurate. I think the issue for us at the outset is to be satisfied with the credentials and reputation of the sponsors of the project. That is a key issue for us. Are these companies experienced in this area? Can we rely on the information they give us? We have to rely to a large extent on the advice we get from them. Our way of verifying and checking as far as we can that that information is correct is through the use of independent advisers...but hopefully that combination of sponsors who know what they are doing and have a good track record and whose information we can trust, plus independent expert advice, is the best compromise.'
>
> John Weiss, former Deputy Chief Executive of ECGD[114]

NGOs and governmental inquiries have questioned to what extent Equator Banks should rely on the work done by the sponsor or the advisers to the

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[114] Evidence given to the Trade and Industry Committee (TIC), Tuesday 16 November 2004.

sponsor[115]. There is a degree of cynicism among some NGOs as to whether sponsors are being wholly truthful in their disclosures about projects and whether their advisers are truly independent and objective; a cynicism that is perhaps fuelled by whistleblowing or an apparent or perceived tendency on the part of sponsors to drip-feed information about technical or contentious aspects of projects. We recognise the force of these criticisms, as there clearly have been instances where information has been drip-fed by sponsors and there are a number of examples of former employees or consultants disclosing defects in project assessment or specifications.

However, we agree with Scott Wilson that the drip-feeding of information or the apparent withholding of information by sponsors is rarely, if ever, due to evil intent. It often arises from a failure on the part of a sponsor or groups of the sponsor's team to appreciate fully the importance of the information or tight time pressures imposed on those producing social and environmental impact assessment reports by those charged with delivery of the project to a timetable imposed for other reasons. This is a criticism that can be levelled at all EA systems that rely on sponsor-sourced material, which is certainly the case in the EU and in US. The difference, the NGOs might say, is that a public authority that is politically responsible reviews those systems, whereas that is not true in the case of a private sector bank. On the other hand, assessment by the Equator Banks of the social and environmental impact of a project where there is no public authority or legal requirement to carry out an EA may be the only social and environmental assessment that will be carried out.

However, it is also true that sponsors or lenders sometimes like to have funding from a bilateral or multilateral lender or an export credit agency as a form of legitimisation of the project and this would involve clearance under the lending policies of the relevant institutions.

A sponsor of a major project must decide which, among possibly a significant number of internal and external reports, should be disclosed. In our judgement, however, generally it is better to make a 'warts and all' disclosure: if in doubt, disclose. By doing so, the sponsor may be able to put any dissenting expert reports in the context of other supporting expert reports. This will not only provide a proper context for the dissenting report but full disclosure of all relevant reports will hopefully promote trust in the

[115] This question was addressed by the TIC in their report on implementation of the ECGD's Business Principles, 8 March 2005, in the context of evidence given by the Baku Ceyhan Campaign.

integrity of the sponsors by regulators, lenders and stakeholders[116]. Equally, it may be circumstantial, but our experience and the experience of environmental consultants indicate that relevant information is rarely withheld intentionally by sponsors but is not provided at the appropriate time because of genuine failure to recognise its importance.

Sponsor and lender capacity

> '[Equator Banks] 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.'
>
> Equator Principles

> 'Sustainable economic performance is the prerequisite for any constructive business engagement in society. There is no point in being penniless and full of values.'
>
> Gary Steel, Executive Vice President and Head of Human Resources, ABB[117]

The capacity of sponsors to deliver a project not only on time and to an agreed price but also according to the environmental and social requirements of the Equator Principles, was stated by banks, multilateral lenders and public bodies during the survey as being of the utmost importance for sponsors and Equator Banks. For example, Calyon indicated that its priority, second only to training in implementation of the Equator Principles, has been increasing its ability to assess sponsor capacity to address social and environmental impacts[118].

Social issues

Amec pointed out that it is wrong to view social issues in isolation from environmental considerations, as environmental effects that lead to social impacts are sometimes even more problematic (eg land and resource use effects that can change local economies and emissions or waste that can have short- and long-term health effects).

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116 A distrust of project sponsors and consultants can be seen, for example, in respect of the NGO assessment of the BTC pipeline coating and the suitability of the material chosen. In their evidence to the TIC, the UK Export Credit Guarantee Department (ECGD) stated that BP had not provided them with a copy of the Mortimore report on the pipeline coating and that ECGD was not aware of its existence. BP had a range of expert views of which this report was one and the advisers to ECGD were satisfied as to the technical quality of the coatings.

117 2004 Business and Human Rights Seminar, London, 9 December 2004.

118 'Putting Principles into practice', *Environmental Finance*, June 2004.

Nevertheless, while accepting Amec's point that social and environmental issues may be closely interrelated and that few environmental effects may have unexpected and undesired impacts on the local community or society, it must be said that project assessment is particularly problematic when dealing with non-environmental assessment, such as the assessment of social, human rights, cultural, political and other impacts.

In the world of industry and finance (excluding oil and gas), if not elsewhere, assessing non-environmental impacts is difficult because of the comparatively 'soft' nature of the issues being assessed, the absence of agreed standards or unified approach to assessment of these issues, as well as a lack of established recognised experts working in the area. There is also, according to NGOs, a western-developed economy bias in the Equator Principles and a resulting absence of tailoring the regime to the specific needs of developing countries in Africa, Latin America, Asia and central Asia.

Even for relatively 'hard' issues, such as legal compliance, there can be differences of view, approach and interpretation. Compliance with law is not always clear, as the governing law may be opaque or subject to derogation or qualification or international framework agreements. This is further complicated where the decision is made, often for the best of reasons, to apply a legal regime other than that normally applicable in the host state to the project. For example, environmental law in the host state may be less developed or more developed than EU law, and the sponsor or the banks may decide to apply the latter instead. This may present real difficulties in that local regulators may be unfamiliar with the requirements of the 'exotic' regime applied and may be inadequately equipped to determine compliance anyway. There are also difficulties in ensuring that nomination of such an apparently stricter regime or a more lax regime in one field protects the project and its participants against allegations that other legal rights in the host state have been overridden or prejudiced. The BTC pipeline, for example, benefits from derogation from national laws[119] and international framework agreements, and has been subject to legal action.

Some aspects of the Equator Principles, such as EA, have been in place for decades and a number of agreed standards and practices have grown around them. Therefore, to a certain extent, it is possible to advise with a large degree of certainty whether there is compliance or non-compliance with local requirements and as to the accuracy of the impacts predicted. A number of lenders have also developed practices for environmental assessment that over time have become sophisticated and well entrenched.

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[119] Although EU environmental standards are applied.

For example, EKF (the Danish ECA) has established a complex system of project classification, environmental assessment, supplementary investigations for potentially more damaging projects and public consultation[120].

Again, this is not the case as far as social, political and human rights impacts are concerned, and the need for improvement in practices in these areas is widely acknowledged by the Equator Banks. This is particularly important for developing countries. Similarly, Western concepts of land ownership and property rights might not be easily transplanted to social systems based on customary, communal or state property rights or to countries without a well-developed system of registration of interests in land.

Environmental assessment is reasonably well established and understood. However, social impact assessment (for example in respect of displacement of indigenous people, labour relations or human rights) is not so well established or understood[121]. Reference has been made above to the difficulty of assessing social impacts. This difficulty stems from several factors:

- first, while there are some general trends to be discerned, social impacts are highly case-specific;
- secondly, social impacts may involve cultural understanding not shared by sponsors or lenders and can be exceptionally diverse;
- thirdly, such impacts are difficult to predict;
- fourthly, we would argue that there is no universally accepted standard methodology for carrying out assessment of social impacts, although our opinion may not be shared by international lending agencies or social consultants; and
- lastly, social impacts, even when they can be identified with confidence, are not self-contained, but may themselves have secondary environmental effects.

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[120] www.ekf.dk.

[121] *Banking on human rights: confronting human rights in the financial sector*, September 2004, EPC Asset Management and KPMG.

These difficulties are not limited to the private sector. The IFC's Compliance Advisor/Ombudsman has identified[122] the assessment of social impact as a shortcoming of the operation of the IFC's Safeguard Policies. Even the Ombudsman's comments, however, were confined to bemoaning the relatively small number of social issues governed by Safeguard Policies (involuntary resettlement, cultural property and indigenous peoples, with the later addition of child and forced labour). The Ombudsman recommended the treatment of additional aspects, such as gender issues, ethnicity, social structure and community health. The report, however, also recognised that even the IFC was deficient in 'social specialist capacity', with the result that there is a danger that, even were the additional issues to be considered, the quality of the assessment may not be improved[123].

Human rights and anti-corruption

> 'This is our work for the next year.'
>
> Jon Williams, HSBC

> 'There is a need for the Equator Banks to develop human rights and anti-corruption policies based on UN Norms and the Extractive Industries Transparency Initiative.'
>
> Steve Waygood, Insight Investment

Scott Wilson states that commercial projects involve a substantial number of possible human rights and corruption issues. Project sponsors must observe international labour standards including those contained in the 'core conventions' of the International Labour Organisation (ILO). Equator Banks need to bear in mind laws to protect the rights of pregnant women and new mothers, to guard against child labour and forced labour, including prison labour and debt bondage as well as laws to prevent sexual discrimination in the workplace. Unlike in most developed countries, the legal or governance framework may not be sufficiently robust to guard against these practices. It is quite wrong to assume that human rights abuses begin outside the borders of the US or the European Union.

