The Equator Principles

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Background

The Equator Principles (EP) are voluntary social and environmental guidelines that 45 banks and financial institutions (together Equator Principles Financial Institutions or EPFI) have agreed to be bound by.[1] The EP form two sets of principles. The first set of EP (EP1) was conceived with the help of the World Bank's International Finance Corporation (IFC) in 2002 and launched in 2003. The second revised set of EP (EP2) has been open for adoption by the EPFI from July 2006. They are not a detailed set of enforceable legal norms but a general framework of ten broad principles[2] which are underpinned by IFC standards, guidelines and policies. Under the EP, the EPFI undertake not to provide loans to a project unless sponsors can demonstrate that the project will be constructed and operated in accordance with sound social and environmental management practices. As most EPFI have adopted EP2 we have focused on the implementation requirements for EP2. A summary of the primary differences between EP1 and EP2 is set out below.

Who can be an EPFI?

The EP were originally adopted only by banks but have now been adopted by other financial institutions such as export credit agencies and development agencies. There are no qualifying criteria for financial institutions adopting the EP.

Prevalence of EP in Project Finance

The EP have now been adopted by 45 EPFI and collectively the EPFI represent around 85% of the world's cross-border project finance.[3] Further, out of the top ten project finance banks globally in terms of debt underwritten, six of them are EPFI (see Chart 1 on the next page). The reach of the EP extends to some of the leading banks in the world. The top ten EPFI represented a share of nearly 80% of the lending market in the first half of 2006 (see Table 1 on the next page). Though the EP are non-binding, they have become an extremely important factor in the project finance market. There are no sanctions for breach of the EP but given their prevalence, the importance attached to compliance with the EP by leading bankers and the ever-increasing scrutiny of projects by civil society, it can be said that there is strong pressure to adopt the EP.

1. An up-to-date list of EPFI can be found at www.equator-principles.com.

2. The Equator Principles can be viewed at www.equator-principles.com.

3. Oliver Balch, "Building a better world (for investors and whales)", 3 July, 2006, The Banker p. 54, available at http://www.equator-principles.com/bbw.shtml.

Chart 1: Top 10 Project Finance Banks: First half of 2006[4]

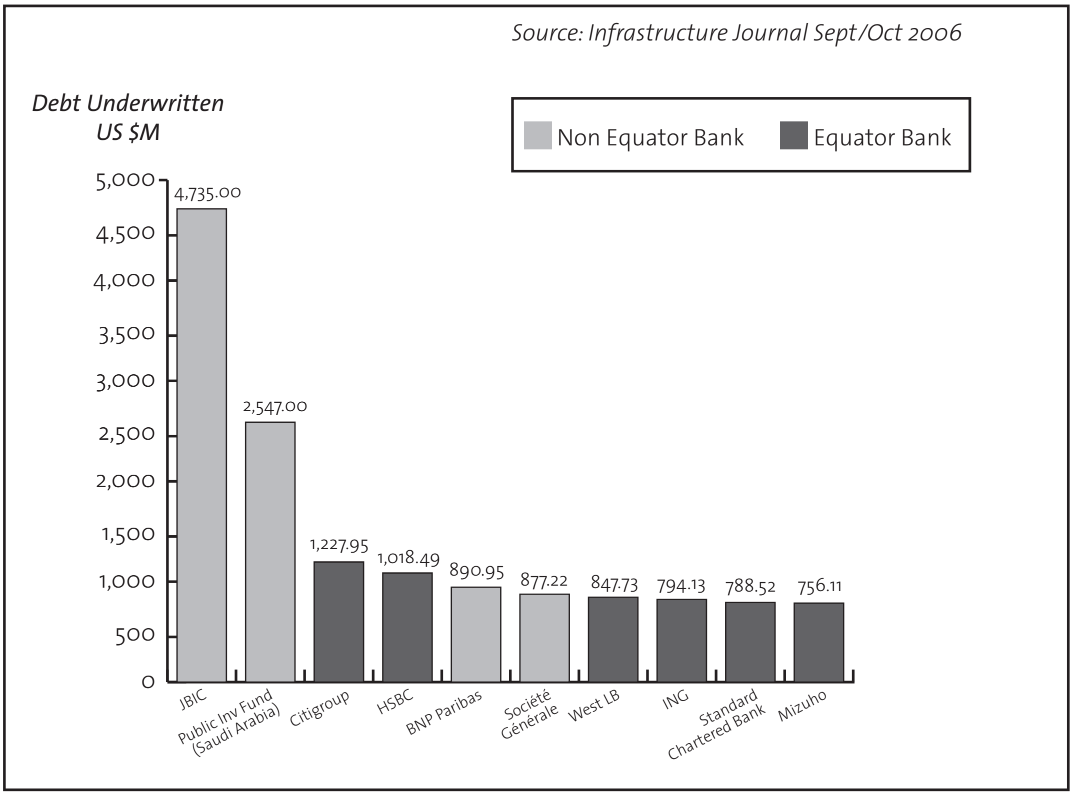

Table 1: EPFI in order of Top Project Finance Lenders: First half of 2006[5]

