Good Faith, Good Practice

Implementation and Accountability of the Equator Principles

BANKTrack

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A BankTrack analysis

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Introduction

During the Equator Principles (EPs) drafting process, an alliance of non-governmental organizations (NGOs) signalled our desire to work with Equator banks in an effort to move beyond IFC safeguard policies and implement best practice sector standards in ways that are consistent with Equator commitments. We remain keenly interested in improving the Equator Principles themselves, and will offer relevant proposals in the future. However, at this early stage we believe that Equator banks' first step must be to immediately create systems and processes to ensure that the EPs are implemented in a meaningful and transparent way.

Implementation is a key concern

As NGOs have pointed out from the launch of the EPs, implementation is key to ensure credibility and effectiveness of the Principles. Even with 30 environmental staff, the International Finance Corporation (IFC) itself has a poor track record of implementing its own safeguard policies. Projects that do not meet IFC standards (e.g. the Oleoducto Crudos Pesados project in Ecuador) often are privately financed in violation of these policies. Equator banks must prove that they are serious about implementation by increasing staff resources, creating internal controls, rejecting unsuitable projects, etc. The first section of this document offers recommendations of how banks can create or enhance existing management systems to support their Equator commitment.

Borrower compliance and loan covenants

From many years of monitoring controversial projects and public financial institutions, NGOs have learned that on-the-ground compliance with banks' environmental and social policies relies heavily on the commitment and capacity of the borrowers. One of the most powerful ways banks can ensure the adequate environmental and social performance of their loans is through the effective use of loan covenants. Suggested environmental and social loan covenants are provided in the next section of this document.

A need for transparency

A fatal flaw of the EPs is that there is no mechanism for ensuring that endorsing banks actually implement the Principles. The lack of transparency requirements prevents endorsing institutions, peer banks and the public to monitor implementation of the EPs. This document offers a proposed annual reporting format that provides Equator banks with a way to demonstrate how they are implementing the EPs, and how the Principles are making a difference.

An independent accountability mechanism

Another critical shortcoming of the EPs is the lack of independent accountability mechanisms. The EPs put most of the social and environmental responsibilities on the borrower, without any way for affected communities to have recourse to the bank in cases where bank standards are not being met or implemented. We propose that an independent accountability mechanism be created which will protect the integrity of the EPs though monitoring annual reporting by Equator banks and ensuring accountability in projects.

Management systems to ensure EPs implementation

Given the considerable ambitions embedded in the EPs, by necessity implementing them requires substantial changes in everyday practices of participating banks. The following proposal is presented in order of importance, but based on widely recognised components of bank Environmental Management Systems (EMSs), including those with ISO 14001 certification.

Initial environmental review

- Banks should identify the environmental and social impact of their existing project finance portfolio and, if absent, create appropriate environmental and social Performance Indicators. Performance Indicators should be developed with external stakeholder consultation.

Policy development

- Banks should identify existing environmental and social policies, procedures and standards and screen them for possible incompatibility with EPs commitments.
- Policies should be made to conform with, or even exceed IFC guidelines and be applied to all project finance transactions (regardless of the banks' role in the project) and as appropriate to non-project finance deals.
- Policies should be mainstreamed with institutions' existing implementation and risk management systems and approved by the board.
- Implementation of Equator Principles should occur within the framework of an overall, comprehensive Environmental/Social Management System (EMS). Where banks' EMSs are ISO 14001

certified, Equator Principles should be a clear part of the system and also subject to verification.

Organizational structure & personnel

- Banks should identify personnel and create governance/accountability systems for implementing EPs. All project finance staff should be responsible for implementing the EPs, while a senior manager or team should take the lead on implementation and reporting to the Board.
- To avoid excessive reliance on outside consultants, banks should have internal environmental and social expertise on staff; where such staff does not exist a budget should be provided for their recruitment.
- Compliance with EPs and superior environmental and social performance should be integrated into performance evaluations and bonuses. Performance Indicators should be developed to assess such compliance.

Environmental procedures & standards for transactions

- Banks should create formal due diligence procedures for researching environmental and social risks of project finance transactions as early as possible in the project cycle;
- Create mechanisms for appraising projects against EP standards and in relation to the banks' reputational risk; mainstream these procedures into existing credit risk management systems;
- Create mechanisms for assessing and considering borrowers' environmental, social and cultural expertise in relation to particular projects.

Documentation

- Environmental Assessments (EAs), Environmental Management Plans (EMPs), Strategic Environmental Assessments (SEAs) and monitoring reports should be part of the credit file and subject to management audit;
- Banks should create mechanisms for reviewing the adequacy of EIAs, EMPs, and monitoring reports;
- Create documentation, such as questionnaires or assessment forms, for ensuring that all EP procedures and standards are implemented in the due diligence and project appraisal phases. Such documentation should be required of staff, consultants and borrowers.
- Loan covenants should commit the borrower to the full EMP.

