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IR/PS CSR Case #07-06

Investigating Compliance/Non-Compliance with the Equator Principles

To Comply of Not to Comply…That is the Question

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Abstract:
While the number of banks who have adopted the Equator Principles is encouraging, actual compliance with the voluntary code is more meaningful and important to note. Relying mainly on theoretical models that explain how reputational risk and costs provide incentives/disincentives for individual firms to adopt and/or comply with the EP, this paper shows that compliance by banks who have adopted the EP is mixed. While some banks are complying with the EP's provisions due to the high reputational risks they face, other banks find compliance too costly, and choose to free-ride off others.

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I. Introduction

In June of 2003, ten financial institutions signed on to the Equator Principles (EP), a set of voluntary social and environmental guidelines governing global project finance transactions. Today, there are forty-five banks who have adopted the EP, comprising over 80% of the project finance market across the globe. While the number of banks who have signed on is encouraging, participation in this initiative is meaningless without credible assurances or visible signs of compliance. This report will seek to answer the question, "How do we know that EP banks are complying with principles?"

This report is divided into three main sections. The first section attempts to introduce the reader to this paper's topic and how the paper will proceed in answer the question above; the second section actually attempts to answer the question through utilizing theoretical models and a case study to explain the costs and incentives that influence a firm's decision to comply; finally, the last section briefly analyzes BankTrack (a consortium of NGOs) and puts a conclusion to the paper.

II. The Birth of the Equator Principles

The story on how the EP was created begins as early as the 1980s, when large public financial institutions were continually being scrutinized by non-governmental organizations (NGOs) for their role in financing large development projects in South America and Asia that had negative environmental or social consequences. A decade later, it wasn't just the International Finance Corporation, a branch of the World Bank, that found itself under the microscope of NGOs worldwide – export credit agencies, who also financed development projects, were also being watched closely. While these public financial institutions contributed

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huge sums to finance projects around the world, the role of private banks in financing these projects was increasing. Suddenly, civil society groups realized that although they may have been successful in stopping a public financial institution from engaging in an environmentally destructive project, there was still the possibility that a whole range of private sector banks could easily finance the project themselves. And because a public financial institution's stakeholders includes individuals who are accountable to the general public, influencing these public institutions to change their credit policies—reflecting civil society concerns—was easier than changing the private banking sector's behavior in this field.

Consequently, finance projects like the Three Gorges Dam in China, which was rejected for financing by the World Bank because of environmental and social concerns but financed through private banks, suggested that while NGOs were successful in reforming the credit policies and review processes of public banks, private banks had the power to undermine their efforts at ensuring global sustainable development projects. Fully cognizant of this reality, NGOs begin to target private banks in the late 1990s, such as the Rainforest Action Network's (RAN) campaign against Citigroup's old-growth logging and oil pipeline project in Ecuador.[1] Other banks like WestLB, Morgan Stanley, and Westpac also felt the heat from NGOs for their participation in financing projects that were deemed socially or environmentally destructive.[2]

Institutional investors like the Calvert Group and Insight Investment were taking notice too, adding even more pressure to financial institutions to address this issue.[3]By October 2002, the International Finance Corporation (IFC) was holding meetings with bankers from the world's

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[1] Richardson, Benjamin J. "The Equator Principles: The Voluntary Approach to Environmentally Sustainable Finance", *European Environmental Law Review* (2005): 280-290.

[2] BankTrack (2004). "Principles, Profits or just PR? Triple P investments under the Equator Principles. An Anniversary Assessment." Amsterdam: BankTrack.

[3] Richardson (2005).

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major private banking institutions, helping them create a voluntary set of codes that would address environmental and social concerns that were present in project financing. Around that same time, Citigroup, which was also had a commercial banking entity, was now reeling from the media exposure lavished on celebrities like Susan Sarandon, Ed Asner, Ali MacGraw, and Darryl Hannah, who all cut their Citigroup credit cards as part of RAN's advertising onslaught. In early 2003, Citigroup actually engaged RAN for sit-down meetings, attempting to lessen any further damage to their reputation.

