Unproven Equator Principles

A BankTrack statement

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Introduction

On June 4th 2003, in response to growing international pressure, ten financial institutions announced the Equator Principles (EPs). Led by Citigroup, ABN AMRO, Barclays and West LB, the banks presented a common approach to manage environmental and social risk associated with financing large projects.

Two years after the launch of the Principles, the number of adopting financial institutions has risen to 31 (29 banks, one Export Credit Agency and one insurance company). Most key players in the market are on board but several leading project finance banks as BNP Paribas, Société Générale and Sumitomo Mitsui Banking continue to opt out.[1] It is estimated that the Principles now govern over 80 percent of all project lending.[2]

The EPs, from being a relatively modest initiative at their launch, are now at the centre of a debate on how the financial sector should take up its responsibility for the social and environmental well being of the planet. The EPs are rightly claimed by adopting banks as the new standard for responsible project lending, and are considered the minimum standard which every project finance bank claiming to be a responsible actor should meet. For some, it can be the starting point from which to embark on more ambitious efforts. A few of the original adopters have moved on and devised sector specific policies that go far beyond what is required by the Principles, while some newcomers have announced their adoption as part of a wider effort to achieve sustainable lending operations.

BankTrack[3] welcomes any initiative of the financial sector that enhances the social and environmental sustainability of its operations. It assesses all such initiatives against the 'six commitments to sustainability' as formulated in the Collevecchio Declaration, a statement signed in 2003 by over one hundred civil society organisations.[4] BankTrack considers the EPs an important initiative with a huge potential.

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[1] Ranked by Dealogic as the #1, #6, and #9 Global Top Mandated Lead Arrangers, respectively

[2] Equator banks arrange about 80% of the global project finance loan market by volume. See wwww.equator-principles.com

[3] An international network of fourteen NGOs tracking the activities of the private financial sector. See www.banktrack.org

[4] See www.banktrack.org under agenda

Precisely because of this importance, BankTrack in the last two years has critically followed the development of the Principles, pointing out shortcomings or outright failures of adopting banks to deliver on the commitment made, but also proposing ways to improve the EPs.[5]

Two years after the launch, where do the adopting banks find themselves then? This short briefing summarises what BankTrack considers the state of affairs with the EPs at their second anniversary. It is partly based on a longer report, published simultaneously, reviewing Equator Banks' reporting on EP implementation.

Year One ; Principles, Profits or just PR?

At the first anniversary of the Equator Principles, BankTrack published a report, 'Principles, Profits or just PR; Triple P investments under the Equator principles'.[6] The report was widely acknowledged as the most comprehensive external assessment of the Principles at that time. It presented a disturbing picture of a promising initiative threatened by a lack of good faith commitment to back it up.

Amongst the main **findings** of the report were:

- **Implementation unclear;** Most adopting banks had not demonstrated how, or even if they had incorporated the Principles in their every day operations.
- **Lack of transparency;** Public reporting on the principles was sketchy to non-existent with most banks. Signing on to Principles also did not formally require the banks to disclose any such information.
- **Little engagement with civil society**; Banks were actively avoiding engagement with civil society, despite their claim that the EPs had the potential to deliver benefits to external stakeholders.
- **No formalised external accountability;** The initiative did not set up any accountability mechanism that would allow communities affected by projects supposedly governed by the EPs to seek redress for problems they may encounter.
- **Unclear future IFC policies;** As the EPs are pegged to the Safeguard Policies of the International Financed

[5] See the publications section of the BankTrack website. BankTrack has also participated in a number of meetings with Equator banks on how to improve the implementation and application of the Principles.
[6] http://www.banktrack.org/index.php?id=112

Corporation (IFC), their future relevance depended on the outcome of the then-announced redrafting of these Policies. There was a concern that the EP banks would use their influence to weaken the requirements embedded in these policies.[7]

- **Business as usual on the ground;** The adoption of the Principles did not seem to have a discernible effect on decision making on a number of deeply controversial projects.[8]

The report also contained a set of **recommendations** to the Equator Banks that would restore public confidence in the Principles:

- **Promote Good Practice and Transparency**. leading banks should shift their focus away from recruiting new signatories, and concentrate on assisting endorsers with implementation and promoting regular public reporting. On a project level, banks should make environmental documentation available to the public.
- **Support Stakeholder Engagement.** Adopting a more collaborative and open approach towards civil society would increase public confidence in the Principles
- **Promote Accountability.** EP banks were urged to install an accountability system similar to Independent Accountability Mechanism that already exist with IFIs.
- **Champion Continuous Improvement.** banks should play a proactive role in supporting improvements to international environmental and social policies and standards.
- **Proof it with the Portfolio.** Equator banks must exclude projects which fail to meet their environmental and social standards and actively seek corrective measures when project sponsors fail to comply with such standards and commitments.

