A matter of principal

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'We will not provide loans directly to projects where the borrower will not or is unable to comply with our environmental and social policies and processes.' *From the Preamble of the Equator Principles*

In June 2003, ten international banks announced a commitment to environmental and social leadership that surprised many in the financial community. Since that time, an additional ten banks have come forward to make this same commitment. By adopting the Equator Principles, these 20 banks have agreed to use clear, responsible and consistent rules for environmental and social risk management in project finance lending. In taking this step, these banks demonstrated leadership in an area where banks have seldom tread.

Underlying this commitment is a transformation in the role of financial institutions in the project finance market. In the past, ensuring environmental and socially responsible development rested solely in the hands of borrowers. While banks have expected appropriate environmental management from project sponsors, they lacked consistent standards, a set of procedures to apply, and generally did not proactively enforce and monitor such management. From the hands off attitude of a few years ago, these banks have come to recognize their role and responsibility for promoting sound environmental and social management.

The Equator Principles are a voluntary set of guidelines developed and adopted by banks for identifying and managing environmental and social issues in project finance lending. The framework of the Equator Principles is based on the environmental and social standards used by the International Finance Corporation (IFC), the private sector lending arm of the World Bank Group. The principles apply globally to a bank's project finance business with a capital cost of $50 million or more.

Four banks were pivotal in developing the Equator Principles: ABN Amro, Barclays, Citigroup and WestLB. In seeking environmental and social standards to guide their effort, these banks quickly concluded that it would take years to develop their own standards. A 'neutral' standard was needed - a standard that no one bank could claim as its own. They wanted standards that had been time tested and proven to mitigate risk, had broad industry coverage, and were credible, widely understood and used. They decided that the IFC environmental and social policies and guidelines, drawn from the World Bank's policies and guidelines, fulfilled these requirements. While recognizing that the IFC standards were not perfect, they agreed that they were the best available. To reflect the fact that this was a global initiative it was labeled the Equator Principles by the originating banks.

The emergence of the principles

Each bank had its own reasons for coming to the Equator Principles: financial loss, increased awareness of the risks, public pressure and reputation damage all were important concerns. Just as important were considerations on shareholder expectations, positioning as leaders in sustainable investment, and attracting and retaining talented young staff to their organizations. These changes coalesced with a clear increase in client receptiveness to engaging on these issues. The banks wanted to be associated only with responsible development. They also did not want to compete on environmental and social compliance.

The Equator Principles have become the new market standard, thus transforming project finance. The 20 Equator banks, based in Europe, North America, Japan and Australia, are estimated to have arranged about 80% of project finance lending in 2003. As more financial institutions adopt the Equator Principles in the coming months, coverage will be truly global. Meanwhile, some banks that have not formally adopted the principles are following its procedures, knowing that this is the new standard by which they will be evaluated. Sponsors planning to raise funds in the project finance market are anticipating and preparing to meet the requirements of the Equator Principles. With the current range of coverage, successful loan syndications are likely to depend on the extent to which projects are Equator Principles compliant. (For a current list of the Equator banks, see the box below.)

In applying the Equator Principles to an individual project, the starting point for a bank is screening the level of environmental and social risk in the project and assigning a risk categorization. Higher risk projects require the borrower to prepare an environmental assessment and develop an environmental management plan. The environmental assessment evaluates the project against quantitative environmental guidelines and against a baseline set of policy requirements, including consultation with local communities. A borrower must meet these requirements or develop a plan to come into compliance. Loan covenants provide ongoing reporting and monitoring of compliance.

In addition to conforming to host country laws, a project must meet the IFC's environmental, health and safety guidelines applicable to the specific industry. In developing countries, projects must also demonstrate compliance with the IFC's safeguard policies, which cover management of cross cutting impacts, particularly social impacts. There are ten safeguard policies addressing key environmental and social development issues including environmental assessment, natural habitats, indigenous peoples, involuntary resettlement and labor standards.