Internal information and training

- Banks should create communication plans for disseminating EP commitments, procedures, and standards to staff, consultants, and borrowers;
- Create training programs for project finance staff. Trainings should be mandatory, regular, and accompanied by goals and mechanisms for monitoring effectiveness;
- Create mechanisms to ensure that staff seek environmental/social expertise when necessary, and provide additional resources through in-house experts, consultants, etc.;
- Create mechanisms for assessing and consultants' environmental, social and cultural expertise in particular deals.

External reporting

- Banks should report yearly on EP implementation according to proposed reporting protocol;
- Make an assumption in favour of disclosure: publicly disclose information on transactions when requested;
- Require borrowers to release EAs before project appraisal, not just during a "reasonable timeframe";
- Engage with affected communities and public interest organisations with respect to projects of concern. Such consultation can inform due diligence and help manage risks.

Consultation and consent

- Banks should make EAs, loan covenants, and monitoring reports available to the public upon request;
- For project finance deals, banks should create mechanisms for ensuring that borrowers or third party experts conduct public consultations in a "structured and culturally appropriate way." These could include referencing best practice consultation methods (e.g. achieving prior informed consent)

Auditing, monitoring & corrective action

- Banks should identify conditions for assigning independent environmental experts to monitor and resolve problems with projects;
- Identify conditions for requiring multi-stakeholder dialogue processes in the project planning phase and, if stakeholders agree, a life-of-the-project mediator;
- Create mechanisms to regularly monitor borrower compliance with EMPs and to determine whether additional monitoring is necessary;
- Create formal processes for addressing borrower non-compliance, which explicitly includes an option to call loans;

- Create protocols for fully co-operating with independent external auditors on EP projects, and for engaging with communities affected by transactions;
- Create specific mechanisms for internally auditing the overall implementation of EPs, and taking corrective action in cases of non-compliance. Auditors should be independent from the project finance department.

Management review and improvement

- Banks should create a management process with timelines to review implementation of EPs, including internal reporting guidelines and stakeholder engagement;
- Review progress on EP implementation based on goals that include measuring environmental and social impact of the banks' project finance portfolio;
- Create board-approved annual goals and action plans to continually improve EP implementation and the environmental and social performance of the project finance portfolio. These should include timelines, personnel and objectives.

Borrower Compliance and Loan Covenants

One of the most powerful ways banks can ensure that borrowers meet environmental and social standards is through the effective use of loan covenants. The following proposal outlines recommendations regarding the content of loan covenants.

General

Loan covenants must include affirmative and negative environmental and social obligations.

In general environmental and social loan covenants should secure:

- The implementation of the full Environmental Management Plan (for A and B projects)
- Compliance with IFC Pollution Prevention and Abatement Guidelines
- Meeting of host country laws and regulations
- Compliance with applicable international treaties and agreements
- Co-operation with legitimised efforts of third party monitoring, such as the compliance audits of an Independent Accountability Mechanism

Project specific covenants

In addition environmental and social loan covenants should include project specific covenants. These must not be formulated only in general terms. The World Bank experience shows that covenants must be very detailed and specify very clearly and concisely the steps required to obtain compliance. Whenever possible an implementation program for specific covenants should be attached in the legal agreement. Such programs specify the steps to be taken in executing the project, those responsible for the action, and the timing or phasing of steps.

Monitoring

Equator banks must develop adequate mechanisms and in house capabilities to monitor compliance with environmental and social loan covenants on a similar basis as the financial loan covenants.

Ensuring and supporting compliance

Equator banks must develop adequate mechanisms and in house capabilities to be able to fulfil their duty under Principle 8 of the Equator Principles, that is to help borrowers to find solutions to come back into compliance with its environmental and social loan covenants. In cases of massive breach of the Environmental Management Plan or host country laws and regulations, or in cases of any substantive claim by affected or local people of socially unacceptable misbehaviour, loans should be cancelled.

Reporting

Loan covenants should be formulated in a way not to hamper the reporting requirements. They should be written in ways that omit confidential information.

Transparency and Accountability

Because the Equator Principles do not include a commitment to disclosure, it limits the ability of the public, and even of the endorsing banks themselves, to measure the efficacy of the Principles. Transparency is vital to promote accountability and demonstrate banks' good faith effort to implement the Equator Principles.

Naturally, external verification provides extra credibility to such reports. It should be noted that providing lists of projects financed does not violate client confidentiality; project information is already routinely provided to financial journalists and companies such as Dealogic (producer of ProjectWare).