Amec adds that a more frequent impact relates to the differential effects between men and women due to different 'roles'. The result can be greatly

122 Compliance Advisor Ombudsman, *A review of IFC's Safeguard Policies*, IFC/MIGA, Washington DC, 2003.

123 Several such social impact assessment specialists are Aidenvironment (www.aidenvironment.org); Congo Consulting (www.congoconsulting.com); Maplecroft Consultants (www.maplecroft.net); Amec (www.amec.com); and Scott Wilson (www.scottwilson.com).

diminished participation in project planning (unanticipated impact risks and ineffective investigation) and benefits. It is both a governance and equity issue.

Scott Wilson observes there is still a perception that asking questions about human rights issues such as labour standards should be confined to developing countries, but that perception is wrong. In the case of one of the largest construction companies in Europe working on an infrastructure project in a EU accession state, it was found that current European health and safety procedures were not being carried out on site. The response to this finding was that construction practices had already improved. It turned out that practices had only been brought into line with UK standards of the early 1990s. Such breaches have also been alleged regarding construction sites in Athens for the 2004 Olympics[124].

Another important human rights consideration is that major projects often involve the use of compulsory land purchase mechanisms in the host state, but these mechanisms may not reflect international human rights expectations as to the adequacy or timeliness of compensation. FoE (UK) observes that such mechanisms may be applied in a discriminatory manner in practice, for example to systematically prejudice an ethnic minority community. They may operate particularly harshly against indigenous peoples or recognisable groups of people which are vulnerable if not indigenous people, either as part of a policy of cultural harmonisation or merely because communal rights are not recognised as property for the purpose of compensation.

The difficulties of operating in ‘conflict zones’ and the impact that this can have on a bank’s reputation and its ‘licence to operate’, even if it is not directly supporting anyone in the conflict, should also be taken into account. A good example of the risks associated with this, according to FoE, is Barclays’ financing of the Thai-Malaysia gas pipeline where it was unaware of both the Thai government’s violent suppression of Muslims in the south of Thailand where the pipeline was being built and the findings of the Thai Human Rights Commission.

It is worth noting that BP developed a new Human Rights Impact Assessment procedure[125] for the Tangguh Indonesian LNG plant project. Independent legal counsel advised BP on this procedure, and the Tangguh

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124 ‘Safety lacking as Greek building booms ahead of Olympics’, *Agence France Presse*, 15 July 2003.

125 Reviewed by Foley Hoag LLP (www.foleyhoag.com).

Independent Advisory Panel has reviewed the impact on human rights and other aspects of the project on a procedural basis[126].

BP has also established the independent Caspian Development Advisory Panel (CDAP) in order to monitor BTC and other related BP activities in Azerbaijan, Georgia and Turkey. The CDAP has an advisory role, but will have no executive authority or responsibility over the project, though it will report to the BP Group Chief Executive.

The CDAP has made more than 100 different recommendations in order to help ensure that BTC and related projects serve as a template in the future for major investments in developing and transition countries by multinational companies in extractive industries. These recommendations have included that BP and BTC establish an ombudsman in each host country and a special human rights co-ordinator to implement, co-ordinate and monitor human rights commitments related to the projects and to interact with all key stakeholders, including host governments and non-governmental organisations[127].

Human rights concerns may be far-reaching and take unexpected forms. A common source of exposure lies in the oil and gas industry in the use of local security personnel whose use of physical violence, although unremarkable in the host country, would be regarded as unthinkable under human rights expectations in the home state of the lender. BP has also entered into voluntary principles on security and human rights which they have applied in both the BTC pipeline project and the Tangguh gas project in Indonesia.

It is also encouraging that the Azerbaijani government, the state oil company and foreign oil companies, including BP, signed a Memorandum of Understanding in Azerbaijan in 2004 under the Extractive Industries Transparency Initiative. This sets out the process under which revenues to the government from energy companies will be disclosed.

These important innovations and developments by BP should be recognised fully as BP and the other sponsors of the BTC pipeline and the lenders to the BTC pipeline projects have been subjected to widespread and often unfair criticism over the assessment and management of the BTC pipeline project.

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126 cf Tangguh Independent Advisory Panel Reports of 2002, 2003 and 2005 and *Insight Investment Investor Responsibility Bulletin*, Spring 2004.

127 'Caspian Development Advisory Panel releases report on Turkey' and 'Project-related security and human rights issues in Azerbaijan, Georgia and Turkey', 17 December 2003, www.prnewswire.co.uk.

Monitoring

Where there is an EMP, the bank that has responsibility for the Equator Principles will receive information from the borrower and other project participants and will be expected to monitor the construction and operation of the project. This gives rise to a number of issues, such as the desirable frequency of monitoring and whether other banks are to rely practically and legally on the Environment Bank to implement their obligations under the Equator Principles fully. In the words of one consultant we interviewed, monitoring is the 'true Achilles heel' of the Equator Principles.

With a few exceptions, including the Chad–Cameroon pipeline project, there is no effective third party monitoring or supervision of environmental and social management plans. All the consulting money is spent 'up front', whereas environmental and social impact occurs on implementation, whether this is a resettlement or construction of infrastructure. The only organisation that the consultant we spoke to was aware of which had a consistent programme for third party monitoring was the Inter-American Development Bank's Private Sector Department (IDB PRI).

Internal processes

> 'Bank experience confirms that systematic supervision and monitoring are fundamental to the successful implementation of projects, and EMPs in particular.'
>
> World Bank[128]

The adequacy, in light of the Equator Principles, of existing internal processes for receiving and assessing information and reporting up the line to senior decision-makers should be reviewed. Processes already in place for financial and other traditional commercial information may need to be tailored for handling Equator Principles information. It is also necessary to ensure that the person who receives the environmental or social information has the requisite expertise to handle it or is aware of and has ready access to external sources of such expertise. In BankTrack's latest report on the Equator Principles, they identify a number of areas that should be addressed in order to ensure proper Equator Principle compliance[129].

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128 *World Bank environmental assessment sourcebook: update on environmental management plans*, 1999, p 5.

129 *Unproven Principles – the Equator Principles at year two*, appendix 2. These include initial environmental review; policy development; organisational structure and personnel; environmental procedures and safeguards for transactions; documentation; internal information and training; external reporting, consultation and consent; auditing; monitoring and corrective action; and management review and improvement.

Banks should consider whether they wish to be in the position of having the right to force the borrower to remedy pollution or contamination. If banks do wish to have such a right and fail to exercise it, then potential liability for ‘knowingly permitting’ could arise. In jurisdictions such as the UK and India, legal liability may arise when a person ‘knowingly permits’ pollution, because that person is informed or may be said to have constructive knowledge of pollution in addition to having the power to prevent it re-occurring or continuing. The more information that banks require or possess about pollution, contamination, environmental harm or damage, the greater their potential exposure to liability for knowingly permitting, where they have a right and not necessarily a duty to act but fail to do so.

In human rights terms, the use of the concept of ‘complicity’ in, for example, the UN Global Compact and its extension to ‘direct’, ‘indirect’ and ‘beneficial’ complicity is equally important to the reputation, if not yet legal liability, of banks. There may also be similar or analogous liability triggers, such as shadow directorships, principal/agency relationships, complicity in the acts or omissions leading to the pollution or failure to act to protect against or prevent pollution or complicity in human rights abuses. There is a risk in such cases that information will be received by Equator Banks, but not acted upon, or that the actions taken will be inadequate or unnecessarily delayed and that inaction may, in certain circumstances, lead to an allegation of liability for the Equator Banks. It is therefore important that there should be a clear chain of communication within the bank discharging the Equator Principles function (the Environment Bank), and that a senior officer within the Environment Bank should supervise information assessment and communication within the Environment Bank itself and within the syndicate of banks. This should be an ongoing process.

However, we do not wish to appear alarmist as there are a number of general reasons why banks are not usually held liable for knowingly permitting pollution or human rights abuses. These are set out in detail in Annex II.

We must stress that the question of responsibility for pollution and for human rights abuses is very complex and we do not seek to give any more than some illustrative points rather than to discuss these matters in depth.

In sum, legal liability of a bank for knowingly permitting pollution or complicity in human rights abuses arising from a failure to exercise rights in loan documentation is possible but unlikely. Exposure to potential liability is more likely to arise when a bank takes enforcement action by taking possession of the land or project or where a receiver or administrative receiver seeks intervention. However, even these possible exposures may be reduced or limited by devising and implementing appropriate processes and protocols within the bank to ensure that rights of foreclosure or to take possession are properly controlled and that receivers are appointed on terms that protect the bank.

Whatever the answer to the question of potential legal liability of the lenders, where a loan is syndicated, syndicate members will have to be confident that the Environment Bank (whether an Equator Bank or non-Equator Bank) nominated to ensure that the project is compliant with the Equator Principles is sufficiently robust to ensure that the reputation of each syndicate member is protected.

