GOOD PRINCIPLES ARE HARD TO LIVE UP TO

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Dan Siddy: EP is 'not a panacea'

Cracks are starting to appear in the Equator Principles. While banks may not lend money for non-compliant projects, they are still free to invest or to lend to export credit agencies that do the financing. *Geraldine Lambe* explores the new reputational risks this throws up.

Companies cannot wait to tell people about their corporate social responsibility (CSR) programmes. As a branding exercise, it has proved incredibly seductive. Recently, in a single newspaper, there were 14 advertisements showcasing various corporates' CSR credentials; and when, in January, **The Banker** asked financial institutions to submit information for a CSR Q&A, we were overwhelmed with more than three times as many responses as we expected (and would normally receive).

A plethora of environmental, social and governance (ESG) initiatives bear witness to such enthusiasm. One example is the Equator Principles (EP), a voluntary set of guidelines laid down in 2002 by 10 banks under the auspices of the World Bank Group's International Finance Corporation (IFC), upon whose performance standards the principles are based. In a bid to address social and environmental risks, and to mitigate reputational risk, signatories agree to incorporate ESG concerns into their internal credit risk procedures, and require borrowers to observe standards relating to working conditions and environmental conservation, for example, as a condition for lending on any development projects costing $10m or more.

Enthusiasm for principles

The principles have been taken up with a fair degree of gusto. A total of 41 banks have since signed up to the initiative, which now represents more than 80% of private project finance worldwide. And the principles have done a lot to improve banks' engagement with stakeholders, particularly non-governmental organisations (NGOs), which was previously relatively limited and usually confrontational. By establishing a common language and encouraging earlier and more granular risk assessment, the EP have helped signatory banks to avoid the reputational risk associated with development projects that often involve disruption to communities or the environment.

On the downside, by setting higher standards, the banks have also opened themselves up to even greater scrutiny and to accusations of non-compliance. The proliferation of initiatives and undertakings (Société Générale, for example, may not be an Equator Bank but has signed up to the London Principles of Sustainable Finance, the carbon disclosure project, United Nations' Global Compact, the Wolfsberg Group, the Organisation for Economic Co-operation and Development's recommendation on common approaches to environment and officially supported export credits, and The United Nations Environment Programme's Statement by Financial Institutions on the Environment & Sustainable Development) makes life complicated for banks that have to balance new corporate ethics with sensitive and lucrative client relationships, and diverse businesses that include asset management and principal investment arms.

Have banks committed themselves to principles that their businesses will make it hard to keep?

Reputations at risk

In the recent commodities boom, many banks have invested via their asset management or principal finance arms in mining companies, energy firms or other sectors that are commonly associated with project finance. Such investment is not covered by the EP, which applies to project finance but not to asset management or proprietary investment, but this subtlety is easily lost on outsiders. From a layman's perspective, it is semantics; a bit like saying: 'I'm going to be good some of the time, but for the rest of the time I can't promise anything.' Many argue this has the potential to erode bank reputations and the integrity of the principles.

According to records from the Australian Securities Exchange, JPMorgan Chase (JPMC) owns 5.23% of Lafayette Mining, an Australian company that owns and operates a controversial polymetallic open mine in Rapu Rapu Island in the Philippines. BankTrack, a group of 12 NGOs that have pooled their finance advocacy, claims that the project breaches the EP because of resistance by local communities to the mine, and it argues that the environmental and social impact assessments are inadequate in the face of the island's regular exposure to typhoons. This perception was underscored by cyanide spills in October 2005.

The project is again in the spotlight. Its operational permit, which had been temporarily revoked by the Philippines government's Department of the Environment and Natural Resources following the cyanide contamination, was reinstated on February 7.

Although it could be argued that it is the job of BankTrack and other NGOs to find and advertise holes in banks' ESG policies, JPMC's share ownership exemplifies the tensions that are inherent in living up to the EP and other ESG codes of practice at the same time as running a global, universal bank. JPMorgan may argue that the project does not breach the principles – after all, risk assessments were carried out and operation permits granted by the Philippines government. It may also contend that the shares are, in fact, owned by JPMorgan Asset Management rather than the corporate entity (although most asset management decisions are made by a fund manager, not individual investors). However, ownership still exposes the bank to the reputational risk that the EP were supposed to prevent.

Vulnerable position

Ironically, JPMorgan's determination to make a powerful corporate commitment to ESG leaves it particularly vulnerable to criticism; when it adopted the Equator Principles, the bank extended their reach beyond project finance to cover all loans, debt and equity underwriting, and financial advisory. Even if share ownership is not included, the bank's otherwise all-embracing pledge – and the positive change it effects – is undermined.

JPMorgan declined to be interviewed on the application of EP, but a spokesman stressed that the investment represented client funds, not JPMorgan investment, and that it was not up to the bank to dictate where client money was invested.

