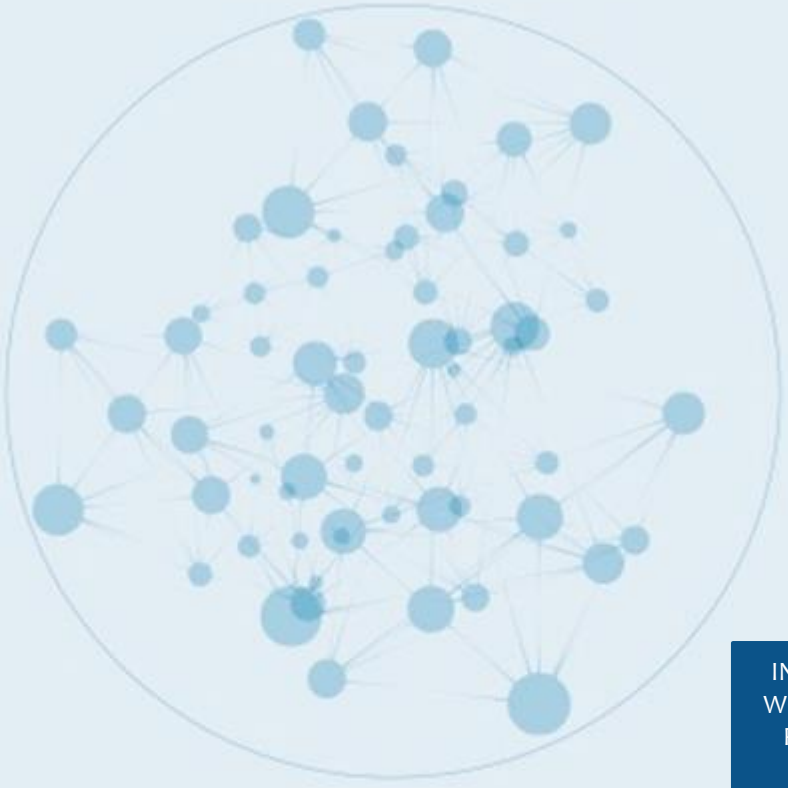
Inquiry: Design of a
Sustainable Financial System

UNEP

THE EQUATOR PRINCIPLES

Do They Make Banks More Sustainable?



INQUIRY WORKING PAPER

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The UNEP Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance policy options to improve the financial system's effectiveness in mobilizing capital towards a green and inclusive economy—in other words, sustainable development. Established in January 2014, it published its final report, The Financial System We Need, in October 2015.

More information on the Inquiry is at: *www.unep.org/inquiry* or from: Ms. Mahenau Agha, Director of Outreach *mahenau.agha@unep.org*.

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About this report

This working paper results from a workshop the UNEP Inquiry and CIGI held on 2-3 December 2014 in Waterloo, Canada to discuss options for a sustainable global financial system. The workshop included participants from a range of academic and research institutions from the Waterloo region and abroad, including the University of Waterloo, the University of London, Harvard University, and the University of Gothenburg.

Comments are welcome and should be sent to *simon.zadek@unep.org*.

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Abstract

The Equator Principles (EPs) are a voluntary code of conduct and a risk management framework for determining, assessing and managing environmental and social risks in projects, such as energy or infrastructure projects. Since their foundation in 2003, the EPs were lauded for integrating social and environmental assessment practices into project assessments. Critics reason, however, that without fundamental implementation efforts and enforcement, the EPs will not contribute to any change with respect to effects of projects on sustainable development. To analyse the effects of the EPs, a literature analysis, interviews with project financiers and stakeholders, and an analysis of EP signatories' reports were conducted. The results suggest that the EPs are mainly adopted because of reputational benefits and risk management and that they do not create significant changes in project financing institutions. Our conclusions are that criteria should be implemented that define sustainability thresholds for projects to be financed and that enforcement mechanisms are needed to guarantee the compliance of the signatories with the principles.

Introduction

The Equator Principles (EPs), launched in 2003, are a financial industry benchmark for managing environmental and social risks (see *www.equator-principles.com*). These 12 years of existence can be equated to the phase of an adolescent still seeking to establish relevance in an atmosphere of flux and uncertainty. This paper shows that as of December 2015, Equator Principles Financial Institutions (EPFIs) have increased from the original 10 founding members to 83 members, which demonstrates that environmental and social assessment of projects is increasing in global adoption and scope. Thus, prospective sustainability risks associated with project finance are taking three forms. The first is the risk to the environment, society and particularly the communities in which the projects are situated (project impacts or inside-out connections). Second are the environmental, social and sustainability risks that impact the financial performance of projects (downside risks or outside-in connections). Third are reputational risks for the financiers that are associated with financed projects. These risks drive and dominate the discussion agenda of EPFIs, non-governmental organizations (NGOs) and other stakeholders. The EPs, as also expected of recent private transnational regimes, continue to attract perspectives, debates and contestations in regard to implementation and compliance. This paper will analyse the different types of risks and ways that they are managed through the application of the EPs.

Though they have undergone a number of changes in order to adapt to new developments with respect to environmental, societal, and sustainability, the overall review of the EPs more than 10 years after their foundation is mixed. Proponents argue that the EPs are visionary principles that are able to redefine social and environmental practices for the good of both sustainable finance and society. In contrast, critics reason that without radical implementation and enforcement, the EPs are merely window dressing and do not have any effects on project sustainability or the sustainability of the financial sector.

