Don't just market it - make it

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Investors or financial institutions (FIs), including public and private banks, institutional investors, equity funds, and so on, can clearly help promote environmentally and socially sustainable private sector investment by providing financing (project or corporate) or equity to the right projects.

Many FIs, to their credit, already have implemented environmental and social policies and principles related to their international project finance – such as the Equator Principles. When FIs apply safeguards to manage environmental and social impacts and risks, they are helping to ensure a project's sustainability. This not only builds management capacity in private sector companies, but also puts environmental and social concerns into the mainstream of corporate decision-making.

Experience has shown that FI proactive participation can add substantial environmental and social value to large-scale private sector projects by helping to identify, assess and manage potentially negative impacts and risks, promote stakeholder involvement, implement monitoring and supervision systems, and promote benefits. Thus, FI participation must be proactive, using qualified and experienced specialists.

However, FIs have really not come up with financial mechanisms that assist companies seeking to implement more environmentally and socially responsible projects, leaving the costs in the hands of the company or project sponsor. While FIs often talk about supporting sustainability, they have seldom used their own resources to support the additional actions required for greater sustainability in major private sector projects. Three specific areas where FIs can provide financial mechanism are in their lending, underwriting and advisory services.

Lending

FIs need to utilize financial mechanisms associated with the financing of projects to more actively promote and encourage environmental and social sustainability. In project financing, FIs can substantially influence the shareholders of a project or company by providing more favourable terms and conditions to companies practicing sustainability. In these structures, projects are typically greenfield (i.e., no major civil engineering has taken place) and the shareholder's main concern is return on equity on the project. Thus the type of financing significantly impacts equity return, and can be a strong factor in determining whether to make the investments necessary to go beyond minimal environmental and social requirements. FIs must know the target internal rate of return (IRR) and return on equity (ROE) that shareholders are expecting in order to provide terms and conditions attractive enough that the additional works will improve both the IRR and ROE.

Associated with financing projects, various specific mechanisms exist for a FI to promote environmentally and socially sustainable private sector investments. For example, lower fees (origination, loan administration, refinancing, etc.) could be charged if a borrower agrees to incremental environmental or other sustainability conditions and subsequently meets them. Failure to fulfill conditions could require payment of such fees.

Alternatively preferential financial terms or conditions could be provided, such as lower margins or longer maturities, for meeting targeted environmental or social criteria. These may include step-down interest rates as a company fulfills particular obligations, or grace periods on principal payments as such obligations are met. These could be applied to: (1)

companies that pursue environmentally and socially sustainable development projects; (2) projects in which the borrower's actions present a lower environmental risk; (3) the portion of a company's investment that specifically goes beyond compliance, and thus helps reduce environmental risk; or (4) the portion of the company's investment that provides enhanced local benefit (e.g., community investment programs, corporate responsibility programs). Each of the items listed above may be priced separately or as a combination to obtain the desired sustainability goal.

In terms of covenant related mechanisms, loan or guarantee extensions (e.g., by accepting a slightly reduced debt-to-service coverage ratio, or loan life coverage ratio) could be offered to cover the additional costs associated with investments or actions that go beyond compliance. Another example is early partial or complete release (or adjustment) of project-specific financial mechanisms established to mitigate environmental risk (e.g., reserve accounts, performance bonds, escrow accounts) in the case of higher than anticipated environmental and social performance (i.e., resolution of environmental liability quicker than planned in financing documents). Alternatively, a FI could offer a right to refinance, improved financial rates or conditions (i.e., adjustments), or refinancing for companies that meet environmental or social performance criteria during the life of the loan. This can be done in such a way as to offer the project's borrowers the possibility of readjusting/refinancing their debt on a more favorable basis if the project meets certain environmental performance criteria. This could also include reducing or waiving portions of such fees.

A FI may also offer a financial incentive, such as an 'equity kicker' for achieving prescribed social or environmental targets or cash rebates or bonuses when repayment is complete if environmental targets are exceeded. These are analogous to more classical financial performance bonus mechanisms used to compensate performance beyond specified objectives/goals.

Three key components to implementing such financial mechanisms are willingness, sustainability measures, and potential costs.

