Putting some bite into the Equator Principles

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Since 2003, Equator Principles financial institutions, most of them major banks, have provided about 85% of the worlds project finance capacity. These institutions provide financing only to projects that comply with the Equator Principles, a voluntary set of guidelines designed to ensure large projects are financed in socially and environmentally responsible ways. Although over 70 financial institutions have adopted the principles, critics argue that they are merely greenwash, and have little actual impact on the financial or, perhaps more importantly, extractive, industries.

Evaluation of these criticisms is difficult because Equator institutions have reported little about their compliance with the principles. A comprehensive survey conducted by the authors of this article of the institutions reporting performance under the current principles suggests that, in general, reporting by the institutions is inconsistent and fails to adequately highlight what impact the principles are having. Is this because the principles in fact have little actual environmental and social impact, or are the principles themselves failing to adequately encourage transparent and meaningful reporting?

In fact, using the mining industry as a case study, there are clear indications that the principles are actually positively influencing mining industry practices on the ground. Despite these positive results, neither the banks nor the mining industry have responded to criticism by highlighting their success stories. As a recent internal strategic review and evaluation by the Equator Principles Association, the principles member body, concludes, banks and probably borrowers as well should highlight compliance and successes in order to dispel criticisms and receive recognition for their social and environmental sustainability efforts.

However, stemming from this Equator Principles Association strategic review process, the principles are now on track to be revised in early 2012 and are expected to include, amongst other matters, an increased focus on encouraging institutions to adequately report on their compliance with the principles. They will also incorporate sanctions for those institutions that fail to adhere to reporting requirements. These changes are certainly to be welcomed if the true impact of the principles is to be made more tangible and transparent.

The Equator Principles and their critics

In 2003, ten leading banks responded to increasing criticism of the social and environmental risks associated with project finance decisions by creating the Equator Principles. Following their revision in 2006, the principles now apply to all projects with a total cost of $10 million or more, though banks are free to use the principles to assess some or all of their other financing.

Under the principles, institutions classify each project in accordance with its potential social and environmental risk. The borrower must conduct a social and environmental assessment, reviewed by an independent expert, for projects in emerging markets with potential adverse risk. It must also prepare and execute an action plan to address the assessments findings. The institution will only finance the project if it is satisfied that the assessment and plan are in compliance with the International Finance Corporations performance standards and industry-specific environment, health and safety guidelines. The principles also require undertakings of continued performance.

Although the Equator Principles added another layer of sustainability review to project finance, critics, including some NGOs and academics, believe that the principles do not have enough bite. They express concern that Equator institutions implement the principles inconsistently, for example by categorising high-risk projects as low-risk to circumvent the assessment process. They claim institutions might also ignore the independent expert review of the risk assessment, or rebrand project finance as a corporate loan to evade the principles, which only apply to project finance.

Many of these criticisms are speculative. The real problem, recently acknowledged in the 2011 Equator Principles strategic review, is that it is difficult to assess the impact of the principles, or an Equator institutions compliance, because the principles members report so little about their experiences.

The strategic review noted that banks do assess environmental risks but simply do not report about their assessments. If the institutions surveyed reports are to be believed, this is probably true all of them mention in some way that they subscribe to the principles and that they play some role in the financing process. Accordingly, a key question is whether institutions that do not report rigorously in fact have robust principles processes in place.

Under the current principles, banks are expected to report on the number of projects they categorise as high, medium, or low risk, as well as to provide information regarding implementation. The strategic review points to these current, relatively minimal, reporting requirements and notes that it is disheartening to see that many banks fail even to meet those by not providing some information on their implementation. The current guidelines do not require much beyond a table with project numbers and a short description of the general incorporation of the principles in the banks finance policies.

A key recommendation of the strategic review is that the Equator Principles Association and the banks have a responsibility to make sure that there is adequate information about how the business of the EPs is conducted, and that currently accountability is insufficient. The authors survey of Equator institutions reports supports this conclusion they average the bare minimum, which is not much.