Project Finance Lender	Amount of Lending (US $M)	Share of Market (%)
Citigroup	1,227.95	12.18
HSBC	1,018.49	10.10
WestLB	847.73	8.41
ING	794.13	7.88
Standard Chartered Bank	788.52	7.82
Mizuho Financial Group	756.11	7.50
SMBC	746.66	7.40
Calyon	643.58	6.38
Royal Bank of Scotland	545.81	5.41
BOTM	527.20	5.23
TOTAL	7,896.18	78.31

4. Simon Ellis and Vander Caceres, ''Equator Principles Financing: The International Fallout'', *Infrastructure Journal*, September/October 2006.

5. See Simon Ellis and Vander Caceres, ''Equator Principles Financing: The International Fallout'', *Infrastructure Journal*, September/October 2006.

Scope of EP

The EP apply to project finance transactions only (rather than any other kind of lending with a similar effect). They only apply to projects with a total capital cost of US$10 million (decreased from US$50 million for EP1). However, several EPFI have abandoned the financial threshold altogether or have done so in relation to mining or other extractive activities. ''Staged'' projects should be reviewed as a whole rather than on a piecemeal basis. Under EP2 there is a requirement that a project be reassessed where it is expanded or upgraded, but only where the social or environmental impact of an expansion or upgrade is ''significant''. Further, under EP2, the EP apply to ''advisory'' in addition to lending activities.

What do the EP Require of an EPFI?

Categorisation of Projects

The EP require projects to be categorised as Category A, B or C projects in accordance with the degree of risk which the project presents to society or the environment.

Category A	High Risk	Projects with potential **significant adverse social or environmental impacts** that are **diverse, irreversible or unprecedented**
Category B	Medium Risk	Projects with potential **limited adverse social and environmental impacts** that are **few in number, generally site specific, largely reversible and readily addressed through mitigation measures**
Category C	Low/No Risk	Projects with **minimal or no social or environmental impacts**

Category A and C projects are relatively straightforward to identify. If a project is categorised as a Category B project, the applicable requirements differ depending upon whether the project is located in a Non-OECD country or a non High-Income OECD country.[6] Regardless of this distinction, it may be considered appropriate to subject certain projects to a particular requirement (see next page).

6. High-Income OECD countries are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Republic of Korea, Luxembourg, Netherlands, New Zealand, Norway, Portugal,Spain, Sweden, Switzerland, United Kingdom and United States of America (http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20421402~pagePK:64133150~piPK:64133175~theSitePK:239419,00.html) and for thresholds, see Annex III at http://www.oecd.org/dataoecd/45/48/37124663.pdf).

Requirements of EPFI for Category A and Category B projects

Requirement	Category A	Category B
Environmental and Social Impact Assessment (ESIA)	All Category A	All Category B
Action Plan and Management System	All Category A	Category B*
Public Consultation	All Category A	Category B*#
Grievance Procedures	All Category A	Category B*#
Independent Expert Review	All Category A	Category B#
Independent Monitoring	All Category A	Category B#
Annual Reporting Obligations	All Category	All Category B
Loan Covenants: — Materially comply with applicable social and environmental laws, regulations and permits — Materially comply with the Action Plan and Monitoring/Management Systems — Compliance and enforcement mechanisms — Decommissioning Plan — Compliance with Decommissioning Plan	All Category A	Category B*#

KEY

* Non-OECD countries and non High-Income OECD countries.

\# Considered appropriate to subject the Category B project to the requirement.

Assessment of projects

An Environmental and Social Impact Assessment must be carried out for all Category A and B projects. This should set out how the project complies with a number of factors, including the IFC Performance Standards set out below.

IFC Performance Standards

Performance Standard 1:	Social and Environmental Assessment and Management System
Performance Standard 2:	Labor and Working Conditions
Performance Standard 3:	Pollution Prevention and Abatement
Performance Standard 4:	Community Health Safety and Security
Performance Standard 5:	Land Acquisition and Involuntary Resettlement
Performance Standard 6:	Biodiversity Conservation and Sustainable Natural Resources Management
Performance Standard 7:	Indigenous People
Performance Standard 8:	Cultural Heritage

The borrower must prepare an Action Plan and Management System for all Category A projects and Category B projects in non-OECD countries and non High–Income OECD countries. The Action Plan draws on the conclusions of the Social And Environmental Impact Assessment and addresses its findings. It describes and prioritises actions needed to implement mitigation measures, corrective actions and monitoring measures necessary to manage social and environmental risks. In addition to the Action Plan, borrowers are to build Social and Environmental Management Systems which address identified impacts, risks and actions required to comply with host country social and environmental laws and regulations and applicable IFC Performance Standards.