Even against the reservations identified in the literature, the EPs hold the promise and potential to contribute to social and environmental sustainability. For this to come to fruition, the present gaps in the EPs will need to be filled. Of particular importance are gaps in how EPFIs address the implementation of the guidelines in a project's finance decision-making, how they implement it in practice and, perhaps more importantly, whether the implementation will have a positive effect on project sustainability. Our analyses and research have addressed these gaps.

1 Project Finance

The EPs focus on project finance, which may take the form of financing the construction of a new capital installation or the refinancing of an existing installation, with or without improvements. A non-recourse debt is often used for capital investing. In such transactions, the lender is usually paid solely, or almost exclusively, out of the capital generated by the contracts for the projects output, such as the electricity sold by a power plant.

The borrower is usually a special purpose entity, also called a legally independent project company, which is not permitted to perform any function other than developing, owning and operating the installation. The consequence is that repayment depends primarily on the project's cash flow and on the collateral value of its assets. Additionally, the loan sum of projects is usually very high; about 50 per cent of financed projects cost more than US$1 billion. Consequently, they are financed mostly through syndicated loans with more than one lender.

Globally, project finance-related loans were US$197.5 billion in 2012, down from US$223.4 billion in 2011 (Thomson Reuters, 2013). The share in the total financial product portfolio, however, is rather small given that, for instance, global banking assets in 2010 were higher than US$10 trillion.

Though the portion of project finance in the financial market may be small, the impact of projects may be caused by their size and their sectors. The biggest project completed in 2012 was an offshore natural gas field in Australia with US$16 billion. Five out of the 10 biggest projects in 2012 were in the oil and gas sector, followed by two projects in transportation, and one in leisure and property, power, and industry, respectively. In total, the 10 biggest projects globally comprised a package of US$55 billion. The average project proceeds in 2012 were US$365 million with power, transportation, leisure and property, oil and gas, and mining as the five biggest sectors (Thomson Reuters, 2013). Other studies mention natural resources – such as mines, pipelines, oil fields and infrastructure (toll roads, bridges, telecommunications systems and power plants) – as the most common applications of project finance (Esty, 2004).

Project finance is often connected with sustainability risks. Conversely, three types of sustainability risks are usually associated with project finance:

- Financed projects have an impact on the environment and communities in the region where the project is implemented, termed the "inside-out relation" (Porter and Kramer, 2006). This is valid for many business activities. Big projects, however, create more significant impacts than smaller business activities.
- The project itself may be impacted by environmental or societal risks. This refers to the "outside-in relation" (Porter and Kramer, 2006). The income of a project may suffer from environmental risks, such as extreme weather events, strikes by people working for projects, or NGO or government blockades. Consequently, these risks have an impact on the project's financial return and on the project financier.
- Projects are subject to reputation risks. Controversies in the news or on the Internet may not only affect project sponsors, but project financiers as well. Nearly all EP signatories have already been criticized on popular websites and news channels, with respect to their involvement in controversial projects, as project financier, financial consultant or others.[1]

[1] *For example, Credit Suisse was criticized for its role as a financial advisor for the Sakhalin project. See* http://wwf.panda.org/wwf_news/press_releases/special_coverage/sakhalin/*. A Google search for Credit Suisse and Sakhalin creates more than 80,000 hits.*

2 The Equator Principles as an Example of a Private Code of Conduct

For a long time and without exception, public regulatory bodies issued regulations. The traditional position was that the nation-state commands the means and capability to supervise business activities and backs them up with coercive power in necessary circumstances. Recent regulatory examples and crises, such as the last financial crisis, show however that public regulation can fail, may be too weak or does not interfere deliberately.

In addition to public, state-based regulation, two other forms of governance exist: international regulations occur in order to regulate issues of international impact that are increasing as a result of globalization; NGOs and businesses introduce private codes of conduct and regulations in order to self-regulate, and to design and enforce rules on themselves (Abbott and Snidal, 2009; Haufler, 2013). Accordingly, various organizations have set regulatory architectures and standards to self-regulate.

Industrial self-regulation covers many issues (such as quality standards or assurance, reporting standards or environmental issues) and actors, for example the International Organization for Standardization, the Global Reporting Initiative, Responsible Care (a regulatory scheme for the Chemical Industry (Barnett and King, 2008; Bernstein and Cashore, 2007)) and the Carbon Disclosure Project, which published a database of corporate carbon emissions (PwC and Carbon Disclosure Project, 2013). Within the financial industry, a response to this governance evolution has taken the form of voluntary codes of conduct or, more accurately, transnational private regulations for institutional investors (Principles for Responsible Investment, 2012), for banks and the insurance business (UNEP Finance Initiative, 2012) and the EPs for project finance. All of the codes of conduct are process oriented instead of outcome oriented and most of them do not impose any consequences on their signatories in case of non-compliance.

By subscribing to private codes of conduct, organizations can respond to reputational challenges or preclude regulations by demonstrating compliance to self-imposed rules (Thistlethwaite, 2012; Wright and Rwabizambuga, 2006). The literature on voluntary codes points to two streams of scholarships:

- The first suggests a normative persuasion, as when corporations adopt generally accepted behaviour, which earns trust among stakeholders (Bondy, Matten and Moon, 2004) and, consequently, legitimizes corporations to conduct their business (Suchman, 1995). This stream is called the normative view.
- The second, called the instrumentalist view, states that voluntary codes help shape corporate objectives towards some altruistic ends, the ultimate outcome of which being profit. The past and current spectre of human rights abuse associated with outsourcing, as well as the negative environmental impacts of large projects, are some rationales for adopting voluntary codes.

