EIRiS
ETHICAL INVESTMENT RESEARCH SERVICES

SEE risk briefing

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Project finance: a sustainable future?

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1. Overview

Project finance[1] is a rapidly expanding field, with almost USD 200bn lent to companies to finance particular projects in 2004[2]. While project finance has its origins in the natural resource and infrastructure sectors, the current demand for infrastructure and capital investments is primarily fuelled by deregulation in the power, telecommunications, and transportation sectors; by the globalisation of product; and by the privatisation of government-owned entities in developed and developing countries. The long-term prospects are strong, as countries with limited government resources try to meet the growing demand for infrastructure assets.

Given the right applications and structures, the benefits of project finance can more than offset the higher transaction costs, increased time commitments, and higher debt rates typically associated with project financings.
However, project finance may result in unsustainable practices because banks and project sponsors (bank clients) often do not carry out adequate environmental and social impact assessments of the projects they are financing. In addition, financiers often take inadequate steps to address the issue of sustainability, as environmental and social regulations in some host countries can be weak. This is especially true in developing countries. As a result of the adverse consequences big infrastructure projects may have, civil society has increasingly targeted the financiers involved in the projects to act more responsibly.

This briefing seeks to identify the areas of potential risk associated with project finance, and the ways in which these may materialise in the short and

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medium term for financial institutions. The briefing then examines the policies and strategies adopted by nine of the largest financial institutions involved in project finance in mitigating those risks, against a set of indicators devised by EIRIS (see sections 6 and 9). Finally the paper discusses how financial institutions could further decrease their risk exposure while investing in large and often controversial projects, as well as looking at best practice examples within the financial industry.

EIRIS chose explicitly to look at project finance as a financial instrument and its related risks and not solely at the Equator Principles. This inclusive approach also allows EIRIS to look beyond the Equator Principles to analyse companies involved in project finance who have not adopted the Equator Principles.

The key findings of this briefing are:

- Three years after the first announcement of the Equator Principles in June 2003, the number of adopting financial institutions has risen from 10 to 41
- All nine companies analysed in this pilot study have a global project finance policy that includes social, ethical and environmental criteria
- Some of the companies analysed, including ABN AMRO, Barclays, JP Morgan Chase and Westpac Banking Corporation, have taken steps to go beyond the Equator Principles by applying the principles to a lower financial threshold or to other financial instruments such as corporate loans, and by implementing sector specific policies in relation to project finance
- However, despite a number of positive steps that have been taken, not all companies are mitigating their risks sufficiently and only two company's management response is classified as 'good' i.e. sufficient to mitigate risks to an acceptable level
- Investors need to focus on how companies are implementing these commitments to adequately mitigate company risks. Currently the implementation of these commitments and policies vary greatly
- A number of companies (six out of nine) fail to report in detail on their compliance, monitoring and auditing systems
- Only three of the nine companies show evidence of client diagnostic tools or audits to evaluate environmental and social risks
- Five out of the nine analysed companies report publicly on project finance but the extent and depth of information varies considerately
- Reputational risks in relation to project finance could be mitigated to a greater extent by reporting transparently on controversial projects

The Equator Principles represent an important advancement in financial institutions addressing the environmental and social impacts associated with project finance. However, adoption of these, or similar principles, alone does not adequately mitigate the risks facing this sector. The effectiveness of the voluntary standards so far adopted by 80% of financial institutions involved in project finance is also being disputed and criticised by several NGOs[3]. Only by focusing on the implementation of these commitments will the risks be adequately mitigated.

2. Background

2.1. What is project finance?

Project finance, also called non-recourse or limited-recourse finance, is a form of financing for companies and governments where lenders are repaid only through the revenues generated by the project itself e.g. the tolls collected from a toll road, the electricity generated by a power plant. Lenders do not have 'recourse' to the borrower's own assets if a project fails to generate the revenue projected. Project finance is most commonly directed at large infrastructure projects. After massive privatisation and deregulation of industrial sectors in the 1990's, private financing of development projects grew enormously. Although the volume of projects decreased in 2001 as a result of the worldwide economic slowdown and industry-related risks (especially in the power sector), project finance began rebounding in 2002.

The deal cycle is typically very long (often many years), and can involve many financiers. The initial costs of these projects are usually very high, while the benefits can only be reaped in the longer term. Since all kinds of risks may arise (financial, technical, environmental, political etc.) project finance has evolved into a very complex financing method. Project finance is comprised of a mix of equity and debt. Typically 30-40% of a project is funded through equity contributions, while 60-70% is funded through debt. Project sponsors usually contribute the equity and 'own' the project, while debt finance can take two forms: loans and bonds. Project loans are made by commercial banks, with each lender agreeing that loans will be repaid only from the revenues generated by the successful, completed project. Loans normally contain loan covenants or agreements between the lender and the borrower about what the borrower should or should not do, such as providing regular reports and adequate insurance. Larger, more risky projects often require syndicated loans. These loans are provided by a group of financial institutions called a bank consortium or a syndicate. The bank coordinating the consortium and the syndicated loan is called the arranger, and can be different from the banks providing the debt[4].

Project finance primarily benefits sectors or industries in which projects can be structured as a separate entity, apart from their sponsors. A case in point would be a stand-alone production plant, which can be assessed in accounting and financial terms separately from the sponsor's other activities. Generally, such projects tend to be relatively large because of the time and other transaction costs involved in structuring, and to include considerable capital equipment that needs long-term financing. In the financial sector, by contrast, the large volume of finance that flows directly to developing countries' financial institutions has continued to be of the usual corporate lending kind.