The Equator Banks may have to assess the monitoring data required by the EMP during the construction and operational phases of the project. It is not enough for the Equator Banks to receive the information and not assess it, or to receive reports that are stale, ie updates of the reports for the previous year only. Although, as one consultant pointed out, this does appear to be common practice and the same applies to monitoring of general undertakings given by sponsors.

Impact on sponsors

We have very little information on the impact of the Equator Principles on sponsors, although we have discussed this matter with a number of leading sponsors in the energy and extractive industries.

Of the sponsors we interviewed, a number welcomed the Equator Principles, because they provide greater certainty and consistency in the approach of the banks and in higher standard projects.

On the other hand, some sponsors are worried (especially regarding multi-stage or advanced projects) by the banks subjecting their projects to Equator Principles assessment late in the project development process. A number of sponsors (albeit a dwindling number) are also concerned about the time, effort and money involved in complying with the Equator Principles. Some projects are very sensitive financially regarding additional costs that can erode profits or the viability of a project.

Some sponsors, however (especially those in the extractive industries), have been effectively complying with similar requirements to those of the Equator Principles for some time and carrying out stringent environmental and social assessments. For example, despite criticism by NGOs, the BTC pipeline (led by BP but including a large number of equally mature sponsors) is in many ways a model of how to carry out such projects. Equally, however, there has been criticism of energy and natural resources and paper pulp companies and of banks for supporting projects that have arguably damaged the environment (in some cases irreparably) or have destroyed/adversely affected local communities or cultures.

The impact of the Equator Principles on sponsors is the subject of part 2 of our survey.

Transparency and accountability

> 'Greater accountability and transparency are required if banks are to have any meaningful dialogue with NGOs and project-affected communities; without these, banks' assertions that projects they finance are in compliance with the Principles will not be seen as credible.'
>
> Greg Muttitt, Researcher, Platform

> 'What good is a series of principles like this if you can't verify that they are being applied on a project-by-project basis … Equator Banks are saying to people 'trust us', but not allowing any independent verification. That's a problem.'
>
> Steve Kretzmann, Oil Change[130]

The IFC has developed a sophisticated disclosure policy (IFC Policy on Disclosure of Information), some of which relates specifically to environmental disclosure. This does not form part of the Equator Principles and is subject to the current IFC consultation and review. One of the main NGO criticisms of the Equator Banks, therefore, relates to lack of transparency. NGOs would like to see: more extensive disclosure of projects for which lending is refused on Equator Principles grounds; how the categorisation criteria are applied; and to what degree public consultation was carried out. There is some risk for the banks in accepting greater transparency. NGOs have a marked tendency to attempt a 'divide and conquer' approach to banks, where, if one Equator Bank discloses information on how it applied the Equator Principles, it exposes itself to the risk that a competitor may choose not to disclose, rendering itself more attractive to potential borrowers.

NGOs and banks have raised two key transparency issues; the transparency of decision-making and the potential conflict between transparency and the duty of confidentiality owed by banks to their clients[131].

Transparency of decision-making

In general, commercial banks are bound by strict confidentiality rules on protecting information provided by their clients. NGOs, however, have criticised the Equator Banks for their failure to explain why they have supported or declined to support specific projects. In part the push for greater transparency appears to be based on a failure to understand fully the difficulties in terms of confidentiality requirements imposed on banks. The Equator Banks, however, suspect that the NGOs are seeking to create a no-win situation in which, if an Equator Bank declines to support a project, it is inferred that the Equator Banks which do support it are acting contrary to

130 *Time* magazine, 9 May 2005.

131 Please see Annex II for a more detailed discussion of lender's liability.

the Equator Principles. It is clear, for example, from the criticism of the Equator Banks that supported the BTC project that NGOs compared their decision to support the project unfavourably with the decision of the Equator Banks that declined to do so.

This raises the important question: is it legitimate for Equator Banks to disagree among themselves as to whether a specific project is Equator Principles-compliant or the appropriate degree to which there should be transparency in Equator Bank decision-making? A number of justifiable reasons for such disagreement can be identified.

- The Equator Principles are general rules that do not eliminate discretionary action or the need for interpretation by the banks. Therefore, it is perfectly possible for Equator Banks to disagree about the environmental and social impacts of a project without doing violence to the Equator Principles.

- There are many reasons other than breach of the Equator Principles why a bank may decline to support a project. For example, maintenance of solvency ratios, over-concentration of investment by the bank and hence of greater risk in certain sectors and concerns about borrower capacity or political risk can be just as important in contributing towards the final decision as environmental or social risk considerations. The Equator Principles, therefore, are an important factor, but not the only factor in a bank's decision to support or decline to support a specific project.

- The issue of client confidentiality as discussed below.

- It is primarily for the sponsors and not for the banks to disclose information about sponsors' projects. Sponsors have better and more detailed information than banks and it is for the sponsor to explain the project to its stakeholders, rather than for the banks to take on this responsibility.

- Time and experience must also be factored in. Almost the converse of a reluctance to be over-exposed in a certain sector is that banks which have greater exposure to a certain sector will be able to make more informed decisions in a shorter time than banks which have less experience of and exposure to that sector. This also applies to experience of, and exposure to, borrowers. Banks with a long history of supporting specific sponsors in specific industries and in projects of a certain kind in certain areas will be able to take a view of a sponsor's capacity to carry out a project of that type more successfully and responsibly than banks who have had no track record with that sponsor.

A number of banks have indicated to us that a requirement for transparency of decisions made on applications for specific projects may not be meaningful or provide NGOs with the information they want or need in any case. Banks may suggest to potential borrowers in informal pre-application discussions that applications by a sponsor, if made, would be rejected. Banks may also make it clear that they will not support certain types of projects or projects in certain geographical areas or industrial sectors.

We have concluded, nevertheless, that in general it is important for banks to address concerns of stakeholders regarding transparency of decision-making and for them to be as transparent as is consistent with their duty of confidentiality to their clients. For legal and practical reasons, it is difficult to see how, in line with confidentiality requirements, the banks should make disclosure in respect of any specific project, but we can see merit in very general disclosure of support for or failure to support types of projects by Equator Banks. This is not just because of issues of confidentiality for any particular client or one project, as the reasons for rejecting applications tend to be complex and multifaceted commercial decisions and are very rarely limited to just one ‘deal-breaking’ factor (such as environmental non-sustainability).

One of the interviewees in our survey agreed that there might sometimes be a conflict between the issues of transparency and client confidentiality. In his view, Equator Banks should seek to maximise the degree of transparency in their own reporting while showing due regard to client confidentiality. He also supports the principle of Equator Banks advocating maximum transparency on the part of project sponsors, particularly in relation to disclosure of EMPs. Scott Wilson suggested that Equator Banks should disclose EMPs on their websites and insist that sponsors do likewise.

We believe that the Equator Banks ought to develop a consistent system of disclosing derogations from the Equator Principles. Disclosing and explaining derogations from the Equator Principles, where possible, would take away the shroud of mystery currently surrounding project financing and may render banks less exposed to stakeholder criticism.

The reason for the generality of the Equator Principles lies in their gestation and early development. In common with many negotiated documents, agreement on the Equator Principles was achieved partly by avoiding a high degree of detail on some points, leaving a margin of discretion in interpretation and implementation and enabling the general principles to be interpreted on a case by case basis. A necessary consequence is opaqueness and a resulting uncertainty as to how the Equator Banks reach their decisions in particular cases.

In addition, the Equator Principles are relatively new and the sponsors, banks and stakeholders are only just coming to terms with how they should interpret and implement them. Over time, it may be necessary to formulate some rules to reduce uncertainty and to eliminate unnecessary discretion in implementation, although elimination of these differences in the exercise of discretion is unlikely. Some banks – Citigroup for instance – have begun internal auditing of compliance with the Equator Principles[132]. We see this as a positive development that should become industry practice.

The ECAs have their own disclosure rules. A key feature of the business principles of the Export Credits Guarantees Department (ECGD) in the UK, for example, is its commitment to transparency in its operations and decisions[133]. The ECGD 2003-2004 Annual Review speaks of ‘increasing transparency’, which would be achieved by applying the following rules.

- For ‘high potential impact cases’, the ECGD posts on its website, with the exporter’s consent, brief information about the project including the project name, its location, a very short description of the project and the source of environmental information (usually the project sponsor’s name, address and a link to their website). The general target is to carry out this posting at least 60 days before making the underwriting decision.
- In compliance with the OECD Common Approaches, the ECGD states that it expects project sponsors to ensure that EAs have been in the public domain for at least 30 days before the ECGD makes its underwriting decision.

It should be noted, in addition, that under the Freedom of Information Act[134] and other regulations, the ECGD must disclose any information if requested, unless it falls under certain exemptions, including the convention

[132] As reported in BankTrack, *Principles, profits or just PR – triple P investments under the Principles,* June 2004.

[133] TIC evidence, 16 November 2004.

[134] As of 1 January 2005, the Freedom of Information Act 2000 and the Environmental Information Regulations 2004 apply to the ECGD, which means it is obliged to disclose any information requested within 20 working days, unless the information falls under certain exemptions. For further information, see www.ecgd.gov.uk/foi_letter_to_customers.pdf.

that the advice of a government department to a minister should remain confidential[135].