Other scholars assert that codes of conduct are a formalization of corporate values or practices designed to guide the behaviour of companies and enable them to manage different political, social and economic cultures in international business. Therefore, signing private codes of conduct comes from a desire to control stakeholders instead of a motivation to become more environmentally, economically and socially responsible (Bondy *et al.*, 2004; Bondy, Matten and Moon, 2008). Consequently, voluntary codes, such as the EPs, typically signal an intention towards corporate social responsibility and have certain stakeholders as intended targets. The voluntary codes, then, are often couched in blanket statements lacking in specificity. It is therefore not uncommon for an infrastructure project, especially located in developing countries, to build a school or a health facility in order to demonstrate corporate citizenship, instead of focusing on the environmental, social and sustainable performance of the project itself.

3 Theory

Stakeholder theory may be used as a theoretical background for explaining the existence of the Equator Principles. It explains corporate activities based on the interaction with stakeholders (systems, persons, or groups that either affect or are affected by organizations). Consequently, organizational strategies are often based on stakeholder management (Freeman, 1984). Donaldson and Preston (1995) distinguish three approaches to stakeholder theory: descriptive, instrumental, and normative.

The descriptive approach describes an organization as a "constellation of cooperative and competitive interests" (Donaldson and Preston, 1995). In this case, the EPs and their development can be described through the interaction between projects financiers, projects and their stakeholders, and NGOs. The instrumental approach to stakeholder theory applies the theory to examine the interactions between stakeholders and the organization and how the management of these interactions helps to achieve the organization's goal. With respect to the EPs, studies on the interactions between project financiers and different stakeholders were conducted. Some of them state that the establishment of the EPs helped project financiers to achieve their goals such as an increase in reputation, environmental and social risk management, and compliance (O'Sullivan and O'Dwyer, 2009). Finally, the normative approach accepts that stakeholders have a legitimate interest in organizational activities. They can be identified by their interests in the organization that are of intrinsic value (Donaldson and Preston, 1995). In the case of project finance, communities affected by projects that, for instance, use water needed by neighbouring communities, have a legitimate interest in the activities of project financiers. In addition to the three main approaches, stakeholder theory can also be managerial, because it recommends activities, attitudes, strategies, and structures addressing stakeholder management.

Based on the stakeholder theory, Figure 1 describes the EPs and their stakeholders.

Figure 1: Equator Principles' stakeholders

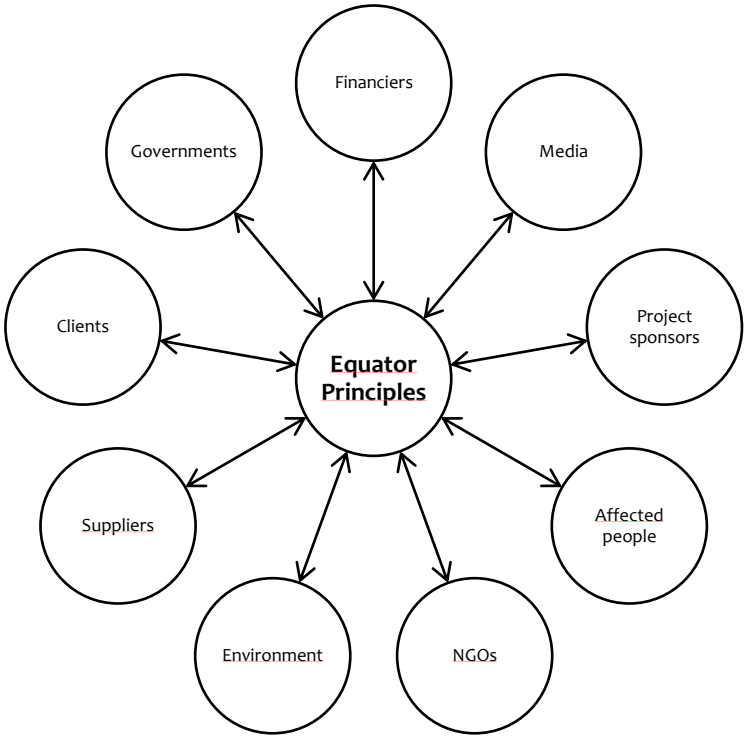

Figure 1 shows that the EPs have to interact with a number of stakeholders ranging from those with mainly business interests to affected communities and the environment. Consequently, stakeholder theory will help to describe the origin and the development, as well as strengths and weaknesses of the Equator Principles.

4 History and Development of the Equator Principles

Project finance is usually used for financing large projects such as infrastructure- or energy-related projects. Because of their size, these projects – including power plants, chemical processing plants, mines and transportation infrastructure – often have a significant effect on the environment and neighbouring communities, although the share of project finance in the total lending portfolio of finance institutions is rather small. The Chinese Three Gorges Dam (Jackson and Sleigh, 2000; Wu *et al.*, 2004), the Turkish Ilisu Dam (Morvaridi, 2004) and the Baku-Tbilisi-Ceyhan pipeline (Balch, 2012) are well-known examples of projects with environmental and societal impacts. The discussion about such projects frequently centres on the trade-off between economic and developmental benefits on the one hand, and ecological and societal risks on the other hand.

