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Research Paper Finance

Equator Principles an Innovative Tool for Environmental and Social Sustainability

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ABSTRACT

Project financing, a method of funding in which the lender looks primarily to the revenues generated by a single project both as the source of repayment and as security for the exposure, plays an important role in financing development throughout the world. Project financiers may encounter social and environmental issues that are both complex and challenging, particularly with respect to projects in the emerging markets. The Equator Principles (EPs) are a voluntary set of standards for determining, assessing and managing social and environmental risk in project financing. The EPs are adopted voluntarily by financial institutions and are applied where total project capital costs exceed US$10 million. Equator Principles Financial Institutions (EPFIs) commit to not providing loans to projects where the borrower will not or is unable to comply with their respective social and environmental policies and procedures that implement the EPs.

Keywords : Equator Principles, Project Financing, Environmental Risk, Equator Principles Financial Institutions (EPFIs)

Equator Principles an Innovative Tool for Environmental and Social Sustainability

Project finance is often used to fund the development and construction of major infrastructure and industrial projects. Project financiers may encounter social and environmental issues that are both complex and challenging, particularly with respect to projects in the emerging markets. The Equator Principles (EPs) are a credit risk management framework for determining, assessing and managing environmental and social risk in project finance transactions. The EPs are adopted voluntarily by financial institutions and are applied where total project capital costs exceed US$10 million.

Equator Principles Financial Institutions (EPFIs) commit to not providing loans to projects where the borrower will not or is unable to comply with their respective social and environmental policies and procedures that implement the EPs.

The EPs have become the industry standard for environmental and social risk management and financial institutions, clients/ project sponsors, other financial institutions, and even some industry bodies, refer to the EPs as good practice. The EPs have also helped spur the development of other responsible environmental and social management practices in the financial sector and banking industry (for example, Carbon Principles in the US, Climate Principles worldwide) and have provided a platform for engagement with a broad range of interested stakeholders, including NGOs, clients and industry bodies.

The Equator Principles were developed by private sector banks – led by Citigroup, ABN AMRO, Barclays and West LB – and were launched in June 2003. The banks chose to model the Equator Principles on the environmental standards of the World Bank and the social policies of the International Finance Corporation (IFC).

The adoption of the Equator Principles confirms that the role of global financial institutions is changing. More than ever, people at the local level know that the environmental and social aspects of an investment can have profound consequences on their lives and communities particularly in the emerging markets where regulatory regimes are often weak. And if financial institutions want to operate in these markets, there is a bottom-line value in having clear, understandable, and responsible standards for investing. The Equator Principles have clearly thus also affected the manner in which project finance is taking place in emerging markets. Till date, 68 institutions, including 16 from the emerging markets, have voluntarily adopted the Principles.

Scope

The Principles apply to all new project financings globally with total project capital costs of US$10 million or more, and across all industry sectors. In addition it also apply them to all project financings covering expansion or upgrade of an existing facility where changes in scale or scope may create significant environmental and/or social impacts, or significantly change the nature or degree of an existing impact.

The Principles also extend to project finance advisory activities. In these cases, EPFIs commit to make the client aware of the content, application and benefits of applying the Principles to the anticipated project, and request that the client communicate to the EPFI its intention to adhere to the requirements of the Principles when subsequently seeking financing.

The Equator Principles are currently available in Chinese, French, Japanese, Portuguese, Russian and Spanish. Nonetheless, the official version is the English one.

Classification of Projects

As part of their review of a project's expected social and environmental impacts, EPFIs use a system of social and environmental categorization, based on the IFC's environmental and social screening criteria, to reflect the magnitude of impacts understood as a result of assessment.

These categories are:

- Category A – Projects with potential significant adverse social or environmental impacts that are diverse, irreversible or unprecedented;
- Category B – Projects with potential limited adverse social or environmental impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures; and
- Category C – Projects with minimal or no social or environmental impacts.

The Principles

Principle 1: Review and Categorization

When a project is proposed for financing, the EPFI will, as part of its internal social and environmental review and due diligence, categories such project based on the magnitude of its potential impacts and risks in accordance with the environmental and social screening criteria of the International Finance Corporation. Projects are classified, relating to social or environmental impacts, in Category A (significant impacts), Category B (limited impacts) and Category C (minimal or no impacts).

Principle 2: Social and Environmental Assessment

For all medium or high risk projects (Category A and B projects), sponsors complete an Environmental Assessment, the preparation of which must meet certain requirements and satisfactorily address key environmental and social issues. The Assessment should also propose mitigation and management measures relevant and appropriate to the nature and scale of the proposed project.

Principle 3: Applicable Social and Environmental Standards

The Environmental Assessment report addresses baseline environmental and social conditions, requirements under host country laws and regulations, applicable international treaties and agreements, sustainable development and use of renewable natural resources, protection of human health, cultural properties, and biodiversity, including endangered species and sensitive ecosystems, use of dangerous substances, major hazards, occupational health and safety, fire prevention and life safety, socio-economic impacts, land acquisition and land use, involuntary resettlement, impacts on indigenous peoples and communities, cumulative impacts of existing projects, the proposed project, and anticipated future projects, participation of affected parties in the design, review and implementation of the project, consideration of feasible environmentally and socially preferable alternatives, efficient production, delivery and use of energy, pollution prevention and waste minimization, pollution controls (liquid effluents and air emissions) and solid and chemical waste management.