With the Equator Principles as the new standard, the attention of the banks has inevitably turned to implementation. To adopt Equator, each bank must commit to develop an implementation plan along the full project cycle. While management of the Equator Principles is being squarely placed in the business line, each bank is free to develop its own implementation model.

How to implement?

Paul Mitchell, secretary general of the International Council of Mining and Metals (ICMM), indicates strong support for the Equator Principles. "Consensus among bankers on a common standard for sustainable performance is a major step forward for the mining industry." Nonetheless, his enthusiasm is tempered by implementation matters, particularly in ensuring consistency in monitoring of individual projects. "Banks have limited experience in monitoring environmental and social compliance and will rely on outside experts. Getting high quality, consistent and independent advice will be one of the major challenges for the banks and for borrowers," adds Mitchell.

In December 2003, 18 Equator banks met in Amsterdam for an implementation conference. The banks exchanged views on issues ranging from project categorization and sponsor screening to rewriting credit policies and finding the necessary consultants.

It is clear that these banks are adapting their organizational structures and developing policies and procedures to better manage environmental and social matters. At the same time, there is no denying that some institutions are further along in the process than others. Some of the banks had only adopted the Equator Principles a few weeks before the December meeting, while others had already trained dozens of project finance staff worldwide. For many banks, designating an Equator specialist for their institution was the starting point. Others already had environmental and social expertise internally and only procedural changes were required.

With its policies and procedures at their foundation, the IFC has a stake in seeing that the Equator Principles are well understood and implemented within each bank. One banker characterized the IFC's role as the godfather of Equator. It is an accurate characterization: no birthrights, but an enduring responsibility for its education.

For this reason, the IFC has committed to provide training to the adopting banks. Three course modules have been developed to meet the needs of different banks and the range of professionals within the institutions that will be involved with the Equator Principles. A short, half-day course is targeted for bankers that need familiarity with the risks and issues, and how the process works, but are not at the front line of implementation. A two-day course is geared to project finance professionals to provide them with the tools to identify risks, understand project categorization, apply the policies and procedures and implement monitoring measures. Interactive case studies are used that are developed from the bank's own projects. A five-day master class provides in depth knowledge and application for those professionals who will play a gatekeeper role in their institutions.

Beyond training, specific areas where the banks need advice and guidance have begun to emerge, and the IFC is working to fill these gaps. For example, while many banks have experience in managing environmental issues, evaluating the social dimensions of projects is newer terrain. As a result, the IFC is structuring targeted workshops to share its experience in managing these types of issues. Regular communication about the IFC's policies and procedures is also important to the banks.

The IFC is embarking on a process of revising its safeguard policies. With the Equator banks in mind, a key objective of the update is 'to promote the applicability of the safeguard policies to the private sector and support their efforts toward environmental and social sustainability.' Considering the role of the safeguard policies in the Equator Principles, the IFC will actively engage with the banks in the revision process.

The recently closed Baku-Tbilisi-Ceyhan (BTC) pipeline project provided a vital test of the Equator Principles. This $3.6 billion pipeline carries oil from the Caspian Sea in Azerbaijan, through Georgia, to Turkey's Mediterranean coast. The project was complex and controversial due to the range of impacts along the pipeline route. In addition to the IFC and EBRD, the financing included eight Equator banks and five export credit agencies. The IFC and EBRD held unprecedented multi-stakeholder forum meetings on the project, and a 120-day comment period on the environmental and social impact assessment was provided. The IFC published a detailed response to the public comments; and independent environmental and social specialists and engineers, working on behalf of the financial institutions, evaluated all of the project work. It was a cooperative, well managed and successful financing of a visible and highly complex project.

More than a declaration of intent, the Equator Principles provide precise procedures and standards. They create a common language and framework for the banks to engage with their borrowers and with one another. While it is up to each adopting bank to implement the Equator Principles, the banks and the IFC all have a strong commitment to get this right. Of course, the devil is in the details. But if the beginning is any indication, these banks are surely trying to make this work.