Equator banks should annually report on their implementation of the EPs using the following indicators;

List all project finance transactions, including:

- Name of project, including country and deal size
- Indication of whether Principles were applied, and categorization (A, B, or C)
- List of non-project finance transactions where Principles were applied

For Category A projects during the last year:

- Projects not financed due to lack of compliance with EPs
- Projects financed that do not comply with EPs or are not fully covenanted to the EMP, and in each case justification for deviation
- Projects financed that have an independent expert monitoring the EMPs
- Projects financed discovered to be in default due to non-compliance with EPs or loan covenants, and corrective actions taken by the institution and/or borrower
- Loans suspended or called due to non-compliance with EPs or EMPs, including project name, borrower and reason.
- Describe how the EPs has enhanced EMPs or resulted in better social/ environmental performance of projects

Implementation systems

- Banks should describe the internal guidelines they have adopted as a result of EP commitment, and explain any deviations from the IFC environmental and social safeguard policies and/or Pollution Prevention and Abatement Handbook;
- Describe how implementation of EPs relates to the institution's systems of implementing general policies (e.g. anti-money laundering) and managing credit risk.
- Indicators should be integrated into the financial services sector supplement of the Global Reporting Initiative, which is currently under development.
- Banks should explain what level of management is responsible for implementing the EPs and explain the lines of reporting and accountability up and down the organisation;
- Describe training programs for staff for ensuring implementation of EPs, including goals, target audiences, frequency of programs, and methods to measure effectiveness;

- Indicate what additional environmental and social resources there are available to staff;
- Describe the institution's efforts to ensure that borrowers, consultants and peer institutions understand the EPs and have appropriate social/environmental expertise.
- Explain the management audit process specific to the Equator Principles implementation, and describe the independence of the auditors;
- Explain how superior compliance with EPs is recognised and rewarded in the institution and what corrective action is taken in cases of staff non-compliance with the EPs?

Project appraisal

- Banks should describe, if applicable, how the institution's process of implementing EPs differs depending on the bank's role in the transaction (e.g. lead arranger, participant, etc.);
- Indicate what particular documentation is required of EP transactions;
- What mechanisms are in place to ensure the adequate review of EAs, EMPs and other technical documents;
- What particular measures exist to ensure that borrowers and/or third party experts conduct public consultations in ways that comply with the EPs and what corrective actions can be taken if they do not?
- How consultants are selected, what instructions are given to them with regards to EPs and whether these involve site visits and consultation with local communities and NGOs;
- How activities of consultants are verified.

Covenants and Monitoring

- Bank should indicate what loan covenants and monitoring reports are available to the public upon request;
- Whether covenant obliges borrowers to implement the full EMP;
- How borrower compliance with EMPs will be monitored, and how often;
- Under what conditions the institution requires the appointment of an independent environmental expert to monitor EMPs or a mediator to resolve conflicts;
- What mechanisms exist to determine whether additional monitoring is necessary;
- What corrective actions are taken by the institution in cases where environmental and social covenants are breached.

Independent accountability mechanism

When the EPs were conceived, there was no formal mechanism for ensuring accountability. Rather, Equator Banks suggested that they could police themselves by observing in co-financing deals how lead banks implemented the due diligence, procedures, and standards required of the EPs.

However, mere observation is a wholly inadequate system of accountability. Banks must be accountable not only to themselves, but also to the public and those communities that are affected by their transactions.

Instead, we urge Equator Banks to create a joint 'independent accountability mechanism' (IAM) for ensuring the implementation and continuous improvement of the Equator Principles. The experience of the various existing accountability mechanisms of the World Bank Group, the Asian Development Bank and several Export Credit Agencies can provide important guidance for the development of such a mechanism. We envision three main roles for such a mechanism:

Compliance and accountability

To ensure high-quality reporting by banks of their implementation of the EPs and to conduct compliance audits of particular projects financed by Equator Banks.

The IAM could collect and review Equator Banks' annual public disclosures regarding their implementation of the EPs. It should monitor the overall implementation of the EPs to identify and take steps that promote continuous improvement in EP implementation. In the interest of protecting the credibility of the EPs, the IAM could create procedures to address banks that consistently fail to report, or repeatedly fail to apply the EPs. Similarly, the IAM could recognize those banks that have superior reporting or implementation records.

It could also conduct select audits of projects financed by one or more Equator Banks for compliance with the EP. Such audits could be performed at the initiative of the IAM itself, when requested by an Equator Bank, or when petitioned by directly affected communities who believe that the EPs have been breached. It should be noted that the IAM is not intended to conduct management audits of the systems devised by individual Equator banks (a function which should be performed by internal auditors).

Ombudsman

To assist Equator Banks in addressing complaints by people or communities directly impacted by projects in a manner that is fair, objective and constructive.

The IAM should help create processes between Equator Banks and directly affected communities on projects that have received community petitions for IAM compliance audits. At the conclusion of such processes, the IAM could also identify "lessons learned" and make recommendations on systemic issues that have contributed to the problems.

Continuous Improvement

To be an information clearinghouse on specific projects and promote best practice environmental and social policies, guidelines, and procedures.

While the primary role of the IAM should be its Compliance and Accountability function, the IAM could also enhance Equator banks' due diligence processes by being an information clearinghouse on environmentally and socially controversial projects that are in the financing or pre-financing phase. The IAM could also serve as an information resource by organizing workshops to promote better EP implementation and continuous improvement.

Finally, the IAM could foster the improvement of the EPs themselves. For example, it could strengthen the Principles through advocating for stronger IFC environmental and social safeguard policies, extending the scope of the EPs, and updating them to reflect state-of-the-art environmental and social procedures and standards.

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