JPMorgan is not alone. Standard Bank is also listed as a Lafayette shareholder, and ABN AMRO, ANZ (also an EP signatory), Standard Bank, Investec, FA International and Korea First Bank, a subsidiary of Standard Chartered (another EP adopter) are lenders in the bank syndicate.

ABN AMRO declined to comment on the Lafayette Mining project, but Joel Posters, head of the Sustainable Business Advisory group for Asia, speaking from Hong Kong, stresses that any proposed project finance transaction has to demonstrate compliance with the EP. Moreover, he says that ABN AMRO has also developed sector risk policies and assessment tools that outline the bank's due diligence procedures for transactions in potentially sensitive sectors, such as oil and gas, mining, and forestry.

"Depending on the risk profile of the deal, the application of these policies will mirror the due diligence procedures conducted for EP transactions. These internal standards help to ensure that the bank's involvement in any financing of projects, including those not formally covered under the scope of the EP, can be considered responsible," says Mr Posters.

Courting controversy

Other controversial deals raise similarly difficult issues for banks. UK-listed Asia Energy was created to develop a large coal mine and power station in Phulbari, Bangladesh. Barclays Capital acted as financial adviser and, although its role did not involve a project finance loan, the project was prepared to be compliant with the EP. A source close to the transaction says that former IFC environmental experts acted as consultants, and voluminous environmental assessments were carried out, but the IFC discreetly turned down the project, which would displace about 50,000 people in April 2006 and BarCap started looking for new project financiers.

In August last year, however, a 10,000-strong crowd protested at Asia Energy's local office and the police opened fire, killing six people; subsequently, the Bangladesh authorities decided not to grant final permission for the project. The company's shares immediately nose-dived. This did nothing to dissuade Barclays plc (a signatory to the principles) from acquiring 4.32% of Asia Energy's shares on December 1, 2006.

If the shares were acquired by Barclays Global Investors, the rock-bottom share price may well have been the very incentive that made the investment appealing to a fund manager – little worried by their company's project finance principles – who believes that the company (which changed its name to Global Coal Management in January this year and says it remains committed to implementing the Phulbari coal mine) will overcome any short-term difficulties and the share price will rise.

Barclays declined an interview to discuss this project or the Equator Principles in general. It provided the following statement: "Barclays Capital takes its environmental and social responsibilities seriously and we ensure that the projects we support meet our own stringent criteria, as well as local and international parameters, in this case the guidelines set out in the Equator Principles as well as the Bangladeshi requirements."

Quantification is difficult

Overlooking the moot point of whether or not it is wise from a reputational standpoint for Barclays to invest in the company, some argue that the Phulbari project challenges the notion that the EP are effective in managing either social, environmental or financial risk. After more than four years in operation, some analysts question whether anybody can yet quantify what the principles add in terms of risk reduction, shareholder value or to development impact.

"It's a valuable initiative, but it's certainly not the panacea it's made out to be," says Dan Siddy, managing director of sustainable investment consultancy Delsus, and former head of the Sustainable Financial Markets Facility at the IFC. "Just because a project has been through the EP process does not make it a good project; and just because a bank has done impressive due diligence on a project sponsor, does not mean they will turn out to be a good sponsor."

The question is difficult to answer, not least because it is impossible to 'measure' something that is avoided. For example, if a bank or a borrower successfully implements EP and mitigates any environmental damage or social upheaval, it may keep the project out of the headlines, but how can its success be quantified? Equally, because so much information surrounding deals is confidential client data – which in itself draws criticism from NGOs for lack of transparency – it is hard to qualify what is being done behind closed doors.

Reed Huppman: the principles are reducing risk

"The reality is that many of these projects are undertaken in areas where operations involve high levels of risk, whether that be environmental or the sort of social unrest that could bring a project to a standstill and affect sponsors' ability to repay loans, or damage participants' reputation. This kind of risk used to be an 'externality'. While it is easy to pick holes in the Equator Principles, they bring such externalities into a project's due diligence process and, in a large number of cases, reduce those risks. They are a real and effective risk management tool."

There is also the vexed question of whether or not EP has affected deal flow and whether this matters; how many projects have banks turned down because they failed to meet the principles' hurdles? In this respect, banks seem to be in a discomfiting position: if they admit that implementing the EP has had a significant impact on the number and type of deals done, it is a tacit admission that previous lending was not strictly risk managed or that they did a lot of business with little regard for ESG issues. But if banks say that the principles have had little impact on deal flow, then what was the point of adopting them?

Example of success

Eric Cochard, head of the EP co-ordination team at Calyon, the only French bank to sign up to the Equator Principles to date, says that the EP have not significantly changed the bank's deal flow, but sees this as an example of success not failure.