The need for private banks to engage in a dialogue with NGOs and to appear as if environmental and social concerns were being addressed was made explicitly clear on June 4th, 2003 when the EP, "the first collective norms addressing environmental and social issues," was publicly announced and adopted by Citigroup, Barclays, West LB, and seven other banks.[4] This rare occurrence of private banks uniting under one common framework that they had collectively devised and agreed upon was a significant event, but perhaps not surprising to NGOs worldwide who saw this event as a sign of their success in increasing public awareness about the project finance sector and the application of environmental and social concerns into these banks' lending policies.

III. The Equator Principles

The Equator Principles are simply a set of voluntary guidelines relating to how a bank is suppose to conduct its project financing with respect to meeting the social and environmental concerns of stakeholders affected by the project. Collectively devised by private banks, the EP is largely based on the International Finance Corporation's (IFC) Safeguard Policies. To adopt the EP, a bank can merely issue a press release stating its intention to follow these rules. There is no

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[4] BankTrack (2004).

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official organizational body that certifies or monitors EP adoption or implementation – any bank can choose to adopt the EP and comply or not comply with its principles. However, there is an EP secretariat, who is an EP member bank, that assumes responsibility for maintaining the EP's official website (www.equator-principles.com) and helping new financial institutions with adoption of the principles.[5] Currently, Mizuho Corporate Bank, Ltd., a Japanese financial institution and one of the largest private banks in the world, is the EP secretariat. Beyond these stated duties, the secretariat does not do much else, allowing EP member banks to apply all or none of the principles as they wish.

According to the EP's preamble, the purpose of the guidelines are as follows[6]:

> • ensure that the projects [the lenders] finance are developed in a manner that is socially responsible and reflect sound environmental management practices
> • promote responsible environmental stewardship and socially responsible development
> • serve as a common baseline and framework for the implementation by each [EP member] of its own internal social and environmental policies

In addition, the preamble underscores the responsibility of EP banks to "not provide loans to projects where the borrower will not or is unable to comply with our respective social and environmental policies and procedures that implement the Equator Principles."[7] As to the scope of the principles, the EP states that the guidelines are to be applied to all project financings with capital costs of $10 million USD and above. Some of the main tenants of the EP, as written in its 2003 version, are as follows:

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[5] "Mizuho Corporate Bank's Adoption of Equator Principles." Mizuho Financial Group, Inc. Site accessed 3/1/07. < http://www.mizuho-fg.co.jp/english/activity/environment/equator/adoption_eng.html#anchor_01>.
[6] "The 'Equator Principles.'" The Equator Principles (official site @ www.equator-principles.com). < http://www.equator-principles.com/documents/Equator_Principles.pdf>.
[7] Ibid.

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- projects are categorized as A, B or C (high, medium or low environmental or social risk).
- for all Category A projects and some Category B projects, lenders ensure that the borrower consults with local people affected by project, and gives adequate public notice
- The borrower must demonstrate that the project complies with the World Bank Pollution& Abatement Guidelines
- If borrower isn't complying with relevant environmental and social guidelines, lender attempts to bring borrower back into compliance

Because the original EP in 2003 was based on the IFC's Safeguard Policies, when these policies were revised with new "Performance Standards," the EP followed suit in 2006 and was also revised.[8] Some of these major new revisions, as currently found in the EP today, included the following:

- lowering the capital threshold from USD 50 million to USD 10 million
- stronger consultation requirements, forcing the lender to engage with indigenous people affected by the project
- inclusion of labor and working conditions requirements for projects in low and medium income countries
- requirements for compliance with all applicable local, state, and host-country laws
- requirement that EP banks report publicly at least annually on their EP implementation

To view the complete guidelines as it is written, please see the appendix.