Independent Review

For all Category A and some Category B projects, the EPFI can require independent review by a social or environmental expert not directly associated with the borrower. The purpose of the review is to assist EPFI in their due diligence of the development and operation of the project and in respect of EP compliance.

Consultation

EP2 states that for all Category A projects and some Category B projects, there is an obligation on the borrower or third party expert to consult with ''project affected communities'' in a ''structured and culturally appropriate manner''. As many projects are located in pre-literate countries, the emphasis on cultural appropriateness is of great importance. For example, this appears to imply that a borrower or expert should consider whether oral rather than written communication is necessary.

Grievance Procedures

Grievance procedures have been introduced under EP2 in order that borrowers and EPFI become more transparent and accountable to both the communities affected directly by such projects and civil society generally.

Annual Reporting Obligations

EP2 requires EPFI to provide periodic public reports at least annually. The report must cover implementation of the EP processes and the experience of the EPFI, subject to the requirements of client confidentiality. At a minimum, it should address the number of transactions screened by the EPFI, the categorisation of each transaction and information on the implementation of EP. In addition, the EPFI report may include a breakdown of transactions and categorisations by sector or region.

Legal Covenants

The legal covenants already required under EP1 have been made more stringent under EP2 and borrowers should be aware of the requirement to comply with the covenants set out in the table below.

Differences Between EP1 And EP2

There are a number of differences between the approach adopted in EP1 and that taken in EP2. The most important are summarized in the table below.

Issue	**EP1**	**EP2**
Eligible Parties	Equator Banks	Equator Principles Financial Institutions
Financial Threshold	$50M US	$10M US
Object of Assessment	Projects only	Projects **plus expansions to and upgrades of projects if the social or environmental impact of the expansion or upgrade is significant**
Scope of Activities	Lending	Lending **plus advisory activities**
Scope of Assessment	Environmental assessment (EA) only	Environmental assessment **plus social assessment** (SEA)
Action Plan and Management System	Environmental Management Plan (EMP)	**Action Plan** (AP) and Management System (APMS)
Independent Expert Review	EA, EMP and consultation	**SEA and AP compliance and consultation**
Consultation	In a structured and culturally appropriate way with project affected groups Broad community support for project EA and EMP to take account of consultations Consultation subject to Independent Expert Review	**With project affected communities** **Prior informed consultation (not prior informed consent) for projects with significant adverse impacts** **Consultation process and results to be documented in AP**
Grievance Procedures	No requirement	**New requirement for borrower to establish grievance procedure for project affected communities throughout the project life cycle**

Issue	**EP1**	**EP2**
Annual Reporting Obligations	No requirement	New requirement for at least annual reporting by EPFI
Legal Compliance Covenants	No requirement	New requirement on borrower to comply with local, state and host country social and environmental laws, regulations and permits in all material respects
Action Plan Compliance Covenant	Borrower to comply with EMP	Borrower to comply with AP (where applicable) in all material respects
Reporting Compliance Covenant	Borrower to provide regular reports on compliance with EMP	Borrower to provide regular reports of compliance with AP and laws, regulations and permits
Decommissioning Covenant	Borrower to decommission facilities in accordance with a Decommissioning Plan, where applicable	Same as EP1 save also where appropriate
Remedial Steps to Remedy Covenant Breach	Lender to engage with borrower to remedy non-compliance with covenants when borrower in default	Reserving its rights to exercise remedies for non-compliance or default, EPFI discretion to work with borrower to bring it into compliance with covenants
Appointment of Independent Expert	Lender right to appoint an independent environmental expert to provide additional monitoring and reporting services	EPFI discretion to require the appointment of independent experts over the life of the loan
Streamlining Assessment	No requirement	Adopts a streamlined approach to assessment of social and environmental impacts in applying EP2 to countries, principally High-Income OECD countries, which are presumed to have existing high standards for assessing and addressing social and environmental impacts

Effects of the EP

The full effects of the EP on project finance are not yet known. On a practical level, the following factors should be considered:

— The EP now apply to advising as well as lending activities. EPFI will need to become involved with projects at an earlier stage than under EP1 or pre-EP

— Borrowers should be aware that projects will be subject to detailed assessment, may be required to be independently appraised and that community consultation and grievance mechanisms may be required to be implemented

— Both borrowers and lenders are subject to annual reporting requirements

— Borrowers are required to covenant to comply with local, state and host country social and environmental laws, regulations and permits in all material respects

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