The most prominent project finance sectors are telecommunications, power plants, infrastructure, natural and other resources, petrochemical and chemical plants. Most project finance is lent to projects in Western Europe. North America is another major destination, followed by Latin America, including the Caribbean, and Southeast Asia.

2.2. The Equator Principles[5]

On 4 June 2003 ten financial institutions launched the Equator Principles (EPs), a set of guidelines for managing social and environmental issues related to the financing of

projects[6]. According to the civil society organisation BankTrack[7] it is the first time that banks, which are otherwise in competition with each other, have presented a united approach in attempting to mitigate environmental and social risks associated with financing projects.

The Equator Principles commit adopting banks to:

"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"[8]

Three years after the first announcement of the EPs, the number of adopting financial institutions has risen to 41. Most of the key players in the market are on board but a number of leading project finance banks, including BNP Paribas and Société Générale, continue to opt out. The Equator Principle banks themselves estimate that the Principles now govern over 80% of all project lending[9].

The banks pledge to apply this framework to all projects with a capital cost above USD 50m[10] (GBP 26,7m; EUR 39,3m; JPY 5,6bn), in all industries globally. The principles are presented as a framework for developing individual internal practices and policies. Banks are adopting and implementing these principles voluntarily and independently. Banks adopt these principles but are not signatories to them.

The environmental and social screening process for projects is based on that used by the International Finance Corporation (IFC). Projects are categorised as A, B or C projects (respectively, those displaying high, medium or low environmental or social risk). For all Category A and Category B projects (high and medium risk), a borrower must carry out an environmental assessment (EA), which addresses the environmental and social issues identified in the categorisation process. The environmental assessment must show that the project complies with host country laws, regulations and permits required for the project; with the World Bank guidelines; and with IFC Pollution Prevention and Abatement Guidelines for the relevant industry sector. For projects in 'low and middle income countries' only[11], the environmental assessment must also take into account the IFC Safeguard Polices, which provide guidance on issues such as natural habitats, indigenous peoples, involuntary resettlement, safety of dams, forestry, cultural property and other matters. For all Category A projects and certain Category B projects, the borrower or a third party expert must prepare an environmental management plan (EMP). A number of quality controls are envisaged: compulsory independent expert reviews of EAs and EMPs for Category A projects and an independent expert review of compliance, when judged necessary. However, the principles do not specify who will carry out these reviews or their timelines, what recourse there will be for potentially affected persons, and do not clarify the circumstances under which independent monitoring will be considered necessary[12].

While civil society organisations have very much welcomed the development of the Equator Principles and the commitments contained in them they have also made clear that they expect adopting banks to apply them rigorously, and in good faith, in their decisions on whether or not to finance specific projects. The biggest areas of criticism are currently accountability

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and transparency of the Equator Principles, and implementation and compliance monitoring of them. Several civil society groups also criticised the EPs for not providing a sufficient description of public consultation processes in relation to controversial projects[13].

However, as the Equator Principles were just launched in a revised form one major improvement is seen in the expansion of the scope of the principles: the new principles apply to all new project financings with total capital costs of USD 10m or more across all industry sectors globally. In addition, while the principles are not intended to be applied retroactively, the financial institutions will apply them to all project financings covering expansion or upgrade of an existing project where changes in project scale or scope create significant additional environmental and/or social impacts, or significantly change the nature or degree of an existing impact.

The civil society response 'Equator Principles II - NGO comments on the proposed revision of the Equator Principles' issued in April 2006 welcomes the extension of the scope of the EPs as the most obvious improvement. One of the main criticisms in this paper is the application of the EPs to limited financial operations (only project finance loans are covered; other financial instruments, like corporate loans, are not included) which significantly impedes one of the stated goals of the EPs: 'to promote responsible environmental stewardship and socially responsible development.' The civil society response points out that it is the scale of the impact, not the nature of the transaction that should determine the appropriate response and approach of the financial institutions[14].

The Equator Principles offer a comprehensive framework for assessing a company's risks in relation to project finance. However, as the implementation and compliance mechanisms are not defined within this framework it is insufficient from an investor's perspective to solely adopt the Equator Principles without filling this framework with a meaningful content which is specifically tailored to each individual financial institution and its business operations.

3. Scope of EIRIS research

EIRIS' analysis in this report focuses on companies who are involved in project finance.

The selected companies are ABN Amro, Barclays, BBVA, BNP Paribas, Credit Suisse First Boston, Deutsche Bank, JP Morgan Chase, Sumitomo Mitsui Banking and Westpac Banking Corporation. All nine companies derive a substantial amount of profit from project finance[15].

EIRIS has selected companies from a wide geographical range to present a broad overview of approaches and steps taken to mitigate the risks in relation to non-recourse finance.

All companies in the FTSE All World Developed Index have been classified as high, medium or low exposure and their management response will be assessed over the year.

A snapshot of EIRIS's findings is presented in section 6.1.

4. Potential social, environmental and other ethical risks and opportunities

This briefing seeks to identify areas of potential risks and opportunities associated with project finance, and ways in which these may materialise in the short to medium term. The key risks identified are direct risks such as political, social and environmental risks but also indirect risks such as reputational risks.

4.1. Direct risks

4.1.1. Environmental risks

Large infrastructure projects often carry significant environmental risks that may not be immediately visible to the banks[16]. Environmental risks may have a direct bearing on project returns when, for instance, the life-expectancy of a dam is shortened by unexpected ecological processes.