Although the Equator Principles Association created a rule in 2010 to combat underreporting any bank that does not meet the minimum standards will be delisted very little reporting is needed to avoid this punishment. The associations response seems to have recognised this problem and in the short term the association wants to improve communication and reporting requirements to increase transparency. The association is currently developing a detailed reporting template or standard, expected in March 2012, and in the medium term, the association intends to develop a common Equator Principles Assurance Standard to audit implementation.

The Equator Principles Association is also struggling with two key additional issues: first, whether to broaden membership and admit new members from emerging markets that might not have the resources to comply with the principles and, second, whether to restrict the principles application to project finance, which represents a diminishing portion of institutions portfolios. The Equator institutions responses to these problems suggest that many of them genuinely strive to implement the principles. Institutions that comply do not want new members to dilute the Equator brand by non-compliance, and some institutions have voluntarily expanded their implementation of the principles beyond project finance. Nevertheless, any attempt to measure the true impact of the principles must be done indirectly, given the absence of stricter reporting requirements.

Incentives to improve reporting are sorely needed. Some critics estimate that historically around 40% of institutions have not met their reporting obligations. A comprehensive survey of the most recent bank reports by the authors of this article confirms that underreporting is a legitimate concern. While all banks reported the number of Equator projects they had financed, few described the role the principles play in their project finance decision-making processes, and even fewer provided concrete examples of the principles impact. Somewhat surprisingly, banks in the Americas were less likely to report detailed information than banks in Asia and Africa. Nonetheless, industry leaders are found on every continent, such as BNP Paribas, Export Development Canada, and certain Japanese and Chinese banks.

Banks are hesitant to report more because of confidentiality concerns surrounding their projects, but the lack of comprehensive reports leaves the public unable to scrutinise whether the principles are correctly and consistently implemented. By publishing only generic reports, banks invite NGOs to rely on evidence of a few controversial projects to paint a bleaker picture about the principles than is warranted by their actual impact.

The mining industry as an implementation case study

Despite the criticisms, poor reporting does not necessarily reflect poor implementation of the principles on the ground. On the contrary, a case study of the mining and metals industry, where project finance is frequently used, illustrates how the principles have an impact beyond what the bank reports suggest. Evidence from the industry suggests that the principles do have bite, and that they have influenced mining projects around the globe.

The major mining companies, for instance, have all publicly embraced the Equator Principles in their current form and have welcomed enhancements to the Equator Principles over the years. Rio Tintos general counsel has said that It is entirely appropriate that the EPFI[s, Equator Principles financial institutions] support good projects. It is in the interest of all those concerned to abide by the Equator Principles. Companies like BHP Billiton, Anglo American and Newmont Mining have socio-environmental risk policies in place that closely align with the principles, and some mining companies have incorporated the principles into their own corporate policies.

The Mining Weekly, an industry magazine, featured several articles in 2011 highlighting the principles importance as a key framework for mining companies. One article on Mining.com cautioned that the bottom line... is that failure to comply or demonstrate compliance with social and environmental standards may impede or hinder access to capital and potentially threaten the financial viability of a project...[E]vidence suggests that changes within the financial sector should not be under-estimated or the new standards dismissed.

As another example, RUSAL, the Russian aluminium producer, worked with Equator banks on a smelter project in 2007. The banks generally were happy with the risk profile of a player as large as RUSAL, indicating that the principles risks were assessed and taken seriously. DeBeers, the diamond mining conglomerate, started developing a set of internal guidelines in 2007. According to its report, the guidelines were meant to build on other frameworks, specifically the UN Global Compact and the Equator Principles.

Mining companies are also hiring consultancy firms to perform due diligence, create risk assessments, and provide advice to companies on compliance with social and environmental rules after project work has started. These consultants have stressed that the industrys need to comply with frameworks like the principles to obtain financing drives demand for their work. For example, one consultant reported that its client initially did not even know what the word environmental meant. To obtain financing, that client is now changing its mining processes in line with sustainability frameworks like the Equator Principles.