Transparency and client confidentiality

While pressure by NGOs for increased transparency is understandable, there are professional and legal constraints on Equator Banks that simply cannot be ignored. Private banks are not in the same position nor accountable in the same manner as the IFC or EBRD, which have important social and political objectives and mandates. In some jurisdictions (Germany for one), it is a criminal offence to disclose confidential information and, in most jurisdictions, disclosure of client confidential information would be likely to amount to (at least) a breach of professional obligations and to attract disciplinary action by professional bodies. In any event, it is more likely that banks will choose only to disclose information which they are required by law to disclose and will protect zealously the commercially confidential information of their clients.

A potential way forward may be for banks to disclose the number of applications approved or rejected, but not to name applicants. Thus, in its 2003 annual report, HSBC states that in the future it will report summary numbers for the total value and volume of project finance deals booked, broken down by category. A number of survey participants agreed with this position, stating that, while they would be happy to disclose the number of deals closed, they would be reluctant to reveal the reasons behind their decision to finance a project or to reject a loan application. As discussed above, this is not just because of issues of confidentiality; the reasons for rejecting applications tend to be complex and multi-pronged commercial decisions and are very rarely limited to just one 'deal-breaking' factor. Furthermore, any disclosure that would not address this issue during the decision-making process would be meaningless at best.

Accountability

> 'There is no compliance mechanism and this is a very serious weakness.'
>
> Patrick McCully, Campaigns Director, International Rivers Network[136]

[135] In the TIC report on the implementation of the ECGD's Business Principles, it recommends that in future the department be more transparent.

[136] 'Loan rules with an eye to nature', *International Herald Tribune*, 5 June 2003, www.equator-principles.com.

> 'One of the key weaknesses of most corporate-led voluntary initiatives is the lack of accountability in implementation mechanisms. This may be the fatal flaw of the Principles.'
>
> Michelle Chan-Fishel, Friends of the Earth[137]

> 'BTC was really a poster child for the Principles… We think it was a real success for the Principles because the banks were able to make themselves comfortable with the issues and deal with them.'
>
> Suellen Lazarus, formerly of the IFC[138]

> 'Implementation alone of the Equator Principles may not be enough to satisfy stakeholder concern. How will financial institutions assure stakeholders that adequate systems and processes have been implemented to ensure the principles are being credibly and consistently adhered to?'
>
> James Stacey, KPMG

A positive trend can be observed among non-Equator Banks, who often choose to justify their decision to lend along Equator Principles lines. The BTC pipeline project offers a useful case study. Faced with an almost unprecedented level of criticism by NGOs and other stakeholders on their decision to support the BTC pipeline project[139], a number of Equator Banks and non-Equator Banks disclosed[140] the reasons why they decided to support the BTC pipeline project for the first time.

The high degree of public disclosure by the Equator Banks and non-Equator Banks, though atypical and triggered by NGO and public pressure, is

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137 'Banks sign up for responsible lending accord', *Financial Times*, 4 June 2003, www.equator-principles.com.

138 'Putting Principles into practice', *Environmental Finance*, June 2004.

139 In its report, *Principles, profits or just PR – triple P investments under the Principles* June 2004, Banktrack, for example, suggested that the project continued 'virtually unaltered' in spite of the adoption of the Equator Principles. Furthermore, in June 2003, 72 human rights and environment groups from 29 countries called for a moratorium on the BTC pipeline, arguing that it would worsen the human rights situation along the pipeline route, and that a background of lack of freedom of speech in the region made proper consultation impossible (www.bakuceyhan.org.uk/press_releases/ news08.htm).

140 For a copy of ABN AMRO's press release of 10 December 2003 explaining the reasons for its participation in the project, see www.abnamro.com/com/about/data/abnamro_btcpipeline.pdf. The BTC legal documents are available at www.bakuceyhan.org.uk/links.htm.

understandable in light of the Equator Principles. ABN AMRO thought it necessary to explain publicly why it decided to participate in the BTC pipeline funding and carried out environmental/social due diligence accordingly. Citigroup also exhibited a high degree of transparency (including its independent review) about making the decision to lend to this project.

The surprising aspect was that a number of non-Equator Banks chose to disclose in a similar fashion. Société Générale, one of the joint arrangers in the financing of the BTC pipeline project and a non-Equator Bank, justified its decision to participate in the syndicate because independent consultants and a number of multilateral organisations, such as the IFC and the EBRD, had externally assessed the project. In addition, public bodies with extensive experience in the field and extremely high environmental, social and human rights standards were also involved in funding the project[141].

Similarly, Insight Investment (Bank of Scotland's fund management arm) organised meetings between sponsors, lenders, institutional investors and NGOs to discuss human rights, environmental impacts and legal issues relating to the BTC pipeline. Although the high degree of transparency experienced in the BTC case is atypical, it is indicative of a trend among both the Equator Banks[142] and non-Equator Banks towards greater transparency[143].

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141 Société Générale Sustainable Development Report, 2003.

142 See, for example, HSBC's Sustainability Report 2004.

143 The question of accountability and transparency also applies to public bodies such as the ECGD. cf TIC report on Implementation of the ECGD's Business Principles, 8 March 2005.

Loan documentation issues

Adoption of the Equator Principles effectively requires the Equator Banks to review their loan documentation package in light of the wider social and environmental assessment, monitoring and enforcement obligations that apply. The Equator Principles, however, are voluntary guidelines adopted by Equator Banks. It is therefore inappropriate for lenders to oblige borrowers to comply with them. It is competent and desirable for lenders to require borrowers to comply with the EMP and environmental laws (defined as is appropriate to each case to cover social and environmental laws of the host country and transnational and international legislation, conventions and treaties dealing with the environment, employment, health and safety and human rights) and the policies and guidelines of the World Bank and IFC that underpin the Equator Principles.

Definition and derogation

From the survey and in our experience, it is market practice that to the extent it is used at all in loan documentation, the definition of the Equator Principles is taken from the current published version at financial close. However, this practice may create a tension between the expectation of NGOs and other stakeholders that the Equator Banks will implement the Equator Principles as they evolve, and the need of borrowers for certainty.

Another important issue is whether Equator Banks will entertain borrower requests for specific derogation from the policies and guidelines of the IFC. If Equator Banks follow the IFC and allow exceptions to the Equator Principles, this presents interesting questions of principle, implementation and transparency.

Environment Bank

Almost without exception, at least in our view, one of the Equator Banks in the syndicate should take the role of Environment Bank. The loan documentation should expressly provide that the role of Environment Bank is not delegable to a non-Equator Bank as the Environment Bank role entails onerous assessment, monitoring and enforcement obligations as a means of managing the reputational risk to which the Equator Banks are exposed. However, our survey indicates that this is not always the case. BTC is the prime example of Equator Banks led by a non-Equator Bank on social and environmental assessment, monitoring and reporting. Although there has been no suggestion that the bank in question has neglected to address the issues that an Equator Bank would address, it does look awkward.

Conditions precedent

Typically, all lenders would have to approve the conditions precedent before the borrower can draw under any facility. This should afford Equator

Banks the required degree of negative control if, for any reason, they were dissatisfied with the social and environmental aspects of a project.

Detailed conditions precedent are likely to include:

- certification by the borrower that the environmental representations and warranties are true and correct, possibly subject to a materiality qualification;
- copies of all (material) authorisations and approvals required to be issued by any governmental agency as part of any environmental compliance procedure under any applicable environmental laws;
- receipt of all of the environmental consultants' reports and other reports that will be required to address the adequacy of the environmental assessment process, the project categorisation and compliance with applicable laws and environmental and social policies and specified social and environmental laws, treaties, regulations and guidelines; and
- receipt of the EMP for the construction phase of the project.

In addition, for projects where the social impact is likely to be high, lenders might require as a separate condition precedent (or as an extension to the no material adverse event (MAE) condition) a confirmation that no social unrest event has occurred or is continuing. For this to be acceptable to sponsors, it would have to refer directly to the project and must have sufficient impact to threaten the existence of the project and last long enough to be reasonably likely to affect the timing of the implementation of the project.

Furthermore, one consultant argues there is a need for compliance 'conditions' to be attached to project loan agreement 'milestones' and related to EMP implementation issues. These conditions should be based on adaptive management with penalties for non-performance.

However, Amec disagrees, as in its view 'no social unrest' provisions may be an unreliable performance indicator. The issues, it suggests, are too dynamic and cause-effect relationships are too complex. The indicators need to be project-specific and proactive and frequent monitoring on site is required.

Representations and warranties

Our survey and experience indicate that specific provisions should be included under which a borrower represents and warrants (and where appropriate, repeats at relevant times) that:

- it has provided to the lenders all reports and (material) information on social and environmental matters in its possession or control;
- no environmental claims (defined, if thought necessary, to include social matters, such as claims of human rights abuse, or subject to being in writing or an appropriate level of materiality) have been commenced or threatened against it;
- it has developed, constructed and (if applicable) operated and maintained the project (or procured the same) in compliance with (i) the EMP and (ii) Environmental Laws[144] and (iii) the lenders' environmental and social policies and guidelines[145]; and
- it has in place robust and externally verified systems and processes for recording, reporting on and responding to grievances and complaints.