A specific current example is the Baku-Tbilisi-Ceyhan (BTC) pipeline, a project that spans Azerbaijan, Georgia and Turkey. It has been especially criticised by civil society groups for the risks it poses to the environment. A direct financial risk could materialise to the fifteen major banks that financed the controversial BTC oil pipeline. The financial institutions have been warned that they could face court action if the pipeline leaks. The warning to the boards and legal departments of the fifteen banks came in a letter from UK, Georgian and Azeri campaign groups who have been monitoring the pipeline's impacts. The banks, including The Royal Bank of Scotland and ABN AMRO[17], would be liable to Turkish, Georgian and Azeri claimants if they had prior knowledge of a potential cause of pipeline failure yet failed to act to remove the risk of pollution. Experts have testified that the anti-corrosion coating chosen by BP, who own 30.1% of the project and is the operator of the Azeri-Chirag-Guneshli offshore oil field complex as well as the Shah Deniz gasfield, does not stick to the pipeline.[18] Peeling and cracking of the coating has been reported in internal BP reports. The participating banks could incur civil or criminal liabilities if a coating failure causes a leak. The banks were informed of reports documenting the extent of coating failure and of the potential civil and criminal liabilities that might arise if they fail to use their powers as lenders to take effective action to prevent pollution. According to civil society groups, such as Platform London[19] (a member of BankTrack), it is considered a general offence to "knowingly permit" a crime. Corrosion experts have advised that the only course of action that would remove the high risk (and potential liabilities) of a leak would be for the pipeline to be re-coated with a coating that is suitable for the purpose[20].

A similar example which could pose a possible legal risk to financial institutions is the Sakhalin II project in Russia where an environmental impact assessment was conducted by Shell. As non-governmental organisations such as the World Wildlife Fund (WWF) and BankTrack have pointed out[21] Shell has not produced oil spill models for the Sakhalin II project with sea-ice conditions, emphasising in the report that there are no existing mathematical models to predict the movement of oil in ice. The syndicate of the financiers should therefore be aware of the lack of an oil spill response. In the case of an oil spill the bank could be made liable through their knowledge of insufficient protection of the environment by claimants in Russia.

These environmental risks thus pose a significant financial risk to lenders, especially given that project finance arrangements stipulate that lenders have little recourse beyond the revenues generated by the project itself. The collateral in these arrangements are lower than in normal credit transactions, meaning that credit risks are automatically higher. There is a direct link between the environmental risks of the project and the credit risks borne by the lenders[22]

4.1.2. Social risks

Social risks may have a direct impact on project returns if left unmanaged. These risks can lead to commercial consequences for the business in both the short-term (e.g. in relation to construction schedules and costs, production output and timely facilities maintenance) and the long-term (e.g. reduced access to in-country growth opportunities and damage to global reputation).

For example, the resettlement of people can have far-reaching and serious impacts. As a result of displacement, systems of livelihood are disrupted, and productive assets and income sources lost. Community structures and social safety nets are weakened, human security diminished, and there are reductions in cultural identity, traditional authority and the potential for self-help. Poorly managed resettlement can cause severe, long-term social degradation, impoverishment and increased vulnerability. Wherever resettlement occurs, there is increased potential for conflict arising from many causes including: disputes over ownership, rights to land or resources; inadequacy of compensation; conflicts between resettled people and their host populations; or as a result of corrupt behaviour by implementing officials.

Project design that minimizes resettlement should be considered of the highest importance, as well as following established international guidelines for the management of involuntary resettlement.

A meaningful engagement of communities in project decision-making could generate substantial benefits that may reduce operational risks for financial institutions.

The mitigation of social risks in relation to project finance will gain more importance in the future due to the revision of the Equator Principles. The revised principles put extra emphasis on the social impacts of projects with labour conditions, health and safety, and the impacts of projects on communities highlighted.

4.2. Indirect risks

4.2.1. Reputational risk

Banks' reputational risk can be defined as the probability of being a target of a public campaign multiplied by the cost for the bank of such a campaign. It is reasonable to assume that both the probability and the cost of a campaign will vary across the type, size, and geographical location of banks. Banks with a well established brand name located in countries with strong non-governmental organisations are more likely to be the target of public campaigns than small specialised banks located in countries with weak NGOs. Banks involved in commercial retail banking, and thus vulnerable to consumer boycotts, will be likely to incur higher losses than specialised financial institutions from NGO-led public campaigns. Hence we can reasonably assume that financial institutions differ greatly in terms of reputational risk. This disparity in reputational risk could generate a

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competitive advantage for some banks at the expense of others. At its simplest, the more exposed banks are obliged to adopt voluntary standards in their project financing business in order to deflect NGO criticisms, while the less exposed ones are not. However, simply adopting the Equator Principles will not mitigate the reputational risk of a bank. Mechanisms must also be put in place to ensure that the Equator Principle requirements are integrated into a bank's operational system.

Reputational risk can harm brand value, employee morale, ability to recruit and, in some cases, ability to write business. This is especially true in the retail market where boycotts have occasionally erupted over particularly high-profile client relationships[23]. In such cases stakeholders, including a growing number of shareholders, can be expected to seek assurances regarding exposure levels and risk management practices. Yet banks' internal tracking mechanisms are often found wanting and policies and practices are, in many cases, not clearly articulated. This is often a consequence of a bank's concern over potential competitive implications, which precludes internal working papers addressing policies and practices from being publicly disseminated. Furthermore banks cite client confidentiality as an additional barrier to fully disclosed practices[24].
There is a strong link between reputation and branding. Over 85% of consumers have a more positive image of companies that are seen to be pursuing more responsible business practices and over half of European consumers say they are prepared to pay more for environmentally responsible products[25]. However, it may still take some time until consumers will choose a bank because of their social, environmental and ethical policies and products.