Bank responses

The report generated a significant amount of interest and response from the banks. Many of the EP banks argued that one year –or less in case they signed on later- was not enough to

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[7] This concern was raised by a joint letter in April 2004 by a group of Equator banks seeking to prevent the World Bank from adopting several key recommendations of the Extractive Industries Review

[8] The report listed almost a dozen examples such as the Baku-Tblisi-Ceyhan oil pipeline project in the Caucasus, the Sakhalin II oil and gas development in Russia, the Trans-Thai Malaysia pipeline and the Omkareshwar dam in India.

move a sector as entrenched as the banking industry fully in the right direction, implement the necessary procedures and guidelines, conduct the training of staff etc.

Equator Banks also commented that some of the critiques stemmed from a lack of understanding of how banks operate -- for example overestimating the influence a bank may have on a project sponsor, or the legal constraints that may prevent the release of documents.

Finally, While BankTrack maintained that the Principles eventually should lead to changes in the overall portfolio of banks –the result of rejecting problematic projects and moving towards socially and environmentally sustainable ones- EP banks insisted that the EPs had to be judged on how many Category A or B projects they would generate, rather than how many business opportunities they would forego.[9]

Year Two: one step up, challenges ahead

If one accepts that change in the banking sector takes time and that the first anniversary was too early to judge the efforts of the EP banks, how far have they come at year two then?

The overall picture is mixed: There are certainly promising signs among some of the Equator banks. A handful of Equator banks have been forthcoming in demonstrating their seriousness and good faith in implementing the Principles, and in tracking whether the EPs are having a positive impact. Their actions generate hope and goodwill, but a majority of EP banks have not produced similar evidence.

Given the fact that a) the EPs still have serious “design flaws” regarding lack of transparency and accountability, b) they have not yet proven on a generalized basis that they are making a difference to people on the ground, and c) the continued support to environmentally and socially harmful projects that according to BankTrack should not pass the ‘Equator test’, there remains ample reason to follow the advice of last year.

Promote Good Practices and Transparency

One of the key weaknesses of the EPs continues to be the lack of transparency required of adopting banks; the absence of regular reporting on EP implementation undercuts the credibility of the

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[9] See the Equator Principles for an explanation of the categorization. www-equator-principles.com

Principles and invites allegations of 'greenwash'. BankTrack has consistently underscored the importance of requiring such transparency as part of the overall commitment made by adopting banks, yet the initiative still leaves public reporting up to the discretion of individual banks – with discouraging results.

A closer look at the disclosure efforts of the individual banks shows a mixed picture.[10] Many of the banks that have chosen to report seem to have improved over the last year.[11] However, the vast majority (80%) of Equator banks is providing limited or no disclosure. Among the more transparent banks, few have risen to the higher level of reporting proposed by BankTrack and the ethical investing community, providing such details as number of transactions, percentage rejected etc.[12] 'Better reporting' appears to be a future goal for several EP banks, and such an emphasis indeed is needed to enhance public confidence in the EPs.

BankTrack again encourages Equator banks to consider a minimum set of reporting and implementation requirements for newly adopting banks.

Improve implementation

Given the poor rates and quality of public reporting by EP banks, it is difficult to ascertain the state of EP implementation generally among the banks. The quality and extent of implementation seems to vary greatly. For example, at least four banks do not have environmental management systems designed to manage environmental/social credit risks.[13] The lack of such systems, combined with an absence of any indication to build such systems in the future, does not bode well for the ability of those banks to effectively implement the EPs.

Fewer than half of the banks have created new procedures, standards, tools, etc. to implement the EPs. Surely any bank that implements the EPs in good faith must make some changes to the usual ways they do business. Training, the necessary first step for many banks, is necessary but not sufficient. Creating new practices of doing things is paramount and such efforts should be disclosed by all EP banks.