Principle 4: Action Plan and Management System

Based on the Environmental Assessment, Equator banks then make agreements with their clients on how they mitigate, monitor and manage those risks through a ‘Social Environmental Management Plan’.

Principle 5: Consultation and Disclosure

For risky projects, the borrower consults with stakeholders (NGOs and project affected groups) and provides them with information on the risks of the project. The borrower has to consult the project affected communities in a structured and culturally appropriate manner. The process will ensure free, prior and informed consultation for affected communities.

Principle 6: Grievance Mechanism

The borrower will establish a grievance mechanism as part of the management system. This will allow the borrower to receive and facilitate resolution of concerns and grievances about the project’s social and environmental performance raised by individuals or groups from among project-affected communities. The borrower will inform the affected communities about the mechanism in the course of its community engagement process and ensure that the mechanism addresses concerns promptly and transparently, in a culturally appropriate manner, and is readily accessible to all segments of the affected communities.

Principle 7: Independent Review

For all Category A projects and, as appropriate, for Category B projects, an independent social or environmental expert not directly associated with the borrower will review the Assessment, AP and consultation process documentation in order to assist EPFI’s due diligence, and assess Equator Principles compliance.

Principle 8: Covenants

Incorporation of covenants linked to compliance. Compliance with the plan is required in the covenant. If the borrower doesn’t comply with the agreed terms, the bank will take corrective action, which if successful, could ultimately result in the bank cancelling the loan and demanding immediate repayment. Where a borrower is not in compliance with its social and environmental covenants, EPFIs will work with the borrower to bring it back into compliance to the extent feasible, and if the borrower fails to re-establish compliance within an agreed grace period, EPFIs reserve the right to exercise remedies, as they consider appropriate.

Principle 9: Independent Monitoring and Reporting

To ensure ongoing monitoring and reporting over the life of the loan, EPFIs will, for all Category A projects, and as appropriate, for Category B projects, require appointment of an independent environmental and/or social expert, or require that the borrower retain qualified and experienced external experts to verify its monitoring information which would be shared with EPFIs.

Principle 10: EPFI Reporting

Each EPFI adopting the Equator Principles commits to report publicly at least annually about its Equator Principles implementation processes and experience, taking into account appropriate confidentiality considerations.

An illustrative list of Social and Environmental issues to be addressed

In the context of the business of the project, the Assessment documentation will address, where applicable, the following issues:

- Assessment of the baseline social and environmental conditions
- Consideration of feasible environmentally and socially preferable alternatives
- Requirements under host country laws and regulations, applicable international treaties and agreements
- Protection of human rights and community health, safety and security
- Protection of cultural property and heritage
- Protection and conservation of biodiversity, including endangered species and sensitive ecosystems in modified, natural and critical habitats, and identification of legally protected areas
- Sustainable management and use of renewable natural resources (including sustainable resource management through appropriate independent certification systems)
- Use and management of dangerous substances
- Labour issues (including the four core labour standards), and occupational health and safety
- Fire prevention and life safety
- Socio-economic impacts
- Land acquisition and involuntary resettlement
- Impacts on affected communities, and disadvantaged or vulnerable groups
- Impacts on indigenous peoples, and their unique cultural systems and values
- Cumulative impacts of existing projects, the proposed project, and anticipated future projects
- Pollution prevention and waste minimization, pollution controls and solid and chemical waste management

Indian Scenario

In December 2007 the Reserve Bank of India (RBI) issued a circular citing the importance for banks to act responsibly and to contribute to sustainable development. The circular referred banks to the Equator Principles and suggested that there is a need for Indian banks to evolve institutional mechanisms to enshrine sustainability. However conspicuous absence of Indian banks from the list is distinctly depressing. While Indian financial institutions (including banks) can hardly be described as major players in the funding of infrastructure projects at a global level, the fact remains that their adoption of the Equator Principles or other similar ones to guide their lending within the country would have given a major fillip to India's environmental initiative, such as it is.

Unfortunately, the truth is that Indian financial institutions are concerned to the exclusion of all other considerations about the ecology of their balance-sheets and, therefore, focused on ever-greening their assets. With a number of ongoing projects being dragged to court, clearances and EIAs being challenged and reviewed by the Ministry, project developers and companies facing protests from communities and NGOs, it is imperative that Indian financial institutions recognize the need to act now. However some of the foreign banks operating in India like ABN AMRO Bank, N.V. ,Bank of America,Barclays plc, Calyon, Citigroup Inc., HSBC Group, JPMorgan Chase, Mizuho Corporate Bank , Standard Chartered Bank , Societe Generale

have registered for equator principles.

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