NGO campaigns pose an indirect reputational risk to financial institutions involved in controversial projects. The BTC pipeline project, for example, has been criticised by a consortium of internationally recognised NGOs for causing significant social and environmental impacts, undermining human rights, and contributing to the destabilisation of peace in the region. Since nine Equator Principles signatories decided to support the controversial pipeline in 2004, leading environmental and human rights groups have been pressing these banks to abandon providing finance to the project as they argue that it breaches the Equator Principles on several counts.

For the 2005 report on the Equator Principles, "Banking on Responsibility", 32 financial institutions were asked by the international law firm Freshfields Bruckhaus Deringer to state their main reasons for adopting the Equator Principles. Among reasons such as 'protection of market share', 'level playing field' and 'financial risk rating' it was stated that 'reputation' and 'stakeholder and NGO activism' were significant drivers in the decision making process[26].

5. Exposure factors

In identifying the companies most exposed to risks related to project finance EIRIS has taken the following into account: a) whether the company is a 'mandated arranger'[27] or a 'provider' in specific project finance deals; b) the location of the majority of financed projects; and c) whether financed projects are located in a high risk sector.

5.1. Role in project finance deal

EIRIS considers 'mandated arrangers' and 'providers' to be at highest risk as they are essentially the 'operators' of a project and those that provide the largest proportion of financing. These terms are defined below.

Mandated arranger status is assigned to the banks awarded the mandate by the borrower. These banks take the leading roles in the negotiation of contracts and covenants. The title is assigned to all banks within such a group.

Providers finance the project on a non-recourse or limited recourse basis. A syndicate of banks from different countries may be required to gather the amount of money necessary for the project.

The other two key players are legal advisers and project sponsors. Project sponsors are parties with a direct or indirect interest in the realisation of the project such as contractors, suppliers, purchasers or users of the projects products or facilities. Neither of these groups will be analysed within this briefing as it is focused upon the indirect impact of the financial sector.

5.2. Location

EIRIS has developed a model of geographical categorisation to identify regions where projects face a higher exposure to risks. The following table illustrates this categorisation:

Region	Exposure
Asia	High
Australia & Japan	Low
Europe	Low
Latin America	High
Middle East & Africa	High
North America	Low

This is based on identifying regions where there is limited regulation to prevent environmental or social damage.

5.3. Sector

EIRIS has also identified four sectors as the largest and most significant sectors for project finance. This is based on annual league tables compiled by Dealogic[28].These league tables provide information on the aggregate annual number and US dollar volume of all syndicated loans and in particular project finance (PF) loans by country of the borrower and year of the signing.

As major oil and gas or power projects pose a much higher risk to the environment and surrounding communities they have been classified has 'high' risk. EIRIS may allocate a higher risk rating to controversial projects within the Public Private Partnership (PPP) category after looking at a specific project and its related risks.

The sectors have been classified as following:

Type of project	Exposure
Oil & gas	High
Power	High
Transport	Medium
PPP	Low

5.4. Exposure classification

Overall, a company will be classified as 'high exposure' if it is identified to be in at least two high exposure categories. A company in the medium exposure category will be exposed to a maximum of one high risk factor. Low exposure companies will only be exposed to low exposure factors and to a maximum of one medium exposure factor.

EIRIS has chosen the following selection of companies to analyse in this paper. It represents a mixture of significant high and medium risk companies from a broad geographical range to offer an overview of approaches and steps taken in relation to project finance. All companies are also providers.

Company	Mandated Arranger - Total Loan Amount 2004[29]	Exposure
BNP Paribas (France)	USD 2019m	High
BBVA (Spain)	USD 1741m	High
Sumitomo Mitsui Banking (Japan)	USD 1618m	High
Deutsche Bank (Germany)	USD 1479m	Medium
Westpac Banking Corporation (New Zealand)	USD 1313m	Medium
Barclays (United Kingdom)	USD 1264m	High
ABN Amro (Netherlands)	USD 1240m	Medium
JP Morgan Chase (USA)	USD 1083m	High
Credit Suisse First Boston (Switzerland)	USD 899m	High

All companies in the FTSE All World Developed Index have been classified as high, medium or low exposure and their management response will be assessed over the year.

6. Managing the risks

In order to manage the risks described above financial institutions should undertake in-depth environmental and social risk assessments in their due diligence process.

To analyse the ways in which the financial industry can manage the risks identified by this study, EIRIS has assessed the selected companies' policy and strategy statements, risk assessment tools, public reporting and dialogue, and their performances and innovations in relation to project finance. These indicators support the spirit of the EPs but also aim to go beyond the reach of them. The assessments are made on the basis of publicly available statements and information provided to EIRIS directly.

EIRIS has identified 22 key indicators for assessing companies' management of risks related to project finance. Detailed definitions of indicators are provided in Annex 9.1. The indicators fall into five categories:

Strategy and responsibility

- Global project finance policy including social, environmental and ethical (SEE) criteria
- Public Equator Principle (EP) commitment within policy
- Policy commitment only to enter loan syndication with EP banks, or if EPs are fully applied to the project
- Commitment to environmental management plan / environmental impact assessment for all project finance deals
- Commitment to social management plan / social impact assessment for all project finance deals
- Commitment to environmental management plan / environmental impact assessment for all project finance deals considered Category A (IFC)
- Commitment to social management plan / social impact assessment for all project finance deals considered Category A (IFC)
- Environmental and social impact assessment (if appropriate) for Category B (IFC) projects

Risk assessment

- Client diagnostic tool to assess clients on their sustainability profiles for approval of project finance deals (specific sector or all sectors)
- Environmental audits and site visits to evaluate environmental risks of a specific project
- Social audits and site visits to evaluate social risks of a specific project