IV. Project Finance 101

One of the keys to understanding why some banks would want to adopt or comply with the EP is found in the structural nature of the project finance market. This section will attempt to provide an overview of the project finance market and its transactional dealings.

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[8] Id. at "Frequently Asked Questions about the Equator Principles." Site accessed 3/1/07. <http://www.equatorprinciples.com/faq.shml>.

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According to the International Project Finance Association, the term project finance is defined as "the financing of long-term infrastructure, industrial projects, and public services based upon a **non-recourse or limited recourse** financial structure where project debt and equity used to finance the project are paid back from the cashflow generated by the project" (emphasis added). [9] Essentially, project financing differs from conventional financing in that lenders have limited rights (meaning very little or none) to the borrower's assets. This is apparent in the figure above[10]: the borrower (in this hypothetical example) is Shell Oil, and the project itself is their oil pipeline. Equity financing (or internal financing) is provided from Shell, giving them control of the project once it is completed. If debt financing is provided by more than one bank (as it is in our example), then the group of lenders is called a syndicate. In a syndication, there will be an arranger, who we will assign as Citigroup in this example, whose responsibility is taking a lead role in negotiating and coordinating financing among the different lenders. Because they are financing the project directly and not relying on the credit risk of the borrower, properly screening the project's risk and forecasting its future cash flow is crucial. Again, everything relies on the project. However, through syndication, banks decrease their exposure to the project's risk by allocating an amount less than they would if they financed the project completely.

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[9] "Project Finance." Investopedia. Site accessed 3/1/07. <http://www.investopedia.com/terms/p/projectfinance.asp>.
[10] Although the diagram was made by myself, it is based on information and other diagrams in the following: "Project Finance, the added value of insurance." Swiss Reinsurance Company (Zurich). Nov. 1999, 3000 en. <http://www.swissre.com/INTERNET/pwswpspr.nsf/alldocbyidkeylu/MBAR-4UZHCB?OpenDocument>. Also the following: "Project Finance." Wikipedia. Site accessed 3/1/07. < http://en.wikipedia.org/wiki/Project_finance>.

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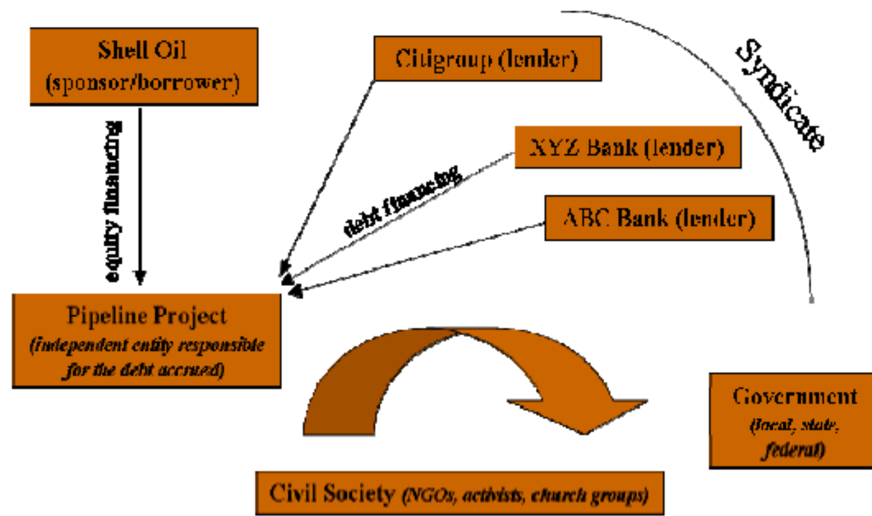

Decision to lend based upon project's expected cash flow
(determines probability that lender will be repaid; lender's claim on borrower's assets is limited)

Fig. 1: Project financing process and key players

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The diagram also shows the role of the government and civil society, which can be described as being outside of the financing process. In truth, if there is no public financial institution involved in financing the project, then the government does not intervene in the process unless the project violates local, state, or federal laws. As for civil society, although they have an interest in the project, they mainly rely on public knowledge and information to assess the project and its social and environmental effects. Because many of the details that civil society groups like NGOs are interested in (i.e. whether the pipeline may be susceptible to leakage in the future due to improper or weak coating) are not legally required to be disclosed, they must rely on disclosed government documents, news articles from the press, or information that cannot be kept private between the lender, borrower, and project's staff, contractors, or consultants (such as big cloud of smoke emanating from the project site). It should also be understood that project

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finance largely deals with huge infrastructure projects, such as an oil pipeline, power plant, hydroelectric dam, or major transportation road.