In order to encourage responsible and sound environmental and social policies in project finance, and in response to criticism from affected communities and NGOs, major project financiers created the EPs in 2003. As a credit risk management framework for determining, assessing and managing environmental and social risk in project finance transactions, they are an example of a voluntary code of conduct based on the environmental and social standards of the World Bank Group. The IFC, the World Bank Group's private sector lending arm, provided and continues to provide through its Performance Standards in Environmental and Social Sustainability (International Finance Corporation, 2012) much of the present base of the EPs' environmental and social sustainability architecture.

Before NGO attempts and the beginning of advocacy, campaigns criticizing financial institutions for social and environmental oversights began with the 2003 birth of the Collevecchio Declaration on Financial Institutions and Sustainability, widely considered an EP precursor. The Declaration lists six commitments to be incorporated into financial operations: sustainability, "do no harm", responsibility, accountability, transparency, and sustainable markets and governance. Financial institutions were requested to integrate these commitments into their business. As a response to NGO pressure, some of the biggest project finance institutions met in 2002 in order to draft environmental and social risk management principles for project finance (O'Sullivan and O'Dwyer, 2009). The EPs were launched in 2003 by the banks presented in Table 1 (see also Balch, 2012).

Table 1: Founding Equator Principles institutions

Founding Equator Banks	Country
ABN AMRO	Netherlands
Barclays	UK
Citigroup	US
WestLB	Germany
Crédit Lyonnais (Calyon)	France
Crédit Suisse	Switzerland
HypoVereinsbank (Unicredit)	Germany
Rabobank	Netherlands
Royal Bank of Scotland	UK
Westpac	Australia

Source: O'Sullivan and O'Dwyer (2009)

Currently, 80 EPFIs have signed the principles. According to Watchman (2006), when there were only 40 EPFIs, these institutions accounted for at least 80 per cent of the worldwide project loan market. Therefore, the 2014 market share of the EP signatories should be even higher. Table 2 shows that

80 per cent of the global project arrangers are signatories of the EPs. This result demonstrates that globally the majority of project assessment should follow the EP guidelines where applicable.

Table 2: Biggest mandated project arrangers in 2012

Project arranger	Country	EP member
Mitsubishi UFJ Financial Group	Japan	Yes
State Bank of India	India	No
Sumitomo Mitsui Financial Group	Japan	Yes
Mizuho Financial Group	Japan	Yes
Korea Development Bank	Republic of Korea	No
HSBC Holdings PLC	UK	Yes
Crédit Agricole CI	France	Yes
Société Générale	France	Yes
BNP Paribas SA	France	Yes
BBVA	Spain	Yes
Lloyds Bank	UK	Yes
Commonwealth Bank of Australia	Australia	Yes
ING	Netherlands	Yes
National Australia Bank	Australia	Yes
Standard Chartered PLC	UK	Yes
IDFC Ltd	India	Yes
UniCredit	Italy/Germany	Yes
ICICI Bank Ltd	India	No
Axis Bank Ltd	India	No
ANZ Banking Corp	Australia	Yes
Citigroup	US	Yes
RBC Capital Markets	Canada	Yes
KfW IPEX-Bank GmbH	Germany	Yes
Santander	Spain	Yes
Oversea-Chinese Banking	China	No

Source: Thomson Reuters (2013)

The EPs are based on the eight IFC Performance Standards on Environmental and Social Sustainability (International Finance Corporation, 2011, 2012) to be met by IFC clients:

- assessment and management of environmental and social risks and impacts;
- labour and working conditions;
- resource efficiency and pollution prevention;
- community health, safety and security;
- land acquisition and involuntary resettlement;
- biodiversity conservation and sustainable management of living natural resources;
- indigenous peoples; and
- cultural heritage.

The similarity between the IFC performance standards and the EPs becomes clear in the following abbreviated list of the 10 EPs in their most current version. The principles are process-oriented and a guideline on how to assess environmental and social issues. They do not, however, regulate the outcomes of the assessment and do not provide any guidance on conditions that cause a rejection of finance because of environmental or societal issues.

The 10 EPs are (The Equator Principles, 2013):

1. **Review and categorization:** The EPs describe three risk categories (A, B and C) as categorized in the IFC social and environmental screening criteria. Category A projects have potential significant adverse social or environmental impacts that are diverse, irreversible or unprecedented; category B projects have potentially limited adverse social or environmental impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures; category C projects have minimal or no social or environmental impacts.
2. **Environmental and social assessment:** A mandatory prerequisite for the client seeking financing and required to be done to the satisfaction of an EPFI.
3. **Applicable environmental and social standards:** Following EP II, the social and environmental assessment would have to be conducted in tune with the socio-environmental standards obtained in the country or jurisdiction of the project. Differences exist between standards in non-Organisation for Economic Co-Operation and Development (OECD) high-income and OECD countries ("designated countries" as per EP III). For projects located in non-OECD countries, and in those not designated as high-income the assessment will refer to the applicable IFC performance standards and the applicable industry-specific EHS guidelines.
4. **Environmental and social management system and EPs action plan:** Drawing upon the results of EP III and its conclusions, the client/borrower must prepare action plans describing and prioritizing between mitigation measures, monitoring and corrective actions, the appropriate details of which align with the potential severity of anticipated risks.
5. **Stakeholder engagement:** This is required for category A and B projects. It requires the client, host country or third party expert to engage with affected communities in a culturally appropriate manner, seeking their free, informed and prior consent about the project.
6. **Grievance mechanism:** The EPs require that the client establish a grievance mechanism appropriate to the level of risks and adverse impacts of the projects and whose existence should be brought to the attention of the affected communities.
7. **Independent review:** The EPs require an "independent expert" – independent of the borrower – to review documents on social and environmental assessment, environmental and social management systems, and environmental performance assessment procedures to inform on the due diligence process.
8. **Covenants:** This refers to covenants with the host country, compliance with the assessment procedure, periodic reports and, where applicable and necessary, a decommissioning plan.
9. **Independent monitoring and reporting:** A client will retain an independent monitoring and reporting expert for category A and B projects where "appropriate".
10. **Reporting and transparency:** The EPFIs will annually report on their implementation outcomes or report frequently or scaled to the severity of potential risks. In addition, EP III requires online reporting.