Compliance and monitoring

- Training of relevant staff by consultants on environmental and social risks relating to project finance
- Guidance notes for understanding of possible risks related to PF available to staff
- Attach conditions to loan agreement relating to SEE issues where necessary
- Monitor compliance with any SEE conditions attached to the loan agreement

Reporting and dialogue

- Engagement on proactive basis with stakeholders (throughout project life)
- Detailed public response to NGO allegations concerning the financing of controversial projects (where relevant)
- Public reporting on project finance : project finance business data; proportion of loans; types of loans (A, B or C as classified by the IFC)
- Quantitative reporting on implementation of project finance policies including KPIs
- Qualitative reporting of challenges and compliance
- Reporting on how many client companies/ projects were denied credit due to social, environmental and ethical reasons or due to Equator Principles screening (where relevant)
- Disclosure of person/committee responsible for approving project finance deals

Performance and innovation

- Project finance policy applied beyond scope of Equator Principles commitment threshold: policy applicable below threshold of USD 10m or the Equator Principles are applied to other financial instruments such as corporate loans
- Policy leadership – policy going beyond EP policy guidelines in relation to project finance

6.1. Snapshot of EIRIS findings

Set against the indicators described above, two of the nine companies' management responses has been assessed as 'good'. Where an assessment of 'good' represents a company which EIRIS considers has mitigated the risks to an acceptable level. Two of the nine companies have been assessed as 'intermediate'. As shown in the table, the companies which reached the grade 'good' were ABN AMRO and Barclays. BBVA and Westpac Banking Corporation have been assessed as 'intermediate'. The remaining five companies are assessed as mitigating the business risks associated with project finance in a 'limited' way. These companies are BNP Paribas, Credit Suisse First Boston, Deutsche Bank, JP Morgan Chase and Sumitomo Mitsui Bank.

Westpac Banking Corporation is close to achieving a 'good' assessment. In order to achieve a good assessment, Westpac Banking Corporation needs to report in greater detail on the following three categories:
1. Risk assessment:
Does the Company have a Client diagnostic tool to assess clients on their sustainability profiles for approval of project finance deals?

or

- Does the Company conduct environmental and (where relevant) social audits and site visits to evaluate environmental and social risks of a specific project?

2. Compliance and monitoring

- Does the Company attach conditions to loan agreement relating to SEE issues where necessary?

or

- Does the Company monitor compliance with any SEE conditions attached to the loan agreement?

3. Reporting and dialogue

- Does the Company respond in detail and publicly to NGO allegations concerning the financing of controversial projects?

Credit Suisse is closest to achieving an 'intermediate' assessment. In order to achieve an intermediate assessment Credit Suisse should indicate that its compliance and monitoring processes contain at least one of the following points:

- Training of relevant staff by consultants on environmental and social risks relating to project finance
- Guidance notes for understanding of possible risks related to PF available to staff
- Attach conditions to agreement relating to SEE issues where necessary
- Monitor compliance with any SEE conditions attached to the agreement

EIRIS' research, based on the analysis of these nine medium and high exposure companies, has found that in order to mitigate their environmental and social risks in relation to project finance all of the companies have set up global project finance policies including non-financial criteria. Five out of nine companies are committed to drawing up an environmental management plan or to conduct an environmental impact assessment.

The Equator Principles, which were developed by a consortium of banks in 2003, have gained more credibility since their launch. Seven out of nine companies analysed within this briefing have adopted these principles. Three years after the first announcement of the Equator Principles in June 2003 the number of adopting financial institutions has risen from 10 to 41. This indicates that the Equator Principles are becoming an industry standard in international project finance.

However the Equator Principles adopters need to 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. This should relate to the application, interpretation and implementation of the Equator Principles. Only three out of these seven EP adopters indicate that training is offered to relevant staff on the Equator Principles and environmental and social risks in relation to project finance.

To strengthen their risk management approach in relation to direct and indirect risk the project finance banks need to focus specifically on developing a proactive dialogue with NGOs and other stakeholders and sponsors by meeting them on a regular basis to discuss general issues and specific concerns relating to project finance and its possible risks. Only three of the nine financial institutions analysed in this paper state that an engagement process and proactive discourse with civil society groups has been implemented.

There also still seems to be a need to proactively identify relevant stakeholders as soon as possible in the project finance cycle to be able to recognise any potential problem within a project.

To better understand how the risks arising from project finance deals relate to a company's business model, the following additional questions could be considered:

Questions for analysts

What level of financial risk does the Company attribute to environmental and social factors in project finance and what steps are they taking to minimise this risk?

What projects does the Company identify as most potentially risky and how are these risks being mitigated?

How does the Company identify project stakeholders (e.g. community) for each project and address their concerns?

Which NGOs are significant to the Company's project finance business and how is the Company engaging with them on this issue?

7. Good practice examples

Companies are addressing the risks related to project finance by applying some of the approaches identified in the EIRIS indicators.

Regarding the scope of EP application, some banks have embraced the best practice approach of following the spirit of the Equator Principles. Barclays, Citigroup, HSBC and JP Morgan Chase have pledged to apply the Equator Principles more broadly, for example to corporate credits where use of proceeds is known. HSBC perhaps goes furthest in this respect, stating that the EPs will apply 'to project advisory roles, corporate lending where the end use of proceeds is for a project, and to other forms of financial assistance such as bonding and guarantees directly linked to projects[30]; furthermore, it reported that in 2004 it applied the EPs to seven additional transactions which did not fall under the Equator Principles threshold.