The controversy concerning such projects has to do with the social and environmental consequences of such a huge undertaking. For example, building an oil pipeline in parts of South America may include cutting down numerous forests to connect the pipeline to parts of the country. Or a hydroelectric dam could negatively influence a community's natural ecological process, whereby wildlife species die off as a result of changing water levels.

Lastly, lenders will take note of any risk that threatens potential cash flow. However, if a country levies few or no penalties/fines for any negative environmental or social effects from the project AND the project's cash flow still stays consistent, then a "tragedy of the commons" problem becomes present. For many NGO groups, because developing countries lack strong political and legal institutions necessary for effective social and environmental protections and enforcement, they believe it is their responsibility to ensure that unsustainable projects are prevented from getting off the ground. Accordingly, they have found that one way to do this is through attacking the lenders who are financing the project; for without any financing, a project of such magnificent scope would not be possible.

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V. Methodology

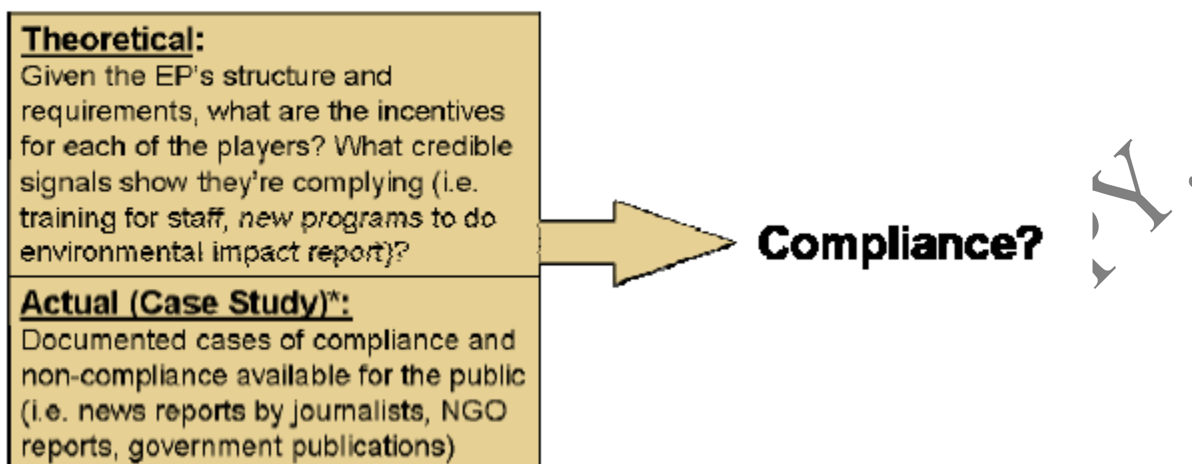

Fig. 2: Methodology to be used

To assess compliance with the EP, this paper will rely on theoretical models and an actual case study. Mainly though, this paper will rely on theoretical models that attempt to explain private banks' incentive for compliance. Due to a lack of transparency and disclosure by EP banks in this area of project financing and because language in the EP can be considered extremely subjective, a theoretical approach should suffice in illustrating what is at stake for each bank by complying, and how this decision is arrived at with consideration to economic costs and reputational risks.