There will usually be some tension between the borrower and the lender over the nature of the compliance warranty. Equator Banks should be wary of diluting compliance warranties by the use of materiality thresholds (particularly the use of MAE or material adverse change (MAC) thresholds) as the more such warranties are qualified, the greater the risk of damage to reputation and the less straightforward enforcement becomes.

Nevertheless, the use of environmental hair triggers is not to be encouraged (indeed it may itself be a breach of the Equator Principles to do so) if this will accelerate unreasonably or unfairly repayment or call-in of the loan merely to protect the reputation of some of the lenders. Rather, enforcement should be subject to carefully drafted warning processes and remediation or default correction periods as the Equator Banks need also to bear in mind the potential risks of exercising step-in rights or taking other action to enforce their security over a project which is not environmentally compliant. This is because of the potentially greater likelihood of exposure to environmental liabilities, whether directly through the lender having taken control of the project or indirectly through contractual indemnities granted to step-in vehicles/receivers who take control on behalf of the Equator Banks, irrespective of whether they might be legally agents of the borrower. All of the Equator Banks may wish to have step-in rights, but no

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144 'Environmental Laws' may be defined to include the lenders' environmental and social policies and guidelines may be defined by reference to the underlying UN, ILO, WHO, World Bank and IFC policies and guidelines, with any derogation agreed by the Equator Banks.

145 This is a sensitive proposal, therefore it should be ensured that loan documentation contains provisions for borrowers to demonstrate that they have in place robust and externally verified systems and processes for recording, reporting on and responding to grievances and complaints.

bank enters into loan agreements with the expectation or hope that step-in rights will be exercised.

Undertakings

In addition to the general undertaking in the loan agreement to comply with all laws, a separate undertaking should be drafted that obliges the borrower to comply (or procure compliance) in all respects with (i) the EMP; (ii) environmental and social laws; and (iii) lenders' environmental and social policies and guidelines.

Borrowers may resist an obligation to comply with the Equator Principles on an ongoing basis for the reason that it is not for the borrower to comply with the Equator Principles but with the EMP. However, the same effect can be achieved if the obligation is cast as an obligation to procure compliance with the requirements of the EMP prepared (both for construction and operational phases) for the project. The EMP is required to reflect the requirements of environmental laws and the agreed environmental and social guidelines and policies of the lenders. EMP undertakings should also include obligations to prepare and deliver (in a satisfactory form, annually or more frequently if an environment-related default or social infringement, such as abuse of human rights, has occurred) an update of the EMP incorporating any changes to the project; and to periodically review the EMP and inform the relevant agent if any modification is required based on changes to the project.

The reporting obligations in the loan documentation should oblige the borrower to provide promptly all material information and reports provided to the borrower by the construction contractor, environmental and social consultants, and the operator under the respective EMP. The obligations should also require the borrower to inform the relevant agent of any environmental claim or social infringement claim against it which is current, pending or threatened; any circumstance that could reasonably be expected to trigger environmental liability, liability for breach of social protection laws, or to affect the borrower's compliance with environmental law and/or the EMP; and any facts or circumstances which are reasonably likely to result in any claim being commenced or threatened against it. Again, there will be some tension between borrower and lender as to the qualification of such undertakings which may be resolved either by ad hoc waiver of acts of default or by a more structured approach to default events.

Events of default

The loan agreement will contain a general event of default for failure to comply with the undertakings in the document. A separate default should be included for failure to comply with the borrower's undertakings relating to environmental matters, which would cover the EMP, environmental laws and, as defined appropriate to each project, environmental claims and environmental liability. The environmental default must include a cure period that satisfies the requirement of the Equator Principle 8; that the Equator Banks engage with the borrower to afford it the opportunity to rectify the default.

Intercreditor issues and control

Our survey indicates that an issue for Equator Banks to consider is the negotiation of intercreditor rights with the other lenders to ensure that Equator Banks retain a controlling vote (or at least negative control) in environmental matters. Depending on the size of the commitments of the Equator Banks in a syndicate and the relative size that the commercial bank tranche bears to other tranches of the overall financing package, Equator Banks may find themselves outvoted on intercreditor voting if a block on non-Equator Banks/other financial institutions hold the requisite voting entitlement when action on an environmental issue is being decided.

We are aware from our survey that some Equator Banks have favoured the use of special weighted voting rights for any action to amend, vary, grant consents or enforce any provision of the loan documentation relating to environmental matters, although this suggestion was not universally accepted. The use of such rights is justified because the Equator Banks face a greater risk to their reputation if they are not seen to be taking action to enforce environmental requirements that have been agreed to by the borrower. We do not expect that syndicate members who are non-Equator Banks or other co-financiers or borrowers will accept this argument because to do so would weaken their voting rights and hence power over decision-making.

However, a similar result could eventually be achieved by the use of a step-down process, applying a progressively smaller percentage of lenders whose decision is required to take the relevant action such that ultimately the Equator Banks could act alone if the majority is not prepared to take the action required after the elapse of an agreed period. A more acceptable solution may be to allow the Equator Banks to exercise negative control over the relevant decision by providing that the lender consent level is set sufficiently high, say 80 per cent of outstanding commitments/participations, to include at least one of the Equator Banks. This will at least ensure that the environmental requirements negotiated at the outset of the financing cannot be avoided by a majority that does not include the Equator Banks.

Syndication issues

A common component of primary syndication is the roadshows conducted by the lead arrangers and representatives of the borrower. This is an opportunity for Equator Banks who are considering participating in the financing to put questions to the lead arrangers and the borrower over the social and environmental impacts of the project. Given the growing importance of compliance with the Equator Principles, lead arrangers may choose to market this as a selling point to potential participants. Participant banks are generally permitted to request that the reports produced by the arrangers' technical adviser be provided to them and should avail themselves of the opportunity to review this material. Lead arrangers should (and in our experience often do) make the point to sponsors that rigorous compliance with the Equator Principles will aid syndication (keeping the door open to Equator Banks that form a significant proportion of project financiers).

For secondary syndication, Equator Banks who are considering participating can mitigate their reputational risk by demanding copies of the technical advisers' reports (even if there is no opportunity to discuss these with the technical advisers) and having their internal environmental experts review these together with the information memorandum. Equator Banks should also request discussions with the Environment Bank to ascertain (i) whether the environment related provisions in the loan documentation are being properly policed and (ii) whether the borrower is complying with them.

Beyond the Equator Principles[146]

> ‘Our heart is in the right place, but we are in the foothills looking up at the mountains. We have started the long journey and we intend to complete it.’
>
> Sir John Bond, Group Chairman, HSBC Holdings[147]

> ‘We foresee the Principles extended to other areas such as export finance and general lending. Five years’ time, maximum.’
>
> Roberto Dumas Damas, Project Finance Co-ordinator, Banco Itaú BBA

> ‘Credit risk management is undergoing an important transition. Banks are no longer treating environmental and other social issues as peripheral to their business concerns; they no longer focus simply on recycling paper or using energy-efficient light bulbs...the majority of the world’s large banks agree that integrating environmental and broader social issues into their core credit risk management is essential to managing credit risk in the 21st century.’
>
> Reed Huppman, Partner, ERM[148]

What ERM describes is the beginning of a paradigm shift among lending institutions and in credit risk assessment, which it attributes largely to the adoption of the Equator Principles by leading international commercial banks.

Our own research tends to confirm ERM’s findings that environmental and social issues are no longer treated as peripheral for lending institutions, but have moved into the mainstream. Whether the Equator Principles will play a leading role in influencing credit risk assessment remains to be seen. Indeed, it is arguable that this may not actually be their purpose, as the Equator Principles do not promote environmental and social values over all others, but merely ensure that they are accorded proper weight in the decision.

Old wine in new bottles

The levelling up effect of the Equator Principles, by which non-Equator Banks follow even if they do not adopt the Equator Principles, is clearly established. Even some NGOs recognise that the Equator Banks have come a long way in just over a year, and it is also clear that, to many banks,

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146 Paul Watchman discusses this in his article ‘Beyond the Equator’, *Environmental Finance*, June 2005.

147 HSBC, Climate Group Launch, Speech by Sir John Bond, 27 April 2004.

148 ERM report – *Credit risk management – banking industry integrating environmental and social issues – how much and how fast?*, 2004.

project finance is a staging post on the road to adopting robust environmental and social policies, not the end of the journey.

It is likely, therefore, that the Equator Principles will act as a stepping-stone for other policies, extending beyond project finance and aimed at increasing sustainability in industries potentially damaging to the environment. For example, at its AGM on 28 May 2004, HSBC launched a new international guideline for the forest land and forest products sector, with a view to ensuring that HSBC's involvement in this potentially sensitive sector is consistent with sustainability principles. The guideline, briefly, states that HSBC's preference is to deal with customers in this sector that are either operating managed forests certified by the Forest Stewardship Council (FSC), or equivalent FSC recognised standard, or who trade in products that are FSC-certified or equivalent[149]. Many banks have adopted similar foresting stewardship and climate change initiatives. In addition, the Climate Group initiative was launched by HSBC in April 2004, and the Bank of America in May 2004 adopted environmental guidelines that set targets and deadlines for reduction of greenhouse gas emissions, based on the recommendations of the Intergovernmental Panel on Climate Change.