Westpac disclosed that in 2004 it applied the EPs to a project under the USD 50m threshold, while JP Morgan Chase has announced that it is lowering the EP application threshold to USD 10m rather than USD 50m. However, as the Equator Principles have just changed one major improvement is seen in the expansion of the scope of the principles: the new principles apply to all new project financings with total capital costs of USD 10m or more across all industry sectors globally. In addition, while the principles are not intended to be applied retroactively, the financial institutions will apply them to all project financings covering expansion or upgrade of an existing project where changes in project scale or scope create significant additional environmental and/or social impacts or significantly change the nature or degree of an existing impact. Several banks have 'gone beyond' the EPs in other ways, by adopting new sector standards for instance. Examples of current best sector policies would be ABN AMRO's forestry policy, HSBC's climate change policy and forestry policy and the wide range of social and environmental policies adopted by Citigroup.

Some of the Equator Banks, such as ABN AMRO, have required non-Equator Banks to undertake to comply with the Equator Principles in the administration of project financing as a condition for their participation in a facility arranged by the Equator Banks. Furthermore non-Equator Banks have arranged facilities to ensure compliance with the Equator Principles in order to secure the widest possible participation in a syndication.

To improve the implementation of project finance policies or Equator Principles policies some institutions have created noteworthy new guidance for their bankers. Citigroup developed guidance notes explaining when an EMP is required and when it should be covenanted; it also produced a guidance note on advisory functions. When Mizuho realised that the World Bank Pollution Prevention and Abatement Handbook did not cover pipelines or LNG plants – two areas where Mizuho actively lends – it produced its own technical environmental standards to assist in EP implementation.[31]

Some of the challenges illustrated in this briefing have recently been incorporated in the new Equator Principles Draft following the revision of the IFC safeguard policies. The first set of EPs expired on 6 July 2006 and the new set of EPs came into effect on 7 July 2006.

Notes

1 See definition in Chapter 2.1
2 Harvard business school http://www.exed.hbs.edu/programs/pf/print.html
3 E.g. BankTrack, Platform London, Rainforest Action Network
4 www.banktrack.org
5 After the IFC revised its safeguard policies the Equator Principles Financial Institutions (EPFIs) reworked the original EPs. The draft for the revised EPs was released in March 2006. The revisions to the existing EPs were undertaken to 1) reflect implementation learning from the past 2 ½ years, 2) incorporate comments from various stakeholders received during this period, and 3) to ensure incorporation of, and consistency with, the IFC Performance Standards. The first set of EPs expired on 6 July 2006 and the new set of EP came into effect on 7 July 2006.
6 The first adopters were ABN AMRO Bank, Barclays, Citigroup, Crédit Lyonnais (now Calyon), Credit Suisse First Boston, HVB Group, Rabobank Group, The Royal Bank of Scotland, WestLB, and Westpac Banking Corporation
7 BankTrack is a forum which unites organisations with a proven track record in monitoring and campaigning on the private financial sector
8 Equator Principles, June 2003, Preamble, page 2
9 Equator banks arranged over 80% of the global project loan market by volume. See www.equator-principles.com
10 The scope of the principles has been extended in the revised version of the EP to the following: "The Principles apply to all new project financings with total capital costs of USD 10 million or more across all industry sectors globally. In addition, while the Principles are not intended to be applied retroactively, we will apply them to all project financings covering expansion or upgrade of an existing project where changes in project scale or scope create significant additional environmental and/or social impacts or significantly change the nature or degree of an existing impact. The Principles also extend to project finance advisory activities wherein EPFIs commit to make our clients aware of the content, application and benefits of applying the Principles to the anticipated project. The EPFI requests that the client communicate to the EPFI its intention to adhere to the requirements of the Principles when seeking future financing."

[11] See the World Bank Development Indicators Database, available at
[12] www.worldbank.org/data/countryclass/classgroups.htm
[13] Franck Amalric: The Equator Principles: A step towards Sustainability? Working Paper No. 01/05, Center for Corporate Responsibility and Sustainability at the University of Zurich, p 3f (www.banktrack.org)
[14] Banktrack: Equator Principles II: NGO comments on the proposed revision of the Equator Principles, April 2006, p5.
[15] Dealogic; all companies are listed in project finance league tables, presenting those companies with a substantial involvement in non-recourse finance.
[16] See Akerlof, George A: *The market for "Lemons": Quality Uncertainty and the Market Mechanism.* The Quarterly Journal of Economics, 84 (30), 1970, p 488-500. For the classic statement of the economic problem that arises from the interaction between unequal quality and uncertainty.
[17] The following commercial banks are financiers for the BTC pipeline: lead arrangers – Citigroup, ABN AMRO, Mizuho, Societe General; other banks: The Royal Bank of Scotland, KBC, Dexia, West LB, Hypovereinsbank, BNP Paribas, Natexis Banques Populaires, Calyon, ING, San Paulo IMI , Banca Intesa.
[18] See articles such as: Michael Gillard and David Connett: "BP 'covered up' pipeline flaw In: The Sunday Times, 17/04/2005
[19] Platform London is a member organisation of the financial monitoring and campaigning forum Banktrack. It is a UK-based organisation tracking the activities of British oil and gas companies. Platform has done extensive research on the compatibility of financing the Baku Ceyhan oil pipeline and the Sakhalin oil project with the social and environmental policies of the banks involved.
[20] Platform London, Banks warned of liability if Baku-Ceyhan pipeline leaks17/02/2006.
[21] Anthony Field / WWF: Shell poses unacceptable oil spill threat, 28/04/2006; also: Banktrack/Platform: Sakhalin II gas and oil project, Further breaches of the Equator Principles, 03/2004-03/2005;
[22] Franck Amalric: The Equator Principles: A step towards Sustainability? Working Paper No. 01/05, Center for Corporate Responsibility and Sustainability at the University of Zurich, p 9.
[23] Note the Morgan Stanley Dean Witter and Citigroup consumer boycotts that developed over these banks' association with funding the China Development Bank, financing arm of the Three Gorges Dam. Source: ISIS: Benchmarking Study: Environmental Credit Risk Factors in the Pan-European Banking Sector, September 2002.
[24] Freshfields Bruckhaus Deringer; Banking on Responsibility, July 2005.
[25] Gareth Chadwick: Profit with a conscience. Financial Times 21/03/2005.
[26] Freshfields Bruckhaus Deringer; Banking on Responsibility, July 2005, p 50.
[27] Mandated Arrangers: mandated arranger status is assigned to the banks awarded the mandate by the borrower. In the event that a group of banks unanimously agree the mandated arranger group, the title is assigned to all banks within such group. Provider: providers finance the project on a non-recourse or limited recourse basis.
[28] Financier tables are based on equal apportionment between all arrangers of loans and final takes for participants. The Dealogic league tables calculate rankings based on the entire amount of debt the bank arranged (or helped to arrange) in that tranche. In some cases, this has the effect of making a bank's financial arranging numbers higher than its 'total amount financed' figure. Second, not all arrangers are equal: Dealogic gives more 'credit' to mandated arrangers than arrangers and co-arrangers. Finally, when figures are given for the number of financial arrangements, it refers to the number of projects arranged, not the number of tranches. Often a bank may arrange several tranches for one project. The total project financing is sometimes divided up in separate tranches with each having a distinct interest rate, maturity, etc.. Where banks are ranked in terms of their dominance, the