One case study on a specific project, namely the Baku-Tbilisi-Ceyhan (BTC) oil pipeline project, will also be explored. The project was well-documented in the press because of its sheer size in crossing national boundaries, especially in locations without much political stability. Moreover, violations of the EP in this study are so blatantly obvious that it would be difficult for someone to use the EP's structural weakness to make a case that EP banks actually complied with its EP requirements. For these reasons, the BTC case study is excellent for satisfying the paper's focus on EP bank compliance.

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VI. Reputational Risk

Before launching into a full discussion of why banks choose to adopt or comply with the EP, this section introduces the idea of reputational risk. Reputational risk is an important idea in this paper because for most banks, it helps them determine whether to adopt and/or comply with the EP. This paper will use the following definition to describe reputational risk: "the probability of being a target of a public campaign multiplied by the cost for the bank of such a campaign."[11] In contrast, reputation will merely refer to how individuals, groups, and organizations view the firm's ability to manage its product, employees, and operations. While the concept of a firm's brand and reputation can be argued to be explicitly different, because many people (including authors on this topic) have intertwined the two, this paper will do the same for simplicity and clarity. Additionally, it is safe to assume that a stronger reputation among different individuals and groups will lead to reduced reputational risk (i.e. if an NGO views a certain firm in favorable terms, then there should be less inclination to launch a public campaign against it).
Basically, firms worry about their reputational risk because it affects the following: the firm's ability to retain and recruit talent; customer, supplier, and even market perceptions about the firm's brand and its value; the firm's relationship with its customers, partners, and suppliers; and the firm's sales and revenue (measured quarterly or annually). All of these things have an effect on the firm's bottom line, which is why firms seek to reduce reputational risk when it is possible and cost-efficient to do so.

Because banks differ due to a number of factors, they face dissimilar levels of reputational

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[11] "Project finance: a sustainable future?" Ethical Investment Research Services (EIRIS). SEE Risk briefing: July 2006.

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risk. Some of the more well-known factors they have been identified as differentiating the level of reputational risk between banks that engage in project finance include the following:[12]

- ✓ % of revenue from the firm's project financing activities
- ✓ firm's size (book or market value)
- ✓ public recognition of the firm's reputation or brand
- ✓ the level of civil society scrutiny in the firm's country(s) of operation
- ✓ whether the firm has commercial retail banking activities

There may be other factors that influence a bank's reputational risk also, such as whether a bank operates in a strong or weak regulatory environment. The idea that a weak regulatory environment would increase a bank's reputational risk seems counter-intuitive but is rational and plausible. In countries with lax regulations on the environment, for example, banks may choose to neglect the project's environmental impact, which could increase NGO activism against the firm. However, in a strong regulatory environment, banks choose to abide by all laws to prevent project delay and costly penalties; not doing so would warrant more attention on the firm by civil society groups. Whether this idea is correct or not isn't too crucial; the main idea is simply that banks that engage in project finance face different reputational risks because of a number of factors that may or may not be applicable to them.

The relationship between some of the factors listed above and a bank's reputational risk is fairly obvious. The last factor, whether a bank has retail banking activities, is a factor in determining a bank's reputational risk because those banks that issue credit cards and checking accounts must worry about the effects on their commercial banking revenue as a result of campaigns against their project financing. The case of Citigroup and RAN illustrates this idea well, as Citigroup faced higher reputational risks relative to other banks involved in project

[12] Ibid.

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finance because they had to worry about how receptive commercial banking clients would be to RAN's campaign against them. Taken all together then, a bank should have higher reputational risk if it depends mostly on its project financing activities for revenue, has a highly visible and recognizable brand name (or reputation for that matter), operates in a country where civil society scrutiny is very high, and has commercial retail banking activities.

