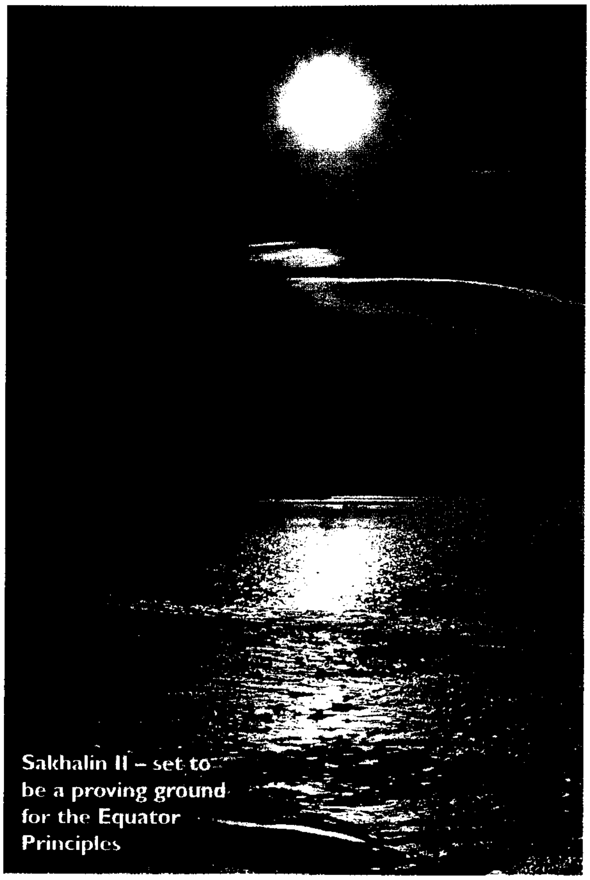
Beyond the Equator

The launch of the Equator Principles promised a radical new approach to managing the social and environmental impacts of large projects. Two years on, **Paul Watchman** considers what their real impact has been – and where the Equator banks go from here



Sakhalin II – set to be a proving ground for the Equator Principles

The rapid take-up of the Equator Principles, and the growth in the share of the project finance market their signatories now account for, has been dramatic. Two years ago this month, 10 banks adopted these voluntary guidelines, which commit them to applying the International Finance Corporation's (IFC's) environmental and social safeguards to projects above $50 million that they finance (see box).

There are now 31 Equator banks (including the Danish export credit agency), which control more than 80% of the project finance market. Although a number of major players, namely Société Générale, BNP Paribas and HBOS, remain outside, the prevalence and influence of the Equator banks on the project finance market, given the need to syndicate large-scale projects, cannot be overstated.

The Equator banks have invested heavily in recruitment and staff training and raising general levels of awareness of the principles, focusing their efforts on the project finance, export finance and legal departments that are most directly involved. Much of the impetus has been "top-down" in the sense that chairmen, CEOs and global and departmental heads have made it crystal clear that their reputation as Equator banks is vulnerable to attack, not only for what the banks do themselves, but for what their clients do. To quote Jon Williams, head of environmental risk management at HSBC: "The reputation of the bank is linked to the reputation of the clients. No one client and no one piece of business is worth risking the reputation of the bank."

Unfortunately, it is not all good news. Chris Bray, head of environment risk policy management at Barclays, has suggested that a few years ago an investment banker would have considered anyone who spoke about social and environmental issues to be a hippy. Regrettably, in some banks, this remains true. There is also some circumstantial – but nevertheless convincing – evidence that some Equator banks do not take their commitments as seriously as others.

The "bottom-feeding" by non-Equator banks, referred to by NGO BankTrack in its report marking the first year of the Equator Principles[1], may be more limited than BankTrack suggests. However, it does appear that a number of non-Equator banks are marketing themselves as 'flexible friends' of project sponsors, in regional if not international markets.

Nonetheless, in *Environmental Finance* in March this year, we described the Equator Principles as "a shining beacon for responsible banking" (see page 4). We stand by that view. They have transformed social and environmental considerations from a last minute concern to a mainstream issue in planning new projects.

So what does the future hold for the Equator Principles and the Equator banks? It will be influenced by a number of factors:

☐ *Technical and practical issues* Many technical and practical issues relating to the Equator Principles remain to be resolved, including the legal liability of lenders, the need for greater due diligence by sponsors and lenders at the front end of projects and for lenders to be consulted much earlier in the project cycle.

☐ *The $50 million threshold* A number of Equator banks have explicitly or implicitly lowered (JPMorgan Chase) or abandoned (Citigroup, ABN Amro) the $50 million limit. This trend is likely to continue as recognition grows that the limit, while possibly justifiable on pragmatic grounds, is not relevant in many cases to social and environmental impact assessment.

☐ *Growth of environmental standards in banking* Equally, there is likely to be substantial growth in sector policies. For example, ABN Amro has developed industry sector policies for, among others, forestry, mining and tobacco. In addition, Citigroup has adopted a comprehensive environmental policy including initiatives on endangered ecosystems, illegal logging, ecologically sustainable development and climate change. HSBC is also developing a series of guidelines for environmental or social impacts in high-risk sectors. JPMorgan Chase appears to have gone even further 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.

☐ *Transparency* Equator banks are trying to redress a perceived lack of transparency, a common complaint among NGOs. For example, HSBC has published details of the number and value of transactions where the Equator Principles were applied, stating that it "declined 12 transactions where non-compliance with the Equator Principles was a contributory factor"[2].