rankings are based on closed and signed deals. In contrast, when countries and regions are ranked, it is calculated on the basis of the total value of all projects, both in finance and those that have been signed. See: http://www.projectfinancereview.com/

[29] Global top mandated arrangers (project finance) in 2003, source: Dealogic, project finance magazine, 01/03/2004.

[30] BankTrack: Unproven principles. June 2005, p 8

[31] BankTrack: Unproven principles. June 2005, p 9

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8. Company assessments

	ABN AMRO	Barclays	BBVA	BNP Paribas	Credit Suisse First Boston	Deutsche Bank	JP Morgan Chase	Sumitomo Mitsui Banking	Westpac Banking
Strategy and policy									
Global policy incl. SEE criteria	•	•	•	•	•	•	•	•	•
Public Equator Principles commitment	•	•	•		•		•	•	•
Policy commitment covering loan syndication		•							•
Commitment to env mgmt plan/ EIA for all PF	•	•		•					•
Commitment to social mgmt plan / SIA for all PF	•	•							•
Env management plan/ EIA for all PF deals considered category A (EP)	•	•	•			•	•		•
Social management plan/ SIA for all PF deals considered category A (EP)	•	•	•				•		•
Env & social impact assessment (if appropriate) for category B projects	•	•	•				•		•
Risk assessment									
Client diagnostic tool to assess clients on their sustainability profiles for approval of PF deal (specific sector or all sectors)	•	•	•						
Env audits & site visits to evaluate env risk of project and (where relevant) social audits & site visits to evaluate social risk of project	•	•		•					
Compliance and monitoring									
Training of relevant staff by consultants on env & social risks relating to PF **or** guidance notes outlining possible risks related to PF available	•	•							•
Attach conditions to agreement relating to SEE issues where nec.	•	•	•						
Monitor compliance with any SEE conditions attached to agreement		•	•						
Reporting and dialogue									
Engagement on proactive basis with stakeholders (throughout project)	•						•		•
Detailed public response to NGO allegations concerning the financing of controversial projects	•				•				
Public reporting on project finance	•	•	•		•				•
Quantitative public reporting on implementation of PF policies incl. KPIs	•	•	•						
Qualitative reporting of challenges & compliance	•	•			•				•
Reporting on companies/ projects denied credit for social or env reasons	•	•							•
Disclosure of person/committee responsible for approving PF deals	•	•	•						•
Performance and innovation									
PF policy applied beyond scope of Equator Principles commitment threshold	•	•					•		•
Policy leadership	•	•					•		
Assessment	**G**	**G**	**I**	**L**	**L**	**L**	**L**	**L**	**I**

NE – no evidence; L – limited; I – intermediate; G – good; A – advanced

Detailed grading methodology is provided in section 9. NB Assessments apply to companies and any subsidiaries and associates over 20% owned. *Data analysis June 2006*

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9. Assessment methodology

	No evidence	Limited	Intermediate	Good	Advanced
Requirements	No indicators	Any one indicator	Any four indicators from marked sections	All marked indicators	All marked indicators
Strategy & responsibility					
Global policy incl. SEE criteria		*	*	•	•
Public Equator Principles commitment			•	•	•
Policy commitment covering loan syndication					•
Commitment to EMP/ EIA for all PF					•
Commitment to social MP / SIA for all PF					•
Env management plan/ EIA for all PF deals considered category A (EP)				•	•
Social management plan/ SIA for all PF deals considered category A (EP)				•	•
Env & social impact assessment (if appropriate) for category B projects				•	•
Risk assessment					
Client diagnostic tool to assess clients on their sustainability profiles for approval of PF deal (specific sector or all sectors)				Any one indicator	•
Env audits & site visits to evaluate env risk of project and (where relevant) social audits & site visits to evaluate social risk of project					•
Compliance and monitoring					
Training of relevant staff by consultants on env & social risks relating to PF or guidance notes outlining possible risks related to PF available			Any one indicator	Any two indicators	•
Attach conditions to agreement relating to SEE issues where nec.					•
Monitor compliance with any SEE conditions attached to agreement					•
Reporting and dialogue					
Engagement on proactive basis with stakeholders (throughout project)			Any two indicators (reporting and performance)		•
Detailed public response to NGO allegations concerning the financing of controversial projects					•
Public reporting on project finance				•	•
Quantitative public reporting on implementation of PF policies incl. KPIs				•	•
Qualitative reporting of challenges & compliance				•	•
Reporting on companies/ projects denied credit for social or env reasons				•	•
Disclosure of person/committee responsible for approving PF deals				•	•
Performance and innovation					
PF policy applied beyond scope of EP commitment threshold					•
Policy leadership					•