The connection between a bank's reputational risk and the EP is that adopting the latter is assumed by banks to reduce the former. This paper will explore the strength of this assumption in a later section. But for right now, it's important to note that most EP banks view the EP as way to reduce their reputational risk. Wright and Rwabizambuga (2006), in discussing why banks would adopt the EP, suggest that "adopting a particular code of conduct, and thereby signaling an intention to conform to recognized industry practice, primarily reflects a strategic desire among firms to maintain or acquire a positive reputation within their institutional environment."[13] And in surveying executives from 31 EP banks, Freshfields Bruckhaus Deringer found that banks who adopted the EP were motivated by the desire to enhance things like their reputation and dialogue with stakeholders such as NGOs.[14] A stronger reputation is assumed to result from adoption because banks now appear to include environmental and social concerns in their lending policies, whereas before, many of them were attacked by NGOs exactly because their policies lacked to consider this issue. So many banks who adopt the EP are hoping that such positive effects like a stronger reputation will decrease the likelihood that they will be a target of

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[13] Rwabizambuga, Alexis and Wright, Christopher. "Institutional Pressures, Corporate Reputation, and Voluntary Codes of Conduct: An Examination of the Equator Principles". Business and Society Review, Vol. 111, pp. 89-117, March 2006.

[14] "Banking on responsibility, Part 1 of Freshfields Bruckhaus Deringer Equator Principles Survey 2005: The Banks." Freshfields Bruckhaus Deringer. July 2005

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a public NGO campaign against them. In essence then, many banks who adopt the EP are attempting to reduce their reputational risk.

VII. EP's Structure and Requirements

In deciding whether to adopt a voluntary initiative like the EP, banks will closely consider the costs of adoption and compliance. These costs of adopting and complying with the EP, however, are based on its structure and requirements. An examination of the EP reveals that there are major weaknesses or structural deficiencies that undermine what NGOs consider to be the main purpose of the EP: ensuring that all applicable environmental and social concerns are accounted for in the process, and preventing unsustainable or environmentally damaging projects from being financed. For example, Richardson and Thomas (2004), two lawyers who dissected the full text of the EP, found that the EP was "so fraught with ambiguity, subjectivity, and voluntarism that [it] may accomplish little more than establishing an ephemeral goal that will not, as a practical matter, be reached."[15] A review of the academic literature on this topic illustrates that the EP falters in these main areas:

- ✓ its requirements on transparency and implementation are weak
- ✓ there is a lack of accountability because there are no requirements on independent
- ✓ monitoring, or any other compliance mechanism (so free-riding is entirely possible)
- ✓ the EP's scope is limited; it only applies to "project finance" loans, which is less common than development loans
- ✓ if the principles are not followed, there is little recourse for communities affected by a project
- ✓ the wording in the EP is too loose and ambiguous, creating subjective interpretations and numerous loopholes

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[15] Lawrence, Robert F. and Thomas, William L. "The Equator Principles and Project Finance: Sustainability in Practice?" Natural Resources and Environment (American Bar Association), Fall 2004.

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Richardson and Thomas (2004) even argue that "the lack of specificity and clarity in the Equator Principles could mean that, for virtually any individual project, opponents can credibly claim that the lender has violated the Equator Principles, and the lender can simultaneous claim that it [has] applied them to its satisfaction."[16]

Most of the academic literature that criticized the EP's weakness was written before the EP was revised in 2006, such as Richardson and Thomas's (2004) study. Nevertheless, most of the same problems that were found in the earlier version of the EP can still be found in the new revised one. BankTrack, which represents a consortium of NGOs dedicated to monitoring compliance with the EP, argues that "one of the most significant problems is that the Equator Principles lack mechanisms to ensure that endorsing banks properly integrate the EP requirements into their operational systems, creating an incentive to adopt the Principles without any oversight or consistency in how these policies and systems are being implemented from bank to bank."[17] While BankTrack acknowledges that the revision included a few notable improvements, such as expanding the EP's scope to now include projects with capital requirements of $10 million USD and above, it points out the existence of words like "may require," which allows lenders to selectively apply the EP's criteria where they see fit. Now to be fair, BankTrack's criticism over the ***proposed*** revision of the EP was published before the 2006 version was finalized. The actual 2006 version corrects a problem where BankTrack had previously noted contained the words, "EPFIs may require appointment of an independent environmental and/or social expert."[18] The actual and final version (as it can be found now), states "EPFIs will, for all Category A projects, and as appropriate, for Category B projects,

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[16] Ibid.
[17] "Equator Principles II, NGO comments on the proposed revision of the Equator Principles." BankTrack. April 26, 2006.
[18] Ibid.