The past decade has seen a profusion of environmental and social responsibility frameworks within the mining industry, suggesting that such responsibility is now mainstream. The most important set of rules is the International Council on Mining and Metals sustainable development framework. The International Council on Mining & Metals is an organisation composed of, and governed by, mining and metal companies and trade associations. Members include African Rainbow Minerals, Anglo American, BHP Billiton, Goldcorp, Newmont, and Rio Tinto. Its goal is to advance the industrys commitment to sustainable development. To that end, all members must implement the framework, a set of ten principles and seven supporting position statements. The principles include integrating sustainable development considerations into corporate decision-making and implementing scientifically valid risk management studies. Moreover, members must annually report their compliance using the global reporting initiative standards and provide third-party verification of compliance. The council publishes an annual assessment of member performance. In 2010, 15 of 18 members obtained high marks for compliance. It has strongly influenced mining companies policies, together with the Equator Principles.

There is also some evidence that governments have improved their social and environmental laws in response to the developments in corporate social and environmental responsibility. Some sources state that government bodies in China have improved their environmental standards in response to the principles. One source says that the Chinese banking regulator in 2007 improved its standards with help from the international banking community, because of increased scrutiny of Chinese activity in Africa. Another states that the Chinese equivalent of the Environmental Protection Agency introduced the principles into its green credit policy after criticism from the World Bank president, and has actually withheld loans from companies that violated the environmental rules. This shows that the principles can carry powerful force even outside of the private project finance sector.

Steps forward

The Equator Principles Association is currently in the process of revising the principles to address the concerns identified in the strategic review. This process is expected to result in the association promulgating revised principles in March of 2012.

As noted above, the expansion of the association to include new banks from emerging market jurisdictions and elsewhere is an important policy step that will need to balance the associations desire to broaden its membership against the risk of diluting the impact of the principles. One unresolved question is whether the membership should contemplate a tiered system of compliance where new members have lower initial requirements to meet but must meet minimum benchmarks for example, reporting on implementation of the principles, that are higher than under the current principles.

Likewise, widening the scope of the principles to include other finance products beyond just project finance is a sensible, practical solution to address the reality that a variety of financial techniques may be used to finance assets which are the target of the principles in this case, where 50% of the proceeds of any finance are to be applied to a single asset (i.e. project), whether the finance is limited or non-recourse, it is proposed that the principles should apply.

Nonetheless, from an implementation and transparency perspective, the key changes of the principles are expected to cover:

improved communication and reporting requirements required of Equator institutions to increase transparency;

requiring that institutions use a detailed reporting template or standard;

introducing a common Equator Principles assurance standard to audit implementation of the principles by its signatories;

enhanced sanctions for institutions that fail to comply with the principles, including reporting requirements; and

the creation of a properly funded secretariat of the Equator Principles Association and expansion of its supervisory and training functions.

While it remains to be seen precisely how these changes will be implemented, they do address the core problem of reporting requirements and must surely be viewed as a step in the right direction.

Conclusions

Despite evidence in particular in the mining industry that the principles are having a positive impact, mining companies and banks are not emphasising their success stories. While plenty of general information about corporate sustainability policies can be found, most successful projects are funded and completed in relative silence. In their reporting, banks do not usually divulge details about projects because of confidentiality concerns. This leaves the story of the Equator Principles largely untold, and allows critics to focus on projects that result in social or environmental damage, which harms the principles credibility.

The Equator institutions should improve their reporting practices and show that sustainability is a concern that they take seriously. They do not have to divulge confidential information, but they could describe their policies and give non-confidential information about successful projects. Auditing would also enhance the credibility of their reports. The proposed revisions to the Equator Principles expected shortly should assist in spurring Equator institutions to embrace these improvements. Ultimately, if project finance is to move towards a more sustainable future, the general public needs to be told the story of the Equator Principles and, hopefully, this will soon be voiced. ■

Christopher Langdon is a project finance partner in London and Riyadh and Claudia OBrien is an environmental regulatory partner in the Washington DC office of Latham & Watkins. The authors gratefully acknowledge the assistance of Stijn Van Osch and Natalie Brown in the work underlying this article.