JPMorgan Chase, however, appears to have gone further even than other banks by adopting an environmental policy which incorporates an environmental management system that includes planning, training, implementation, measurement, reporting and review, and that will apply to new business and existing business that comes up for renewal or extension after 1 September 2005. ABN AMRO, moreover, maintains that it has already extended the application of the Equator Principles by including all corporate lending in the oil, gas and mining sectors. Again, this is indicative of the wider application of sustainability and environmental/social responsibility principles. In areas such as upstream oil and gas projects (historically carried out largely through balance sheet financing), there is also an observable trend towards a similar approach being taken to that required by the Equator Principles ('Equator-Lite').

Another potential development involves banks using the experience obtained through the Equator Principles in order to develop general lending standards. For example, in 2003 Citigroup strengthened its environmental policy framework with the adoption of the Global Corporate & Investment Banking (GCIB) Group's Environmental and Social Risk Management Policy. The GCIB policy applies a rigorous environmental and social

[149] www.hsbc.com/hsbc/news_room. FSC Principles cover the impacts on affected societies, such as land title and land use rights; the rights of indigenous people; community relations and workers' rights; and economic benefits from forest land use.

review of financial transactions above $50m where the use of proceeds is known to Citigroup and is largely based on the Equator Principles. WestLB thought it likely that the Equator Principles would be applied to more of the bank's products in the future, including commodity trade financing and export financing[150].

> 'Environment risk is business risk: it's as simple as that. So our ignorance of environmental risks can lead to costly litigation, but it can also lead to negative publicity and even revenue reduction.'
>
> Bernd Schanzenbacher, Head of Environmental Risk, Credit Suisse[151]

Responsible financing practices are in fact moving beyond screening only large projects. F&C Asset Management's 2002 Benchmarking Study on environmental credit risk found that a number of European banks are considering environmental credit risks in all their lending processes, as a means of reducing liability exposure[152]. Such practices have also emerged in north and south America, Australia and Africa.

The question is: how far will the banks go? It is possible to discern that some Equator Banks, such as JPMorgan Chase, Citigroup, Bank of America, HSBC and ABN AMRO, are already applying the Equator Principles widely, whereas others do appear to be more reactive to NGO pressure than proactive.

Our view is that banks are increasingly sensitive to the need for rigorous environmental and social impact assessment in general decision-making, as evidenced by their commitment to CSR and to fighting climate change and illegal logging, and their attempts to address these issues in different and very difficult industry sectors.

Whether governments will compel banks and companies, beyond their Operating and Financial Review and other procedural requirements, to adopt CSR policies that reflect greater environmental and social awareness largely depends on the success of voluntary initiatives such as the Equator Principles and their implementation by the Equator Banks themselves.

In addition to a range of internal policies aimed at sustainable investment, it is likely that banks will develop alternative networks and initiatives that will exist alongside the Equator Principles. For example, to date over 200

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150 Bank of America reaffirmed its commitment in April 2004 to the Ceres Principles, a 10-point code of corporate environmental conduct.

151 As cited in 'Banks' green pledge earns mixed response', *Swissinfo*, 10 June 2003.

152 *Business Day*, South Africa, 14 July 2003.

financial institutions (including Barclays, Dexia, HSBC, Royal Bank of Scotland Group and WestLB) have joined the UNEP Finance Initiative. The initiative, which claims to provide its members with a network of expertise and contacts forum for engagement with public and private sectors and access to best practice, is intended to help financial institutions to cope with increasing public scrutiny and turn it to their advantage. Commitment to the initiative involves signing a UNEP Statement by Financial Institutions on the Environment and Sustainable Development. Each signatory commits itself to promotion of sustainable development by supporting the precautionary approach to environmental management, complying with local, national and international environmental regulations, recognising, identifying and quantifying environmental risks, developing and publishing a statement of their environmental policy, and reporting on their activities. Although less concrete than the Equator Principles, the initiative is indicative of the general trend towards co-operation on environmental, social and political issues among financial institutions.

The $50m financial threshold in its present form may not be sustainable and it is likely to be abolished. If Equator Banks are not interested in lending to sponsors seeking to develop projects under the threshold, they may wish to consider whether (subject to the bank's relationship with its client) it makes more sense to pull out of this end of the project finance market rather than risk its reputation on a project that has a relatively low value but presents the risk of causing significant environmental harm or damage.

Questions for discussion

$50m
As a number of Equator Banks have effectively lowered or abandoned this threshold, should the $50m threshold be retained, given the need to ensure that all projects that have negative social or environmental impacts are assessed properly?

Extension
Is it appropriate to extend or apply the Equator Principles or a variant of them to areas of banking other than project finance?

Scope
If so, what other areas of banking would the Equator Banks include or exclude? Why?

IFC Review
Should the Equator Principles continue to mirror IFC Safeguard Policies post-review?

Disclosure by Equator Banks
Should Equator Banks each disclose, as part of their annual CSR reporting, general information about the number (as HSBC has done) of Equator Principles projects actively considered? This will include the number of projects in each sector; the number of projects in each Equator Principles category; types and categories of projects assessed by them each year; and the number of projects accepted and rejected by the Equator Bank, as well as derogations from the Equator Principles.

Disclosure by sponsors
If it is accepted that Equator Banks themselves should not disclose any client commercial information or information about a project that is not in the public domain, should each Equator Bank encourage project sponsors to make as much social and environmental information as possible available to the public? Should this be the subject of a loan agreement covenant?

Audits
Should Equator Banks be externally audited each year to ensure that the Equator Principles have been applied appropriately to a sample of case studies of projects?

Toolkits
Can Equator Principles assessment be adequate without better development of assessment tools for social impact?

Reporting
Should Equator Banks disclose the findings of the external audit as part of CSR reporting?

Appointment of Ombudsman
Should the Equator Banks appoint an Equator Principles Ombudsman to review complaints and audit compliance with the Equator Principles by stakeholders as to alleged misapplication of the Equator Principles by an Equator Bank?

Role of Ombudsman
If so, should the Equator Principles Ombudsman be modelled on the IFC Compliance/Advisor Ombudsman or one of the many public or private sector ombudsmen?

Powers of Ombudsman
What should the powers of the Equator Principles Ombudsman be?

Full review by Ombudsman
Should the powers of the Equator Principles Ombudsman be limited to auditing complaints and investigating the alleged misapplication of the Equator Principles, or should its powers include review of the merits of the case and the exercise of discretion by the Equator Bank?

Scope of Ombudsman’s intervention
Should the powers of the Equator Principles Ombudsman be limited to cases where the complainant has no effective legal redress, or be excluded in cases where the complainant or another interested party initiated legal proceedings about the same subject matter?

Disclosure by Ombudsman
If it is agreed that there should be a Principles Ombudsman, should the Equator Principles Ombudsman publish an annual report of complaints, findings and recommendations but keep confidential the identity of the sponsor, the project and the complainant?

Development of best practice guidelines
Should best practice guidelines be developed to provide a model for how project managers should address the Equator Principles as part of the project life cycle?

Raising awareness of the Equator Principles
What steps should be taken to make sponsors more aware of the Equator Principles and how will their requirements affect the project life cycle?

Annex I

Glossary

BTC pipeline	Baku-Tbilisi-Ceyhan pipeline
CSR	corporate social responsibility
ECA	export credit agency
ECGD	Export Credits Guarantee Department
EA	environmental assessment
EMP	environmental management plan
Environment Bank	the bank that will receive information from the borrower and other project participants relating to the Equator Principles and which will be expected to monitor the construction and operation of the project.
Equator Banks	banks and other financial institutions that have adopted the Equator Principles
Equator Principles	Equator Principles, namely, a set of principles signed by a number of project finance banks and other financial institutions starting in June 2003. The Equator Principles commit the signatories to addressing environmental, social and human rights issues in project finance.
FoE	Friends of the Earth
IFC	International Finance Corporation
ILO	International Labour Organisation

JBIC	Japan Bank for International Co-operation
MAC	material adverse change
MAE	material adverse effect
MLA	multilateral lending agency
NGO	non-governmental organisation
non-Equator Banks	banks and other financial institutions that have not to date adopted the Equator Principles
RAN	Rainforest Action Network
Technical Bank	The bank, which on behalf of a syndicate, looks into the technical issues relating to the project including, sometimes, environmental and social issues. Distinguished from the Environment Bank, which only looks at the environmental and social aspects of the project.
TIC	Trade and Industry Select Committee
UNEP	United Nations Environment Programme
WHO	World Health Organisation
WWF	World Wide Fund for Nature

Annex II

Some legal issues

In this Annex, we briefly discuss some of the legal issues that emerged as part of our survey. The discussion is neither comprehensive nor definitive but, hopefully, raises these issues in a way in which a sensible dialogue may take place among interested parties.