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[10] For a detailed overview on both the state of implementation and the level of reporting see 'Unproven Principles; the Equator Principles at year two', an anniversary assessment. BankTrack, June 2005

[11] For example, ABN AMRO, Citigroup, HSBC, ING, Mizuho and Westpac all provided superior reporting and seem to have made progress in implementation last year.

[12] See proposals made by BankTrack and CIS, www.banktrack.org

[13] Banco Bradesco, BBVA, EKF, and MCC

On the positive side, one noteworthy aspect of EP implementation is the fact that five Equator banks have chosen to liberally apply the Principles to transactions other than what is strictly required under the EPs, for example by lowering or abandoning the threshold of 50 million US$ or applying the principles in corporate lending deals where proceeds are known.[14]

Support Civil Society Engagement

A collaborative and open approach towards civil society organizations monitoring the Equator Principles will increase public confidence in the Principles. BankTrack appreciates the fact that some of the EP banks have made a serious attempt to engage with international NGOs over the last year, which has helped to increase mutual understanding and the flow of ideas. Not all EP banks participated in these debates. Notably, the Brazilian (the only emerging market EP banks) and the only Spanish EP bank were absent at these discussions. This is a missed chance for both civil society and fellow EP banks to take into account the perspective of those banks.

This said, civil society engagement should not only take place on this policy oriented level. It is particularly important when dealing with project-affected communities. With respect to project-based information, BankTrack has encouraged EP banks to create public information disclosure policies that make an "assumption in favour of disclosure" which would grant potentially affected communities and local NGOs the right to access all relevant information prior to financial decision making, and throughout the life of the project. It is hard to understand how communities could meaningfully engage with banks and project sponsors without access to this information.

So far, it appears as though EP banks are reluctant to ensure additional levels of project-level disclosure (e.g. disclosing additional environmental and social covenants upon request, requiring clients to permit disclosure of monitoring reports) beyond what is required in the EPs. Indeed it is possible to release this information while respecting client confidentiality laws by including in EP loan covenants a clause that obligates clients to permit the release of documents related to the project's environmental and social performance. This disclosure precedent

[14] ABN AMRO, HSBC, Citigroup, JPMorgan Chase, and Westpac.

has already been set in the case of a few large, controversial projects.[15]

Promote External accountability

EP banks have been squarely opposed to the recommendation in the BankTrack report to establish an independent accountability mechanism, citing legal and practical constraints. Examples of such mechanisms already exist with most multilateral development banks and several Export Credit Agencies and they could be adapted to the specific requirements of private banks.[16] At most, Banks have been willing to entertain the idea to establish such monitoring devices on the project level. BankTrack maintains that such arrangements on bank or even Equator group level would not only improve the external accountability of the Equator banks but provide them with a valuable mechanism to improve compliance with the set of rules they have adopted.

Champion improvement; beyond Equator

Most Equator Banks acknowledge that their responsibility - and the associated reputational risk - extends to any project they support, regardless of the precise nature of their involvement (advisory role, corporate loan, issuing bonds etc). While the Equator Principles may provide a good start for banks active in project finance, the real challenge is to ensure that other types of financing activities are also captured. Several of the EP banks have done just that, by either developing sector-specific policies or widening the scope of the EPs, moves that are welcomed by BankTrack.[17] In the fall of 2005, BankTrack will publish an assessment of these Best Practices that point the way for other financial institutions to follow.

Some Equator banks have illustrated their ambitions to set rather than follow standards during the public consultations of the IFC Safeguard policy review process. The initial concern that the Equator Banks could play a negative role in this process, exerting their influence in trying to downgrade requirements for project sponsors, turned out to be unwarranted. On the contrary, on several occasions Equator banks and NGOs found themselves agreeing on many of the (often harsh) criticism of the IFC's

[15] For example, monitoring reports for the Baku-Tblisi-Ceyhan pipeline are disclosed.
[16] The PPP report provides extensive suggestions on how this could work.
[17] For example in 2005, HSBC adopted a freshwater guideline that follows World Commission on Dams recommendations. Similarly, Citigroup, Bank or America and JPMorgan Chase have adopted illegal logging policies. ABN-AMRO has developed forests, mining and oil & gas policies in consultation with environmental NGOs, while a number of Belgian banks have issued new policies on financing the weapons industry.

proposed new 'Performance Standards'. EP banks and NGOs have also both expressed their disagreement with the wholly inadequate way in which IFC conducted its stakeholder consultation.