Within FIs there has been an apparent unwillingness or lack of commitment, especially by senior management, to develop and implement specific financial mechanisms associated with their project finance operations to promote sustainability. Or at least, if there is a willingness, banks have shown a lack of enthusiasm for marketing and actually implementing such mechanisms.

Effective implementation of these mechanisms that reward sustainability require credible measures for demonstrating superior environmental and social performance. Potential tools to measure such performance include: (a) environmental and social indicators (e.g. Global Reporting Initiative, output based projects/contracts, etc.), (b) environmental, health and safety management systems (e.g., ISO 14001, EMAS, OHSAS 18001, BS 8800, SA8000, etc.), (c) product standards (e.g., eco-labels, fair-trade labels, sustainable labels, food labels, etc.), and (d) industry codes of practice (e.g., CERES, WBCSD, Global Compact, policies developed by multilateral development banks, etc.). In addition, ideally a link is needed between these sustainability measures and risk. This can be done by environmental and social risk analysis tools, similar to those used in traditional credit risk analysis.

The potential cost, or negative effect on return, associated with using these mechanisms is a potential obstacle for FIs. However, research has established a strong and growing link between companies' abilities to manage non-traditional business risks (including environmental and social risk) and their financial performance. Simply put, a company's capacity to manage these complex risks better than its competitors has proven to be a robust proxy for superior management quality overall. Companies that go beyond mere regulatory compliance can obtain benefits that include better access to capital, improved image, better management and financial performance and even flexibility in negotiating terms of compliance with the government.

Since enhanced sustainability actions decrease a company's risk profile, an FI should be willing to encourage or reward them with financial incentives. The importance of environmental and social externalities will grow over the next decade, due in particular to increasing demand from investors and civil society for proper environmental and social management and increasing regulatory and compliance risks in developing countries as enforcement becomes more intense and the implication of non-compliance more significant. Thus, for mid- to long-term project financing, there is an even greater rationale for implementing such financial mechanisms.

Beyond the reduce risk rationale, providing incentives can help a FI build and maintain better client relationships, providing a competitive edge. Thus, such actions can be considered part of a FI's business development budget. The costs of rewarding sustainability in private sector performance can also be incorporated into an FI's corporate social responsibility (CSR) or philanthropic programs. In other words, a FI could just as easily use a portion of these budgets to cover the cost to make a company more sustainable, which may have in some cases more positive societal impact than other CSR actions.

Underwriting

FIs need to offer specific financial products that promote environmentally and socially sustainable development associated with underwriting operations. In particular, existing financial mechanisms needed to be adapted related to funds and bonds/securitization; and new mechanisms established such as vertical credit offerings. The applicability of a particular mechanism will depend upon factors such as market conditions and demands, as well as the role and business focus of a particular FI.

Innovative fund structures are needed to channel greater investment into environmentally and socially sustainable investments. For example, a fund focused on projects or investments in environmental protection or that reduce environmental impacts (e.g., solid waste management or disposal, waste water treatment for industrial parks, renewable energy) or environmentally friendly projects (e.g., eco-tourism, organic food products, clean technology, eco-industrial parks). They could also be used to finance environmental and social components of a larger project (e.g., advanced pollution control technologies in existing industrial plant) or the upgrading of existing environmental equipment and mitigation measures to meet or go beyond local compliance. Funds can also be used to aggregate smaller infrastructure projects and/or components those are deemed environmentally and socially sustainable into larger pools, thus providing better economies of scale of transaction and other costs.

Bonds/securitization products present various opportunities. For example, bonds can be created to finance a project or company (or be bundled among various projects/ companies) that demonstrates environmental and social sustainability. Their long-term nature and local currency denomination make them attractive for pension funds. Guarantees to enhance local bonds to do environmental protection or enhancement projects (e.g., green bonds) can be created. Another potential mechanism involves collateralized loan obligations (CLOs) which would pool loans to environmentally and socially responsible projects and companies. This can be particularly effective in bundling small-scale environmental service initiatives, which present a disparity between project fixed costs and size of projects.