* Additional indicator required

9.1 Indicator definitions

Strategy and policy

Global Finance Policy incl. SEE risk criteria: the Company discloses a public policy including how it tackles social, environmental and ethical risks

Public Equator Principle commitment: the Company has publicly adopted the Equator Principles and refers in its policy to these voluntary principles. EIRIS looks for the following steps: use common terminology in categorising projects into high, medium and low environmental and social risk, based on the IFC's categorisation process; apply categorisation to projects globally and to all industry sectors.

Policy commitment only to enter loan syndication with Equator Principle (EP) (or with an institution that has implemented adequate policies and systems) banks or only if EPs are fully applied to the project: the Company has a policy outlining how to proceed if one or more parts of the syndicate have not adopted the EP. The policy must be made available to EIRIS.

Loan syndication: a group of financial institutions who join together to work on a big project. The banks in the syndicate share the risk of large, indivisible investment projects.

Commitment to environmental management plan / EIA for all PF deals: applies to all project finance deals over a threshold of USD 50m

EIA: environmental impact assessment

Commitment to social management plan / SIA for all PF deals: applies to all project finance deals over a threshold of USD 50m

SIA: social impact assessment

Commitment to environmental and/or social management plan / EIA and or SIA for all PF deals considered Category A (EP) as defined by the IFC: the Company commits to have an environmental and/or social management plan; Category A projects are likely to have significant adverse environmental impacts that are sensitive, diverse, or unprecedented. A potential impact is considered "sensitive" if it may be irreversible (e.g., lead to loss of a major natural habitat) or affect 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. Lead arrangers have to reach a consensus on the categorisation of the project (A, B or C) and on the nature of the appropriate environmental assessment and covenant package.

Commitment to environmental and social impact assessment (if appropriate) for Category B projects as defined by the IFC: a 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. The scope of an EIA for a Category B project may vary from project to project, but it is narrower than that of a Category A EIA. Like Category A EIAs, 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.

Environmental and social assessments have at least considered the following in assessing the impact of a project (where relevant): assessment of the baseline environmental and social conditions; requirements under host country laws and regulations, applicable international treaties and agreements; labour conditions; 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; community health, safety and security; 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; participation of affected parties in the design, review and implementation of the project; consideration of feasible environmentally and socially preferable alternatives; efficient production, delivery and use of energy; pollution prevention and abatement; biodiversity, including endangered species and sensitive ecosystems

Risk assessment

Client diagnostic tool: mechanism for assessing and considering borrowers' environmental, social and/or cultural expertise in relation to particular projects; a tool to assess clients on their sustainability profiles for approval of PF deal (specific sector or all sectors)

Environmental and/or social audits and site visits to evaluate environmental and/or social risk of project: to be commissioned by the financial institution; includes announced or unannounced site visits by the financial institution to verify the environmental and social assessments conducted by either the borrower or the lender

Compliance and monitoring

Training of relevant staff: regular training of relevant employees by experts; includes training by the IFC or internal environmental and social experts

Guidance notes for understanding of possible risks related to PF available: sector specific or risk specific notes for relevant staff outlining main environmental and social risks associated with a range of projects

Attach conditions to agreement: the Company attaches conditions if the environmental and social impact assessments highlighted the necessity of particular actions. Conditions should be applied to each agreement where it is relevant.

Monitor compliance with any SEE conditions attached to the agreement: the Company will monitor the compliance of imposed conditions on a regular basis throughout the project life

Reporting and dialogue

Engagement on proactive basis with stakeholders: stakeholders e.g. non-governmental organisations, affected communities, ethnic minorities, government of host country as applicable, etc. should be consulted throughout project life

Detailed public response to NGO allegations: the Company responds in its annual financial report, in its corporate social responsibility report, or on its website to NGO allegations in relation to controversial high-profile undertakings (if applicable)

Public reporting of project finance data: this could include general PF business data; proportion of loans e.g. sector analysis, area analysis, types of loans (A, B or C as categorised by the IFC)

Quantitative public reporting on implementation of project finance policies including KPIs: e.g. safety performance, environmental performance, compensation for resettlements, training of employees

Qualitative reporting of challenges and compliance: The Company reports publicly on challenges it faces on implementation, monitoring and compliance with Equator Principles and international standards in relation to project finance

Reporting on companies / projects denied credit: The Company reports publicly on projects or companies denied credit due to environmental, social and ethical risks

Performance and innovation

PF policy applied beyond scope of Equator Principles commitment threshold: the Company applies the Equator Principles below USD 50m or the Company applies the principles to other financial instruments (such as corporate loans) where environmental, social or ethical risks are apparent

Policy leadership: the Company has developed policies going beyond the

safeguard policies of the IFC, e.g. freshwater policy, human rights policy

Disclosure of person or committee responsible for approving PF deal: the person does not have to be at senior level

SEE: social, ethical and environmental

See also section 6 – Managing the risk

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