International law

An obvious compliance problem arises when the host state's domestic legal regime contains minimal or inadequate protection for the environment or the human rights of those affected by the project; or where adequate legal protection is provided on paper, but very little enforcement occurs; or access to justice and effective legal redress is denied. This situation, which is relatively common, does not necessarily imply that the host state has scant regard for the environment or human rights, but may simply be indicative of the lack of local capacity to draft or implement what are frequently complex legal provisions.

Use of international standards

In such a case, a common solution is to provide that the parties (including the host state) will apply some internationally recognised legal standards – eg the 'Core Conventions' of the International Labour Organisation or the rights protected by the International Covenant on Economic, Social and Cultural Rights – to the project. However, care needs to be taken lest the application of non-domestic standards is misunderstood (by NGOs) or where perfectly appropriate legal norms or standards are in place. Reference to these widely ratified international instruments is not usually resented by the host state as the imposition of first-world values, as most members of the United Nations have acceded to them and few states are prepared to object to the use of norms which are already binding on them in international law.

Many of these obligations, of course, are cast in general terms, but they at least set the boundaries of acceptable behaviour as between the parties to the project. In some cases, particularly regarding the protection of the environment, quite advanced international or transnational standards may be adopted, for example a project may be subject to EU environmental standards, which are both detailed and demanding. Indeed, sponsors and their bankers often seek the use of such advanced environmental and social standards, as their application to the project means that the sponsors and bankers concerned are unlikely to face criticism in their home states for having exported pollution or settled for labour or other human rights standards that would be unacceptable at home.

Lender liability

Even outside the realm of international law, taking all of the potential liability difficulties together, it may be that the Equator Principles bring banks and their officers and directors within categories of legal liability, including criminal liability. This is because they receive information regarding environmental performance or legal non-compliance as part of the ongoing monitoring of the contribution or operations of a project required by the Equator Principles. Therefore, conditions precedent where a bank may be seen as 'signing off' that a standard reached is acceptable or covenants in loan documentation and management of the monitoring of documentation need to be carefully handled by the bank in order to guard against such risks.

Offences related to non-disclosure of pollution or environmental harm

In a number of jurisdictions, it may be an offence for the owner of project property (which may include a bank which has taken possession of a property), management or key personnel to fail to disclose to a regulator information they become aware of relating to environmental pollution or harm. This is the case, for example, in the Netherlands and parts of Germany for groundwater pollution. Lenders ought to be aware, therefore, of the possibility that as 'owners' failure to disclose such information to appropriate environmental authorities, particularly but not only where it has reason to believe that the borrower has not complied with its reporting obligations, may result in legal liability for the bank or its directors and officers.

Knowingly permitting

Banks should consider whether they wish to be in the position of having the right to force the borrower to remedy pollution or contamination. If banks do wish to have such a right and fail to exercise it, then potential liability for 'knowingly permitting' might be alleged to arise. In jurisdictions such as the UK and India, legal liability may arise on the basis that a person 'knowingly permits' pollution. The more information that banks require (bearing in mind that where the solvency of an operation is questionable banks are likely to become much more actively involved in the management of the project) or possess about such matters, the greater their potential exposure to liability for knowingly permitting, where they have a right to compel compliance by the borrower but fail to do so.

There may also be similar or analogous liability triggers, such as principal/agency relationships, complicity in the acts or omissions leading to the pollution or failure to act to protect against or prevent pollution. There is a risk in such cases that information will be received by Equator Banks, but not acted upon or that the actions taken will be inadequate or unnecessarily delayed and that inaction may, in certain circumstances, lead to an allegation of liability for the Equator Banks. It is therefore important that there should be a clear chain of communication within the bank discharging the Equator Principles function (the Environment Bank), and that a senior officer within the Environment Bank should supervise information assessment and communication within the Environment Bank itself and within the syndicate of banks. This should be an ongoing process.

Liability of banks

As explained above, there are a number of reasons why a lender or a member of a banking syndicate may not be held to be liable for knowingly permitting pollution or similar environmental offences, such as:

- the bank in question may not have actual knowledge;
- in the absence of actual knowledge, a court may be unwilling to infer constructive knowledge on a syndicate of banks with actual knowledge of pollution, or at least impose it on a syndicate of banks including Equator Banks where actual knowledge is held only by the Environment Bank;
- a bank which can show that is has been outvoted by the other members of a syndicate may not be regarded by the courts as having ‘permitted’ pollution or been complicit in human rights abuses;
- legislators and regulators are less likely to target lenders with security interests as opposed to polluters and operators or owners themselves; and
- at least in terms of liability or pollution, a preferential position may be provided for banks or receivers by the legislative or regulatory framework, such as that which exists under Part II A of the Environmental Protection Act 1990[153], which provides specific exemptions from liability for environmental harm or damage for lenders and receivers.

Information received pursuant to loan documentation

In some cases, a borrower will not be required to provide information on environmental breaches and claims unless that breach or claim does, or is likely to, result in a material adverse change (MAC) or MAE, each of which usually are defined as material only in terms of the ability of the borrower to repay the loan or to perform its material obligations under the project documents. In the case of the Equator Principles, however, there

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153 cf section 78X(3) and paragraph D.47 of Annex 3 of DETR circular 02/2000: *Contaminated land*.

may be a requirement under the EMP for information provided to Equator Banks or other lending banks to be periodically on a much lower threshold of required disclosure than MAC or MAE. Therefore, once a bank has acquired knowledge of pollution or other polluting activity, it may be sufficiently precise to raise questions whether liability may arise for the bank permitting the pollution or activity, even though it may not satisfy a MAC or MAE for that bank or any of the banks involved in the project. It is worth noting, finally, that banks are sometimes indemnified for losses arising from the borrower's default, and are sometimes specifically indemnified by the borrower for losses incurred due to failure to comply with environmental laws/environmental claims. However, where the borrower is a special purpose vehicle whose only assets are the project assets, all of which are secured in favour of the lenders as is typically the case in project financings, the borrower may not have sufficient funds to meet such liability unless it has taken out extended environmental insurance cover, which is most unusual.

Constructive knowledge

Equator Banks ought to be aware that there may be no defence that knowledge of pollution is limited to a branch office or a junior employee. In these circumstances, the bank might be deemed to have constructive or implied knowledge.

To avoid doubt, as a number of consultees have raised the issue, we are not arguing that the Equator Principles create a new legal liability for lenders. However, given the combination of greater and more detailed information being provided to the Equator Banks under EMPs, and the need for the banks to have power to take action in circumstances where a MACor MAE (the traditional protections for lenders) are triggered, there is a greater vulnerability for lenders to attract liability for 'knowingly permitting' pollution.

Director and officer liability

In addition to corporate liability, it is usually an offence for a director or officer of the company to cause pollution by act, omission or connivance, though some legal jurisdictions such as Germany impose strict liability on key personnel. There may be circumstances where communication to a senior banking official, director or officer may make that person liable for pollution. Telling the boss is the only way an environmental manager can escape liability.

Annex III

The Equator Principles[154]

An industry approach for financial institutions in determining, assessing and managing environmental and social risk in project financing.

Preamble

Project financing plays an important role in financing development throughout the world. In providing financing, particularly in emerging markets, project financiers often encounter environmental and social policy issues. We recognise that our role as financiers affords us significant opportunities to promote responsible environmental stewardship and socially responsible development.

In adopting these Principles, we seek to ensure that the projects we finance are developed in a socially responsible manner and reflect sound environmental management practices.

We believe that adoption of and adherence to these Principles offers significant benefits to ourselves, our customers and other stakeholders. These Principles will foster our ability to document and manage our risk exposures to environmental and social matters associated with the projects we finance, allowing us to engage proactively with our stakeholders on environmental and social policy issues.

Adherence to these Principles will allow us to work with our customers in their management of environmental and social policy issues relating to their investments in the emerging markets.

These Principles are intended to serve as a common baseline and framework for the implementation of our individual, internal environmental and social procedures and standards for our project financing activities across all industry sectors globally.

In adopting these Principles, we undertake to review carefully all 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.

Statement of principles

We will only provide loans directly to projects in the following circumstances:

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[154] The Equator Principles and their exhibits are available at www.equatorprinciples.com. They are reproduced here with the permission of ING, which is currently administering the Equator Principles website.

1 We have categorised the risk of a project according to internal guidelines based upon the environmental and social screening criteria of the IFC as described in the attachment to these Principles (Exhibit I).

2 For all Category A and Category B projects, the borrower has completed an Environmental Assessment (EA), the preparation of which is consistent with the outcome of our categorisation process and addresses to our satisfaction key environmental and social issues identified during the categorisation process.

3 In the context of the business of the project, as applicable, the EA report has addressed:

a) assessment of the baseline environmental and social conditions;

b) requirements under host country laws and regulations, applicable international treaties and agreements;

c) sustainable development and use of renewable natural resources;

d) protection of human health, cultural properties, and biodiversity, including endangered species and sensitive ecosystems;

e) use of dangerous substances;

f) major hazards;

g) occupational health and safety;

h) fire prevention and life safety;

i) socio-economic impacts;

j) land acquisition and land use;

k) involuntary resettlement;

l) impact on indigenous peoples and communities;

m) cumulative impact of existing projects, the proposed project, and anticipated future projects;

n) participation of affected parties in the design, review and implementation of the project;

o) consideration of feasible environmentally and socially preferable alternatives;

p) efficient production, delivery and use of energy; and

q) pollution prevention and waste minimisation, pollution controls (liquid effluents and air emissions) and solid and chemical waste management.