In order to illustrate environmental and social issues to be addressed in a project assessment, the EP document lists a number of potential issues (The Equator Principles, 2013), such as baseline social and environmental conditions, consideration of environmental and social alternatives, human rights, regulations, laws and treaties, and sustainable management and use of renewable natural resources. The list, however, only includes examples and is neither exhaustive nor exclusionary. Furthermore, the EPs provide an annex, with implementation requirements, that deals with climate change and minimum reporting requirements.

5 The Equator Principles over Time: Revisions and Changes

Since their launch in 2003, the EPs have undergone three revisions (see Table 3). The first was conducted in 2006 (EP II), the second in 2012 and the third in June 2013 (EP III). These revisions were motivated by three drivers. First, they are a result of priorities and recommendations from the EPs' strategic review, with substantial input provided by project finance players, facilitators and civil society. Second, revisions were conducted due to changes in the IFC performance standards, which deliver the environmental and social criteria for the EPs. Third, changes were applied in order to address consistency and to support EP implementation. As indicated, the impetus for these revisions is also due to public pressures by NGOs such as BankTrack and the Berne Declaration, asking for more binding guidelines.

In fairness, the first revision in 2006 may have been backward-looking in the sense that the EPs had been operational for three years. As such, much of the first revision was conducted as a response to the "first test" of implementation. The second revision went beyond the lessons and experiences of the first review to include both contemporary and rapidly evolving issues, such human rights and climate change. Table 3 and the following sections present these changes in detail.

Table 3: Changes in the Equator Principles Versions I, II and II

Topics	Version I	Version II	Version III
Changes reflecting priorities and recommendations from the EP strategic review			
Scope	Lending	Lending, project finance advisory	Project finance, advisory, project-related corporate loans, bridge loans
Reporting	No format required	High level reporting: number of transactions screened and closed	Minimum requirements: number of projects closed including categorization, sector, region and whether an independent review has taken place. Project names for project finance deals (subject to client consent). Online summary of environmental and social impact assessment
Changes to align with updated IFC standards			
Sustainability Issues	Environmental assessment (no social risks, climate change not mandatory)	Social risks due diligence, free prior informed consultation. Climate change as part of World Bank guidelines and general due diligence	Social and relevant human rights due diligence. Free prior informed consent. Addressing human rights. Guiding principles on Business and human rights and UN Protect Respect and Remedy Framework. Climate change: attention in due diligence for high emitting projects.
Changes to address consistency and support implementation			
Information sharing		Informally	Formalized approach to share information related to environmental and social matters with other mandated financial institutions.
Country designation	Assessment in high-income OECD countries equivalent to IFC standards	Assessment in high-income OECD countries a substitute for IFC standards	Assessment process in designated countries (EP list) equivalent to IFC standards
Glossary of terms			Glossary of terms for loan documentation

Source: Weber and Acheta, 2014

The following sections will focus on the most important changes. These are (1) the application of the EPs on bridge loans in addition to project finance, advisory, and corporate loans; (2) more detailed guidelines for reporting; (3) reporting on project GHG emissions in case of annual CO_2 emissions higher than 100,000 tons; (4) a formalized approach in information sharing; and (5) focusing the application of the EPs on "designated" countries.

Regarding their scope, the 2012 revision (which culminated in EP III) expanded the 2006 requirements to include project-related loans and bridge loans. The EPFIs realized that these modes of financing, despite their relatively short maturity and size, could help to abate unsustainable social and environmental project finance activities. It was also recognition on the part of EPFIs, and a gesture towards civil society, especially BankTrack. The NGO had argued incessantly that EPFIs needed to widen their assessment and compliance activities to include these hitherto untouched areas, including the need to respect human rights and climate change. The response was to additionally disclose the number of transactions screened.

With respect to reporting, the EPs require information on implementation, and the structure and staffing personnel involved with implementation. This includes mandatory details on training during the first year of EP adoption in order to demonstrate progress in addressing the EP assessment procedures and training events.

The third version of the EPs also addresses clients' public reporting, which was not required until then. By public reporting, the EPs mean "Online summary of Environmental and Social Impact Assessment, as well as [reporting] Greenhouse Gas (GHG) emission levels for projects emitting over 100,000 tonnes of CO_2 annually during operational phase" (The Equator Principles, 2013). This new guideline addressed general reporting criteria and reporting of GHG emissions and consequently accepts the financial sector's responsibility for indirect, or financed, emissions (Collins, 2012).

For the first time in 2006, changes were introduced regarding climate change. EPFIs were to report on climate, based on the World Bank Group's environmental, health and safety guidelines and general due diligence. The revised EP III highlights in its preamble the need for heightened due diligence, requires alternative analysis of high-emitting projects in line with IFC's performance standard 3 and focuses on climate change issues. Perhaps the most salient aspect, with respect to climate change, is a mandatory requirement for projects emitting more than 100,000 tons per year to report their GHG emissions. However, there is no guidance on how to mitigate GHG emissions of projects.