Changes in portfolio

Many Equator Banks understand that the ultimate proof is in the portfolio. One of the major shortcomings of the EPs is that banks which technically apply the Principles may still finance very environmentally and socially damaging projects.[18]

In addition to this, some companies are now financing controversial projects through non-project finance avenues, thus enabling them –and some Equator Banks ready to go along with this– to avoid the requirements of the EPs. If these practices develop into a wider trend they may undercut the viability of the EPs. For example:

Sakhalin II: The Sakhalin II gas and oil project is the next major test case of the Equator Principles. It is located on Sakhalin Island in Russia's Far East, and is being developed by a consortium led by Shell that is currently seeking financing. It will have severe environmental and social impacts, including threatening the critically endangered Western Gray Whale with extinction, undermining the livelihoods of indigenous peoples, damaging habitats of endangered bird and fish species, and polluting important fisheries. Experts have reported that the project design falls far short of industry best practice, and that its risk assessments are inadequate. As a result, the project risks causing a catastrophic oil spill, as well as major routine impacts. As this project clearly violates the Equator Principles on several counts (i.e. IFC Safeguard Policy on Natural Habitats, Indigenous Peoples, Environmental Assessment and Involuntary Resettlement), it will serve as a key test case of the EPs.[19]

Nam Theun II: This dam project will have serious impacts on the lives and livelihoods of tens of thousands of rural Laotians. Roughly 6,200 indigenous people living on the Nakai Plateau will be evicted to make way for the dam and its reservoir. Another 120,000–150,000 people depend on the Xe Bang Fai and Nam Theun Rivers for their livelihoods. It is likely that they will suffer from destruction of fisheries, flooding of riverbank gardens and other impacts caused by the project. Independent reviews of the

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[18] In one well known case, the Baku-Tblisi-Ceyhan oil pipeline, Banca Intesa, a non-EP Bank even withdrew by recognising as grounded civil society concerns, while influential EP Banks remained in the deal

[19] For an overview of problems associated with Sakhalin II see see http://www.banktrack.org/index.php?id=135

mitigation and compensation plans for Nam Theun 2 reveal that these plans are overly ambitious and have a high likelihood of failure. The World Bank has approved a loan for the dam, and project sponsors have approached several international banks, including Equator banks, for financing. This project tests whether EP banks perform their own environmental and social analysis (or whether they simply default to the dubious decision of co-financing public financial institution), and whether the presence of EP banks actually create any social/environmental value added, such as requiring true independent monitoring for projects.

D6 Oil project: In October 2003 ABN AMRO and Citigroup arranged a 765 million US$ long-term debt facility for the Russian company Lukoil.[20] Although this was not a project finance loan, it was clear that the D6-Project played a prominent role in Lukoil's investment plan, for which the long-term debt facility was used.

This oilfield is directly adjacent to the Curonian Spit, a national park of major international significance, which transcends the border between Russia and Lithuania. The Curonian Spit was designated as a World Heritage Site by UNESCO in 2000. It recently notified Russia that it is considering putting the Curonian Spit on the list of threatened World Heritage Sites.

Lukoil was already the object of a heated campaign by the Coalition Clean Baltic (with over 500,000 members in the Baltic States) and a broad coalition of Russian NGOs In 2004, the Prime Ministers of Sweden, Denmark, Estonia, Latvia and Lithuania put forward a formal complaint to the EU regarding Lukoil's actvities in the Baltic Sea.

In spite of the already high danger to the Curonian Spit through the D6-Project, Lukoil is still planning to develop 14 further oil deposits in the area. BankTrack will be closely monitoring the situation and have challenged banks to discontinue lending for Lukoil until the company adheres to international environment conventions and respects World Heritage site status.