Note: In each case, the EA will have addressed compliance with applicable host country laws, regulations and permits required by the project. Also, reference will have been made to the minimum standards applicable under the World Bank and IFC Pollution Prevention and Abatement Guidelines (Exhibit III) and, for projects located in low and middle income countries as defined by the World Bank Development Indicators Database, the EA will have further taken into account the then applicable IFC Safeguard Policies (Exhibit II). In each case, the EA will have addressed, to our satisfaction, the project's overall compliance with (or justified deviations from) the respective above-referenced Guidelines and Safeguard Policies.

4 For all Category A projects, and as considered appropriate for Category B projects, the borrower or third party expert has prepared an Environmental Management Plan (EMP) which draws on the conclusions of the EA. The EMP has addressed mitigation, action plans, monitoring, management of risk and schedules.

5 For all Category A projects and, as considered appropriate for Category B projects, we are satisfied that the borrower or third party expert has consulted, in a structured and culturally appropriate way, with project-affected groups, including indigenous peoples and local NGOs. The EA, or a summary of it, has been made available to the public for a reasonable minimum period in local language and in a culturally appropriate manner. The EA and the EMP will take account of such consultations, and for Category A Projects, will be subject to independent expert review.

6 The borrower has covenanted to:

a) comply with the EMP in the construction and operation of the project;

b) provide regular reports, prepared by in-house staff or third party experts, on compliance with the EMP; and

c) where applicable, decommission the facilities according to an agreed Decommissioning Plan.

7 As necessary, lenders have appointed an independent environmental expert to provide additional monitoring and reporting services.

8 In circumstances where a borrower does not comply with its environmental and social covenants, such that any debt financing would be in default, we will engage the borrower in its efforts to seek solutions to bring it back into compliance with its covenants.

9 These Principles apply to projects with a total capital cost of US$50m or more.

The adopting institutions view these Principles as a framework for developing individual, internal practices and policies. As with all internal policies, these Principles do not create any rights in, or liability to, any person, public or private. Banks are adopting and implementing these Principles voluntarily and independently, without reliance on or recourse to IFC or the World Bank.

Annex IV

NGOs play a major role in the analysis of project finance transactions. Though they may be considered by many parties to provide unhelpful criticism of projects, lenders and sponsors, they have been an important driver behind the development of the Equator Principles.

While at one time NGOs could be divided between pressure groups that focus on a single issue, such as stopping a particular project, and those that had a general interest in, for example, protecting the environment, these distinctions have become increasingly blurred. NGOs are increasingly well informed, and have made notable progress in persuading even major banks to change their attitudes to social and environmental protection.

In recognition of these factors and the consequential need for parties involved with major transactions to protect their reputations, David Hunter of the American University's Washington College of Law has developed the following 10 guidelines for companies and financial institutions to manage reputational risk:

1. Compliance with local laws is not enough.
2. Don't bribe.
3. Don't sleep with the military.
4. Be transparent.
5. Prevent and avoid (not mitigate) environmental impact.
6. Benchmark to a recognised and robust standard and comply with those standards.
7. Consult: listen and learn.
8. Give something good or useful back to the community.
9. Comply with standards.
10. Don't kid yourself.

Annex V

Equator principles – questionnaire for Equator Banks

This questionnaire is to be used to assist in making enquiries with certain Equator Banks regarding the implementation of the Equator Principles.

	Issue	Comments
1	**Implementation**	
1.1	How has the bank implemented the Equator Principles? (eg does it have it own written internal policy?). What does adoption of the Equator Principles mean for the bank?	
1.2	Why did the bank adopt the Equator Principles? (eg management of reputational risk?)	
2	**External or internal advisers? Recruitment**	
2.1	Does the bank use external advisers or is there a dedicated team that manages the Equator Principles? If the latter, how big is your team? Have they environmental and social expertise?	
2.2	In managing the Equator Principles, does the bank delegate this function to the project finance team or is this the responsibility for internal environmental risk assessment specialists?	
2.3	Has the bank recruited new staff? If so, do they have specialist environmental skills or general risk management skills?	

	Issue	Comments
3	**Awareness and training**	
3.1	Has the bank provided training to its staff? If so, what type? (eg IFC training).	
3.2	Has the training been limited to project finance teams or to sector specialists?	
3.3	Is the awareness level of the bank's adoption of the Equator Principles consistent throughout the bank or limited to those teams whose business is most immediately affected by them?	
3.4	Has the bank encountered any internal resistance or indifference to the implementation of the Equator Principles?	
4	**Experience**	
4.1	How many deals where the bank has participated have involved the Equator Principles? What was the bank's role (eg financial adviser, arranging bank, member of syndicate?).	
4.2	Types and category of projects (eg motorway, category B).	
4.3	Has the bank rejected any deals due to non-compliance with the Equator Principles?	

	Issue	Comments
5	**Consultants**	
5.1	Has the bank engaged any environmental or social consultants on any deals involving the Equator Principles?	
5.2	Does the bank maintain a panel of approved environmental consultants? Would the bank object to a report from a consultant that was not on its approved panel?	
6	**Risk assessment/due diligence**	
6.1	How does the bank undertake due diligence to ensure compliance with the Equator Principles (eg engage an independent consultant?)	
6.2	Does the bank accept the environmental due diligence reports prepared by or on behalf of a non-Equator Principles bank without further review?	
6.3	Has the bank found any timing problems in undertaking due diligence given when it becomes involved in the project?	
6.4	If the bank is not part of the original arranging group, how much confirmatory environmental due diligence to ensure that a project is Equator Principles-compliant can it undertake on joining a syndicate?	

	Issue	Comments
6.5	What tools does the bank use to categorise projects?	
6.6	How does the bank deal with the application of the Equator Principles when it is lending to a project alongside non-Equator Principles banks? Does the bank impose entry requirements on syndicate members? If not, how does the bank ensure that non-Equator Principles banks will follow the Equator Principles in administering the loan? Has it considered qualified voting rights to give Equator Principles banks greater say on environmental matters?	
6.7	Does the bank perform an internal Equator Principles compliance audit?	
7	**Documentation**	
7.1	How is the bank managing the drafting required in lending documentation to cover issues involving the Equator Principles?	
7.2	Have issues have arisen regarding: ■ reporting requirements; ■ information handling; ■ voting rights/structures; ■ step-in rights/default; and ■ drawstops.	

	Issue	Comments
8	**Staged projects**	
8.1	Staged projects – how has the bank dealt with pre-Equator Principles stages and post-Equator Principles stages of a project?	
9	**Client engagement**	
9.1	Has the bank encountered issues in dealing with clients/ sponsors?	
9.2	How does the bank envisage raising client awareness of the Equator Principles or helping clients meet the challenge of the Equator Principles?	
9.3	How does the bank deal with powerful sponsors?	
10	**Opportunities and challenges**	
10.1	Does the bank see any particular challenges associated with implementation of the Equator Principles? (eg social issues).	
10.2	Does the bank consider that the Equator Principles will result in 'better projects' for the bank and its clients?	
10.3	Do the banks regard sponsors mandating Equator Principles banks as a way to deflect/spread the risk of adverse NGO criticism? Should sponsors pay for this?	

	Issue	Comments
10.4	How does the bank deal with NGOs in respect of the Equator Principles?	
11	**Future**	
11.1	Where does the bank see the Equator Principles going (eg limited to project finance or extended to export finance, acquisition finance or to general lending, particularly where the borrower has a limited business or the purpose of a general balance sheet loan is transparent)? Will there be certain ‘no-go’ areas (eg nuclear, extractive industries, tobacco?)?	
11.2	Has the bank adopted any sector-specific policies that go beyond the Equator Principles?	
12	**Transparency**	
12.1	How will the bank report on its application of the Equator Principles?	
12.2	Will it report on a general basis or specifically where it has turned down sponsors based on the Equator Principles?	

Disclosure

International law firms such as Freshfields Bruckhaus Deringer represent a large number of clients in the financial sector including the IFC and a number of Equator Banks and non-Equator Banks, as well as project sponsors and contractors. We also work with many social and environmental consultants. In addition, we have a leading pro bono legal practice; as part of this, we advise a number of NGOs. Over 50 per cent of our pro bono practice relates to human rights issues.

We have neither been paid for, nor sought payment for, work relating to producing this report and no payments have been made for participating in this survey.

We supplied copies of our draft of this report to participants who were given an opportunity to make further comments. Where we have changed the contents of the report, we have made changes at our own sole discretion and in good faith in response to such comments or further recent developments to make the report more comprehensive and accurate than it would otherwise have been.

All participants have been consulted on equal terms. With the exception of a limited number of late participants who approached us after work on the survey had begun, we supplied all participants with surveys and draft reports at the same time and have not declined requests for additional time to comment on the report.

In addition, the IFC has asked us to make it clear that their willingness to review and comment on our draft report was not, and should not be construed as, an endorsement by the IFC of the report or any of its conclusions.

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