Finally, prior to 2013, EPFIs conducted information sharing informally, as might be expected in most competitive industries. Pagano and Jappelli (1993) argue, however, that "information sharing may increase the degree of competitiveness within credit markets, increase the efficiency in the allocation of credit, increase the volume of lending, and may also have policy implications." With the most recent EP revision, EPFI members agree to share social and environmental issues with other mandated financial institutions.

Changes were also conducted with respect to designated countries, which are countries with robust environmental and social governance, legislation systems and institutional capacity designed to protect their people and the natural environment (The Equator Principles, 2013). In the last EP revision leading to EP II, these countries operated with assessment and approval processes that were seen as an acceptable substitute for the IFC performance standards. Thus, the noticeable change is that designated countries are high-income OECD countries, and the appropriateness of this list is a subject of current review.

However, it is questionable whether all high-income OECD countries have regulations in place that guarantee appropriate GHG emissions regulations.

The changes indicated above mean that the EPs continue to evolve against the background of a rapidly shifting socio-environmental landscape. Some changes or pressures for change have been civil society-driven, notably from BankTrack. Others have emanated from internal policy changes within the World Bank Group, particularly the IFC, which provides the basis for many of EP revisions. How these changes have affected project communities is still open. Furthermore, some important issues still remain unclear in the third version of the EPs:

- Potential liabilities for environmental infractions involving, for example, pollution, would likely depend on the host country regulators. The disclaimer in the EPs disavows any potential project liabilities. Project tracking of emissions may be a first step but to what end? Would repeated violations of EP requirements potentially lead to project decommissioning? How feasible is this alternative as it may cause default on loan obligations?
- A particular problem of the EPs' requirement to disclose CO_2 emissions is the validity of the estimation and the measurement of GHG emissions if external auditors do not verify them. Another problem is the willingness of projects to disclose the emissions. Furthermore, disclosing data is a first step of managing CO_2 emissions; actions have to follow the reporting. The EPs, however, do not specify what should be done in case of high CO_2 emissions of projects.
- Apart from required involvement in learning events to better internalize the EPs' requirements and to share mutual experiences, the way EPFIs are to engage in information sharing is not specified. Will EPFIs limit themselves because of trade secrets or customers' privacy? If transparent information sharing is unenforceable, does not sharing information constitute a breach of the EPs' governance rules, given that these are only voluntary codes?
- With respect to the new proposal on designated countries, even high quality standards, as those deemed in these countries, may not fulfil IFC criteria. Canada, for instance, is criticized for how it assesses and qualifies the risks of the oil sands business, and while the Royal Bank of Canada announced in 2004 that it has applied the EPs to an oil sands project in Canada (Miles, 2013), environmental regulations should already be in place that make the EPs' guidelines unnecessary. Furthermore, a number of high-income OECD countries do not have any regulations with respect to CO_2 emissions in place.

6 Equator Principles Implementation and Reporting

This section will introduce two studies analysing the implementation of the EPs and exploring the reporting of EPFIs. In addition to the institutional analysis above, the results provide inside on how EPFIs apply the EPs and whether they comply with their own voluntary standards.

6.1 Equator Principles Implementation

As of October 2014, in-depth interviews with representatives from six EPFIs and one NGO focusing on environmental and societal impacts of project finance were conducted. The EPFIs were from North-America (2), Europe (4), and Asia (1). Structured interviews, both by telephone and in person were conducted. Using 14 questions, the interview focused on the implementation of the EPs by project financiers and on the effect of the EPs on the social and environmental performance of the projects. The interviews were transcribed and analysed according to the questions. The 14 questions were:

- What are the main benefits of the Equator Principles for your organization?
- What are the main risks of the Equator Principles for your organization?
- What is the impact of the Equator Principles on project assessment procedures?
- How do they help with assessing project sustainability?
- How do they help assessing general project risks?
- What are the problems related to the application of the Equator Principles in the project assessment process?
- Do the Equator Principles have an effect on the project sustainability?
- Do the Equator Principles have an effect on the project risk?
- How are social and environmental assessment outcomes on the one hand and risk assessment outcomes on the other hand integrated?
- How are the results of the social and environmental assessment communicated to the financial risk assessment team?
- What happens in the case of different outcomes in social and environmental assessment, and financial risk assessment?
- What happens when a project that bears high social and environmental risk has a positive financial evaluation?
- What would you do to improve the effectiveness of the Equator Principles?
- What are your main goals as the chair of the Equator Principles steering committee?

In this paper, however, we exclusively focus on the questions about the implementation of the EPs by the EPFIs and on the effect of the principles on the environmental and social performance of projects.

The interview results suggest that the main motives to adopt the EPs were that they help to be compliant to regulations, that they increase the reputation of the project financier and the projects, and that they are a tool for managing project risks. None of the interviewed project financiers' representatives, however, stated that the way they assess projects has changed after having adopted the EPs. It seems that following guidelines similar to the EPs has been best-practice in project finance anyway. Therefore, it can be concluded that the EPs did not change the way social and environmental issues in project finance are assessed. With respect to the implementation, all interviewed project financiers have mechanisms in place that guarantee the integration of the results of the environmental and societal assessment into the project finance decision-making process. Consequently, projects that are not compliant with the EPs are not financed by EPFIs. In general, the preliminary results of the

interviews suggest that the EPs do not have an effect on project sustainability but rather 'regulate' and create transparency about what has been done anyway with respect to managing sustainability issues in project management.