Merowe dam: The Merowe Dam is displacing 50,000 people from the fertile Nile Valley to the barren Nubian Desert. The affected communities were promised free services such as irrigation water, electricity and fertilizer for a transition period of two years, but have so far been cheated out of most of these

[20] Some of the other banks that participated were Deutsche Bank, Dresdner Bank, Hypovereinsbank, WestLB, Commerzbank, Landesbank Hessen-Thüringen, BayernLB, DekaBank, DZ Bank, ING, Calyon, BNP Paribas, Natexis Banques Populaires, Dexia, Fortis, KBC, Barclays and JP Morgan.

promises. Although resettlement has only just started, the poverty rate in the affected communities is already soaring, and tensions are increasing. The Sudanese authorities have responded with repression to peaceful protests of affected people. Furthermore, the environmental impacts of the project have never been properly assessed, and the project has never been certified by the competent Sudanese authorities. On this last score, the project violates Sudanese law. Chinese companies are building the dam, and are raising money through the China Export-Import Bank, which in turn raises funds from international banks, including several Equator banks. This project demonstrates that corporate financing can be used to easily circumvent the environmental standards applicable to project financing, and dissipates the banks' responsibility for the impacts of their lending.

Moving Forward

Compared to their first anniversary state, the Equator Principles at year two are clearly one step up. Implementation and civil society engagement have improved with most, but certainly not all adopting banks; some vanguard banks have shown ambitions beyond what is required by the Equator Principles. This said, important shortcomings and flaws remain and banks would do well dealing with them.

The EPs themselves are considered more and more as the simple baseline to which any decent bank engaged in project finance should adhere, with non adopting project finance banks simply out of touch with the demands of our time.

At the same time, challenges remain. The examples of projects that go ahead despite the existence of the Equator Principles indicate that rules covering project finance alone can only do so much. Managing reputational risks extends to all bank operations while the risks involved are not only limited to environmental or social issues. The answer of banks should be a set of robust rules covering all relevant risks.

IFC Policy Review

The one key factor that will determine the future of the Equator Principles is the outcome of the IFC Safeguard Policy Revision. EP Banks have acknowledged that proposals made by IFC, to replace the current Safeguard Policies with the less stringent and more discretionary Performance Standards, are a step in the wrong direction and a direct threat to the credibility of the Equator Principles.[21]

The revision process is due to be concluded at the end of 2005. At the time of this writing it is impossible to predict how much of the concerns expressed by both EP banks and civil society have been taken on board by IFC. Once the Performance Standards come into operation, in January 2006, EP banks face the choice of whether they will adopt the Standards as the new basis for the EPs without any qualifications, or whether they will opt for a so-called 'EP2 approach'. In fact, the adoption of the Performance standards by IFC could be the perfect moment to adapt the text of the Equator Principles to incorporate policy elements that are missing in the Performance Standards or address some of the inherent flaws in the current version of the Principles such as the lack of accountability mechanisms, disclosure requirements, membership conditions etc. As such, the review process opens up interesting opportunities for EP banks to take the lead and set new standards for project finance.

Taking human rights on board

BankTrack welcomes the efforts of several institutions to create financing policies governing particular sectors, such as oil and gas, logging, oil and gas, weapons, and mining. A few banks have also created cross-sector policies that address issues, such as forests or freshwater resources.[22]

While there are many examples of environmental policies that have been adopted by individual banks, one critical area which remains relatively undeveloped is the inclusion of human rights safeguards in lending policies. Many banks are concerned with human rights from an ethical perspective, as well as from a reputational standpoint. However, existing human rights policies and approaches at banks tend to be *ad hoc* and unsophisticated.[23] Equator banks may be particularly exposed to human rights risks, as some project finance transactions occur in markets with repressive regimes; indigenous, tribal or marginalized communities; or in conflict areas. In addition, the IFC policies on which the EPs are based, are weak on human

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[21] See www.grrr-now.org for civil society views on the IFC safeguard policy review. www.ifc.org/policyreview provides details on the revision process

[22] Many banks, either instead of or in addition to financing policies, have created "green" financing facilities to promote particular investments in areas such as renewable energy and eco-housing, which are intended to address issues such as climate change and sustainable cities.

[23] See for example, F&C Asset Management, Banking and Human Rights: Confronting human rights in the financial sector, September 2004. http://www.fandc.com/uploadfiles/co_gsri_banking_human_rights_sep_2004.pdf

rights issues and thus do not provide EP banks with adequate cover on that issue.

Equator banks may seek to expand their cooperation on social and environmental policies and aim to develop joint human rights standards as part of a new Equator package or in a separate exercise.

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