Unfortunately, for some Equator banks,

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

2 *HSBC Corporate Social Responsibility Report 2004*

it is likely that these examples of transparency will be seized upon by NGOs that propose to rank the Equator banks according to the information they provide. The inevitable effect will be to introduce competition between the Equator banks, as no bank will wish to be seen to lag behind. On the other hand, attempts to encourage further transparency are likely to be frustrated, as banks are bound by client confidentiality, breach of which can entail civil, criminal or professional sanctions and damage the relationship between a bank and its clients.

☐ *Accountability* The Equator banks also face criticism for lack of accountability. Steve Kretzmann of NGO Oil Change has asked: "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?"[3]

There are useful precedents which may be followed more generally by the Equator banks. To cite two of them, the Japan Bank for International Cooperation has external advisers on policy and procedures and Citigroup has embarked on external auditing of its application of the principles.

In addition to these issues, the Equator banks face three challenges. The first is the IFC's ongoing review of its Safeguard Policies, on which the principles are based. Both the Equator banks and NGOs are dissatisfied with the IFC consultation. The necessity for a further round of consultation has been suggested by a number of Equator banks. It is no secret that, whereas a substantial number of Equator banks are committed to the Equator Principles come hell or high water, a smaller but significant number may find the outcome of the IFC review – due later this year – unpalatable. There is a very real risk of schism between these two groups and some Equator banks may decide to bale out altogether.

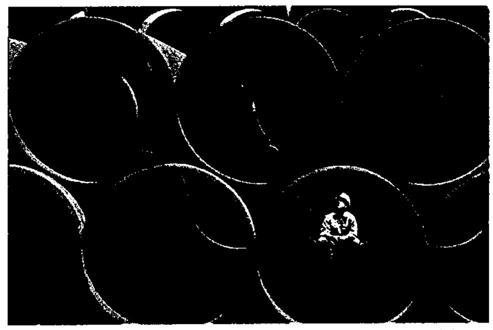
Peter Woicke, the former executive vice president of the IFC, has stated that "Equator has proved more successful than anyone could have imagined". Rachel Kyte, the director at the IFC charged with the review, and her team have the unenviable task of developing a coherent set of policies to underpin the Equator Principles which will satisfy both the Equator banks and NGOs. If they manage to reach anything approaching consensus, they will deserve great acclaim.

The second challenge will be for each Equator bank to deliver the Equator Principles requirements in a consistently robust manner. Market experience shows that a number of Equator banks have adopted a fairly pragmatic approach to ongoing staged and pipeline projects which could not easily be unwound. Pragmatism may be acceptable during a bedding-down period but, as time passes, it looks like a stale and self-serving excuse for failure to apply the Equator Principles rigorously.

3 *Time* Magazine, 30 May 2005

A principle's a principle

When 10 of the world's largest banks signed the Equator Principles, two years ago this month, they took an unprecedented step towards addressing the social and environmental impacts of the projects that they finance. By putting their names to the Principles, they agreed to apply the same safeguards as the International Finance Corporation – the private sector arm of the World Bank – to all project finance deals greater than $50 million in which they were involved.



The Baku-Tbilisi-Ceyhan pipeline – backed by Equator banks

Since then, the principles have grown in both size and scope. The original signatories have been joined by 21 more, including financial institutions from Europe, the US, Japan and Brazil. Between them, the Equator banks, as they are known, are now said to account for 80% of project financings. Furthermore, a number of signatories have also extended the principles beyond the fields originally specified.

Under the principles, every project seeking funds is put into one of three categories: high-impact 'Category A' projects, which require a full environmental impact assessment (EIA) and a programme of local stakeholder consultation; 'Category B' projects with lower likely impacts, which require a less extensive EIA; and 'Category C' projects with minimal or no adverse impacts. The latter do not require an EIA.

In the case of Category A projects, the borrower or a third-party expert must also put an environmental management programme in place to address project compliance, mitigation, action plans and monitoring procedures. Compliance with the environmental management plan is written into a project's loan covenant so, if a borrower breaches its obligations, the bank can withdraw funding.

The final challenge will be to face up to the very real difficulties posed by social and environmental assessment, including meaningful consultation with local communities and the need to develop effective human rights safeguards. No one should underestimate the difficulties in undertaking major projects in developing countries which do not share the same concept of, or adherence to, the rule of law or public participation as mature democracies.

Finally, a word of caution for those who see life beyond the Equator Principles as a world of robust projects led by mature sponsors who borrow from enlightened lenders. In the next 12 months, it is predicted that, in the wake of the Sakhalin II oil and gas project off the east coast of Russia, Shell, Credit Suisse First Boston (itself an Equator bank) and other banks that join the Sakhalin II syndicate will feel the full weight of global NGO activity against them. In this sense, Sakhalin II is likely to be the 'new' Baku–Tbilisi–Ceyhan pipeline and the proving ground for the Equator Principles and the Equator banks.

"The prevalence and influence of the Equator banks on the project finance market, given the need to syndicate large-scale projects, cannot be overstated"

NGOs do not have infinite human or financial resources. However, they are very effective in what they do because they prioritise their targets. As the Sakhalin pipeline is, according to environmentalists, a threat to the endangered western gray whale, it may seem a sensible choice for NGOs amongst competing social and environmental priorities. Those involved in the project need to demonstrate that they have learnt from the many wake-up calls from local communities and NGOs in the past. If they do not, the Equator Principles and Equator banks may be added to the list of endangered species.

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