6.2 Equator Principles Reporting

As mentioned above, the EPs include a guideline on how often their members should report, how they should report, and what content should be disclosed. In order to test whether EPFIs report according to EP's guidelines we used seven criteria taken from EP's guidelines on reporting. The guidelines demand (1) annual reporting, (2) disclosure of screened transactions, the categorization of projects with respect to their (3) assessment status, (4) risk category, (5) sector, and (6) regions as well as (7) reporting on implementation experiences.

All Equator Principles Reports of the 80 EPFIs,[2] as well as other reports, such as corporate social responsibility and annual reports, other publications and website information, were analysed with respect to the seven criteria above during the time of membership at the EP association. Nearly half of the EPFIs (44%) reported annually as proposed in the EP II guidelines and consequently met the respective EP II guideline. Nearly all EPFIs (92%) disclosed the number of screened transactions and 78% of the EPFIs presented a risk classification of their projects. Only 14 per cent, however, reported about the assessment status of the projects.

Of all projects, 14 per cent were classified as category A (highest risk), 23 per cent categorized as B (medium risk), and 29 per cent that do not seem to have significant environmental or social impacts, were categorized as C and consequently do not have to be assessed according to the EP guidelines (The Equator Principles, 2013). The remaining projects have not been classified at all. The question, however, is how a valid classification of social and environmental project impacts can be performed without conducting an in-depth environmental and social impact analysis.

One reason for the relatively small number of A and B projects could be the sector distribution. More than a third of the projects are from the energy sector (36%), followed by 'Others' (22%), and infrastructure (18%). Oil and gas as well as mining projects together account for 24 per cent of the projects. 95 per cent of the projects in these two sectors were classified as A and B, compared to 70 per cent in other sectors. Unfortunately, though the majority of the EPFIs reports about risk categories, sectors, and regions, only a minority reports them in a way that enables report readers to combine the figures and to analyse the risk of projects in certain regions and from certain sectors. Because projects are usually not listed in a way that they are identifiable, the reports are non-transparent as it is not possible to allocate social and environmental impacts to certain projects, sectors, and regions (see also Conley and Williams, 2011; Hadfield-Hill, 2007).

In addition, our analyses suggest three conclusions. First, all EPFIs that are not in their first year (and therefore are not required to report) disclose information on social and environmental issues of project finance. Second, only two EPFIs disclose all the information required by the EP guidelines, though 85 per cent meet at least four out of the seven reporting criteria. Third, T-tests were conducted for both total assets and membership duration and reporting quality. The reporting quality was assessed by analysing how many of the seven quality criteria mentioned above were fulfilled by the EPFI. To create groups a median split was conducted and the higher 50% was classified as high quality reporting. The tests suggested significant differences in the reporting quality between EPFIs with large assets and those with

[2] *As of May 2014*

smaller assets (p=.045, df=70, t=-2.04) and between members with longer membership duration and short time members (p=.010, df=77, t=-2.64).

As mentioned above, the first result can be explained by stakeholder theory. Because the EPs are a voluntary guideline without any enforcement mechanism but stakeholder pressure, only a few organizations disclose all information required by the EPs. Instead of being proactive, they are rather reactive to stakeholder pressure and only report about what stakeholders ask for.

The correlations between the size of an organization and its reporting is in line with earlier research (Brammer and Pavelin, 2006; Gamerschlag, Möller and Verbeeten, 2011; Patten, 1991) that found larger firms reporting on a higher quality level than smaller firms. This finding seems to be valid for the financial institutions in our sample as well and demonstrates the strong impact of economics of scale on sustainability reporting (Scholtens and Dam, 2007) instead of the impact of voluntary codes of conduct. Particularly, larger financial institutions are much more exposed to external scrutiny than smaller institutions with smaller financing power and consequently a smaller impact. Because the financial sector is often criticized for its low transparency, large financial institutions in particular strive for a high reporting quality and are also able to afford the additional reporting costs. Interestingly, factors such as the number of risky category A projects and the number of projects in general do not have an impact on the reporting quality. It seems that reputation is the main reason for a high reporting quality.

Conclusions

Based on our analysis and empirical research, we can draw the following four conclusions:

- First, project financiers that adopt the Equator Principles do so because they hope that it will either increase their reputation or that they serve them as guidelines for risk management. It seems that the EPs did not really change the way how environmental and societal issues in project finance are assessed or that the EPs lead to a rejection or a modification of projects with respect to environmental and societal impacts.
- Second, the new annex addressing climate change only demands that projects emitting more than 100,000 tons of CO_2 per year have to be reported. There is neither a threshold that does not allow financing of projects with high CO_2 emissions nor a mechanism that demands an explanation that no other financially viable alternative with lower CO_2 emissions could have be chosen.
- Third, results on Equator Principles reporting suggest that in some cases EPFIs do not even comply with their own voluntary guidelines. Furthermore, most of the EPFIs report in a way that makes it nearly impossible to analyse the societal and environmental impacts of projects because projects are usually not disclosed in the EP reports.
- Fourth, the EPs are based on IFC Guidelines (International Finance Corporation, 2011, 2012) that have been applied for many years. Therefore, they do not add any stricter rules that have to be followed and EPFIs just mimic a standard that is already applied by World Bank and IFC.

Based on the analysis of the principles including their implementation by EPFIs and reporting practices, we can state that the EPs do not have a significant impact on both project sustainability and on the design of a more sustainable financial system.