Fixed income products, such as bonds, for the environmental sector are more viable when a particular market segment has voiced an interest in a sustainability-oriented fixed income product, there are an adequate number of like transactions to allow for effective risk spreading, and all borrowers are denominated in the same currency. One of the principle challenges has been the identification of investments that can deliver the acceptable internal rates of return set by the funds themselves. Better investment opportunities often lie with smaller projects, which result in increased fund management costs. The critical issue is not so much the lack of projects, but rather the absence of well-structured investments capable of engaging the private sector. More effort needs to be deployed to identifying and applying innovative funding mechanisms to specific projects. Thus project development funds, using technical assistance grants or revolving funds, can be beneficial.

Financing mechanisms are needed that take environmental amenities into account as utilities by providing a steady future stream of environmental services (sometimes referred to as payment for environmental services). Bonds, insurance vehicles or guarantees can provide a guarantee for carbon credits or other environmental benefits that can be securitized, thus increasing the financial returns of a project and lowering lender or investor risk. Adoption of a payment for services approach could be used in instances in which an environmental amenity provides quantifiable future benefits whose economic value exceeds the economic value of alternative uses. These mechanisms can be used for forests or wetlands that provide important services that have economic value, including watershed protection, flood and sediment control, carbon capture, and tourism. Bond proceeds can also be used to compensate local residents for protecting rather than exploiting an environmental resource.

The challenge with such a mechanism is to be able both quantify and monetize a future stream of benefits sufficient to justify the conservation activities. The cost of providing the monetary benefits through conservation activities must be lower than that of alternative means of providing the same benefits. The implementation issues involved in structuring financial transactions can be quite complex. Therefore, appropriate expertise is required and a facility established to structure and bundle the transactions may be warranted.

The use of bond or securitization of future revenues present a major opportunity for mega-projects that often need to demonstrate short-term benefits to local communities, especially to gain and maintain support. For example, many major private sector extractive industry and infrastructure projects often involve significant royalty, canon, and/or tax payments that initiate post-construction (i.e., years after start of construction and once the project is generating revenue) which can be significant sources of revenue for governments to support local economic and social development. Mechanisms could be developed that securitize such future payments in order to make available, in the short and medium-term, resources to fund projects that provide local opportunities and benefits.

Vertical credit product offerings capitalize on environmental opportunities that exist but are distributed among different entities or companies. Such offerings help convene various participants, from the manufacturer to the end user, in the overall product chain. By bringing together the various actors in the chain, the FI can help borrowers get a lower interest rate by increasing the scale of the overall transaction. At the same time, they guarantee the manufacturer or service provider an outlet for their product, while delivering better prices to the developer and end user. These offerings also provide the FI with different potential client groups, which will need access to credit or FI services beyond those of the transaction. Although any individual borrower in this chain may borrow a relatively small amount, in combination the borrowers may require a level of financing that would justify the incremental expenses associated with putting together transactions of this nature. This type of product offering can be pursed in many new product areas, such as wood products (forestry to furniture), organic agriculture, and water supply.

Advisory services

FIs should develop and implement support facilities and instruments that provide technical support to assist private sector companies improve their environmental and social sustainability. For example, FIs could help companies meet international good practice standards, such as a resettlement plan that complies with multilateral bank policies, enhanced ongoing public and stakeholder engagement, or actions to obtain ISO 14001 certification. They can be used to enhance project-related sustainability benefits. The focus of these programs should be local – economic development, poverty reduction, social and environmental improvements such as enhancing local hiring/training programs, community investment programs, and community/regional development funds.

They could also be used to help address negative impacts that are beyond the responsibility of a private company. Take the example of road concessions, in which the government maintains responsibility for expropriation and resettlement of displaced populations. FIs can help governments fulfill environmental, social, health and safety responsibilities in the process, thus helping to establish an environmentally and socially viable project.

FIs can provide these advisory services free or at reduced rates. They can be provided upfront, and include a proviso that they are to be repaid if the company fails to meet the environmental and social performance goals. Alternatively, fees paid for the services can be reimbursed by the FI once goals are met. These resources can even be supplemented from foundations or non-governmental organizations.

Clearly the principal obstacles are FI willingness and commitment to provide such advisory services, and potentially at a reduced costs, and having experienced specialized staff that can provide such services.

But to conclude, if financial institutions truly want to be part of the movement toward greater environmental and social sustainability, they need to be more innovative and proactive in terms of providing specific financial mechanisms to promote sustainable international private sector development. This requires clear commitment and adequate resources provided by senior management, and implementation with innovation by experienced skilled professionals.

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