"First, it is difficult to say that we have turned down a deal because of EP, because there are always many reasons behind any decision," says Mr Cochard. "Second, because EP introduces enhanced levels of environmental and social impact analysis, and brings in these issues at very early stages of the due diligence process, by the time we take a decision on whether or not we want to finance a project, those kinds of issues have already been addressed. This means that deals that are unlikely to be financed because they cannot meet EP criteria are eliminated before they get to the committee that makes the final decision."

In any case, Mr Huppman says that change is happening where it matters most: in the borrower community. Speaking from a mining conference in South Africa in February, he noted that every presentation from a borrower to investors and banks included two or three slides referring to the EP, human rights policies, and engaging with, and creating long-term value for, local communities. "This is a profound change. And it's the borrowers – the project sponsors – that manage the projects. They make the difference on the ground. Lenders have limited leverage," he said.

Lenders do have some influence, however. If a sponsor reneges on ESG promises, banks could exercise the restrictions and covenants written into the loan agreement and recall the loan. But, as one project finance banker suggests, the fact that banks rarely exercise this right highlights again the kind of internal tensions to which banks may succumb. "To my knowledge, few banks ever do that. The risk managers may want to pull the plug, but deal makers will do everything in their power to keep the whole thing afloat and to keep lines of credit open."

Classification anomolies

Some controversial deals that still get bank financing reveal anomalies in how banks classify projects and consequently determine which funding conditions must apply. In January, Calyon confirmed that it will provide financing for the controversial Orion pulp mill project being developed by Finnish company Metsa-Botnia on the Uruguayan/Argentine border. In the past two years, the project has generated conflict between the two countries' governments, and huge social protests from Argentine residents and environmental groups who believe that, during production of an expected one billion tons of pulp a year, the mill will pollute the river that separates the countries and cause other environmental damage.

Calyon says that the project does not need to comply with Equator Principles because it is not a project finance arrangement; it says that, as financing for an export credit agency, it comes from a separate division in the bank. David Barnden, programme officer with human rights group Centro de Derechos Humanos y Ambiente (CEDHA) in Argentina, says that CEDHA met with Calyon in early January and that the bank refused to provide specific details on the type of loans it was providing.

Calyon did not answer requests for comment about the Botnia Mill.

Ripple effect

But, for all the applause or criticism that the Equator Principles may generate, the most challenging issues arising from the EP agenda over the next year may have little to do with the Equator banks themselves, or at least directly. Preoccupation with the compliance technicalities of high profile Equator signatories could be masking the real challenge of what non-signatories, particularly developing country financial institutions, are doing or not doing, and the ripple effect this could have.

It is well known that China, for example, is sitting on close to $1000bn in hard currency and is using this money aggressively to finance Chinese foreign direct investment (FDI) in infrastructure and natural resource development projects by Chinese firms in other developing countries. In an interview with *Les Echos* in October 2006, World Bank president Paul Wolfowitz criticised Chinese banks for ignoring the EP, pointing out that, unlike loans from Equator banks or multilaterals like the IFC, financing provided by Chinese Development Bank, China Exim Bank and the large state-owned commercial banks comes with no environmental or social strings attached, let alone anti-corruption conditionality.

Western banks are arguably facilitating the Chinese to undermine the EP. For example, in June 2005, Citigroup, HSBC, Goldman Sachs, BNP Paribas and Merrill Lynch (Citi and HSBC are both Equator banks), alongside Bank of China International, arranged a $1bn bond for China Exim Bank – the third largest credit export agency in the world – the proceeds of which were used to finance Chinese companies' FDI, but with none of the EP restrictions attached to the loans of participating banks' project finance departments.

"This illustrates the paradox created by the real politik operating in many global banks," says Mr Siddy. "There are already internal tensions and inconsistencies within many Equator banks, where asset management, investment banking and advisory teams are often much less willing to factor in sustainability issues than their Equator-trained project finance colleagues. If all these trends continue, and deal flow is affected, it is not impossible that the boards of Equator banks may begin to re-assess their priorities."

Reassessment

Politicians may also be tempted to reassess EP. In May last year, US-based think tank The Brookings Institution highlighted the potential challenges posed to the international community by China's purchase of upstream assets in its policy brief 'Untangling China's quest for oil through state-backed financial deals'. The paper also highlighted how China's predatory pricing tactics are putting the predominantly Western Equator banks, development multilaterals and businesses at a distinct disadvantage, especially in industries and countries of major geo-political importance.

"China will be encouraged to join the 'race to the top' through the G8 and World Trade Organization process this year: we know that freedom of investment, global investment conditions and the social dimensions of globalisation are on German chancellor Angela Merkel's tentative agenda for the G8 summit in June," says Mr Siddy. "But if such pressure fails, and Western leaders see access to crucial industries or economies threatened, we may see a pushback against the Equator Principles from protectionist lawmakers and business leaders closer to home."

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