What has to be changed to make the EPs a mechanism that shifts the financial sector into a more sustainable direction? We will discuss this question focusing on the motivation for applying the EPs, on the content of the EPs, on enforcing mechanisms, and on the objectives of the EPs.

The motivation for EPFIs to adopt the EPs is based on a business case approach rather than on a sustainability case approach. Mostly, it is argued that the EPs can be beneficial for the financiers. Benefits are increased reputation or more structured risk management processes. Inside-out effects (Porter and Kramer, 2006) focusing on the improvement of the sustainability of projects are not in the focus of EPFIs though positive impacts on the sustainability of projects were the main motives of NGOs for supporting the EPs (O'Sullivan and O'Dwyer, 2009). Similar approaches, such as the Global Reporting Initiative or the Carbon Disclosure Project, went a similar route. They were started to push businesses in a more sustainable direction by increasing transparency and offering guidelines to enable businesses to become more sustainable. They failed, however, to create substantial changes with respect to sustainability impacts of businesses (Dingwerth and Eichinger, 2010; Fonseca, McAllister and Fitzpatrick, 2013; Moneva, Archel and Correa, 2006; PWC and Carbon Disclosure Project, 2013).

Consequently, the question is whether a private code of conduct, such as the EPs, that mainly focuses on risk and reputation management and outside-in relations will be able to drive the financial sector to play a more active role in sustainable development, such as financing a green economy.

Generally, the EPs address the main sustainability issues: the environment, impacts on society and communities, processes to guarantee the inclusion of stakeholders, and climate change. The problem is, however, that the EPs offer guidance for assessment processes instead of proposals and guidelines for

evaluating the results of the assessment processes. Although the EPs claim that they guarantee the assessment of environmental and societal standards, particularly in countries with weak regulations, they are not a substitute for missing or weak environmental and social standards. This becomes especially clear with the new approach to climate change. For instance, even though coal power plants are significant contributors to climate change, they still can be financed in accordance with the EPs, even if they are emitting more than 100,000 tons of CO_2 per year. In such a case, disclosing the emissions would be in accordance with the EPs. The question remains whether disclosure will have any effect in this case. Alternatively, the EPs could have implemented a mechanism that demands to disclose which alternative options have been explored and why they were not selected. Such a 'comply or report' approach would be able to channel financed projects in a more climate-friendly direction.

A third way to improve the effect of the EPs would be to establish enforcement mechanisms. As demonstrated above, a significant number of EPFIs does not comply with the reporting guidelines. In these cases, however, EPFIs do not have to expect any consequences. Enforcement mechanisms may include monetary fines or exclusion from the EP association. The latter would also prevent free-riding by financiers that just want to increase their reputation through being an EPFI. To guarantee non-biased enforcement, the Equator Principles Association should establish an independent body that audits and assures the EPFIs' performances and reports about both compliance and non-compliance. Members of the independent body could be auditors and stakeholders, such as NGOs, affected communities, representatives from multinational organizations, and government representatives.

Finally, the EPs focus only products, services, and processes connected with project finance. An EPFI can follow the guidelines, be sustainable with respect to project finance but behave in contradiction with other products and services. This problem occurs for other voluntary guidelines in the financial sector such as the Principles for Responsible Investing or early versions of UNEP FI that only focused on lending as well. What is missing, however, is a general definition what sustainable banking and finance means, independent from particular products and services. Such an approach could also prevent cases where banks are ranked as leading sustainability performers on the one hand but are involved in controversies and banking scandals on the other hand. Banks such as Citigroup, JPMorgan Chase, Bank of America, Morgan Stanley, or Crédit Suisse are well-known cases, being often labelled as sustainability leaders in their industry and even engaging in impact investing (Weber and Duan, 2012), but deeply involved in the financial crisis and criticized for controversial businesses (Greider, 2011). Therefore, it seems that voluntary guidelines such as the EPs rather focus on the business case of sustainability by selecting areas that must be managed with respect to sustainability risks material for the banks or that provide business opportunities. They do not provide any guidance on how to change the overarching business strategy to become more sustainable and to create benefits for society and sustainable development.

Future Research Needs

Research is needed for the development of indicators that measure the sustainability impacts of the financial sector and consequently connect corporate sustainability with general sustainability. Furthermore, research should explore which banking strategies, products and services are best suited for a contribution to sustainable development: the sustainability case of banking (Weber, 2014). It should be analysed whether and how the financial sector will be able to address major sustainability issues, such as valuing natural capital, mitigating and adapting to climate change, ensuring more equitable wealth distribution, improving food and water supply and distribution systems, and enhancing health care (Barbier, 2011; Rogers, Kazi and Boyd, 2008).

Another stream of research should focus on the effectiveness of private codes of conduct with respect to the improvement of the sustainability performance and the impact of the financial sector on society. Research should focus on whether the EPs have a positive impact on the sustainability and the societal impact of projects. Currently, research focuses either on the business case of the EPs or on institutional analysis. No research, however, analyses the impact of the EPs from a stakeholder's perspective, for instance from the view of affected communities.

Finally, research is needed on the connection between voluntary codes of conduct in the financial sector that focus on particular products and services and their influence on the general sustainability of the financial sector. So far, it is unclear whether the adoption of particular sustainability guidelines influences the strategic approach on corporate sustainability in the financial sector.

This research will be important, because the financial sector provides the underlying resources that power entire economies (Helleiner, 2011; Herring and Santomero, 1995) and is able to channel capital to sustainable businesses (Scholtens, 2008) that create positive impacts on society.

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