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require appointment of an independent environmental and/or social expert . . . ."[19] While the correction here makes this requirement seem much stronger, the rest of this sentence reads, ". . . ***or*** require that the borrower retain qualified and experienced external experts to verify its monitoring information which would be shared with EPFIs" (my emphasis).[20] A critic may argue that this last line, instead of putting the burden of monitoring on the lender, allows the borrower – who has hid in the shadows while lenders have bared the brunt of NGO activism – to hire their own cronies to perform an environmental evaluation on the project. So again, apparent weaknesses haven't been fully corrected in this new version of the EP.

Before ending this section, to fully demonstrate all the problems and weaknesses in the EP, one last example will be given. In Principle 10, which is the last principle in the 2006 version of the EP, the full text reads as follows: "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."[21] First, what exactly should an EPFI, Equator Principles Financial Institution (or EP bank, the term this paper prefers to use), detail in its report on the EP implementation process and experience? The footnote in the official EP guidelines suggests that "such reporting should at a minimum include the number of transactions screened by each EPFI, including the categorization accorded to transactions (and may include a breakdown by sector or region), and information regarding implementation."[22] Again, the word "should" weakens this principle because it allows EP adopters to ignore this critical provision if they wish. Second, even if an EP-bank chose to report

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[19] "The 'Equator Principles.'" The Equator Principles. (2006 Version) < http://www.equator-principles.com/documents/Equator_Principles.pdf>.
[20] Ibid.
[21] Ibid
[22] Ibid

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the details about its transactions according to the suggestion in the footnotes, how is the reader suppose to determine if this reporting is credible? Because the specific project is not identified, a bank can exaggerate the number of transactions that went through screening to appease NGOs that question whether that EP bank is applying the EP to its lending policies. Secondly, an EP bank can interpret commitment of this guideline about reporting publicly at least once a year in many ways. It may issue an annual publication that is available at the same time and location as its annual report (10-K) filed to the SEC; or, it can choose to add one or two sentences about its EP experience in a single press release amid the tens or hundreds of PR releases on its webpage. There is no description requiring an EP bank to do the former. Third, and most importantly, an EP bank can simply choose to ignore this principle outright. Again, the principles are voluntary and adopting the EP does not require an EP bank to follow its every guideline. There is no punishment for outright violation or ignorance in applying one or all of the principles.

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VIII. Economic Costs of Adopting and Complying with the EP

This section will attempt to deal strictly with costs faced by banks in adopting and complying with the EP. Focusing first on adoption costs, most banks would find the costs to be an EP member minimal if anything. As previously mentioned, a bank can voluntarily adopt the principles simply through issuing a press release to let the public acknowledge its commitment to applying the EP's guidelines (whether it actually intends to apply them or not). Merely placing a few words on its website is hardly a cost at all for most banks.

However, it's possible that by adopting the EP, a bank is opening itself to further NGO scrutiny or public criticism. Whereas before, a bank may have blatantly ignored the environmental and social consequences of a project it financed, at least it did not commit to any

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policy that could potentially deem the firm and its actions in this area to be in wrongdoing or negligent violation; but in adopting the EP, the bank is publicly committing itself to a minimum standard when it comes to project financing, so expectations from the public are higher that the bank must uphold its commitment. This idea seems to stand in contract to an earlier assumption made by most banks (mentioned in an earlier section) about how adopting the EP reduces reputational risk. If adopting the EP can actually increase public scrutiny over a bank's project finance activities (which would increase a bank's reputational risk), then why would a bank choose to adopt it? The answer is actually quite simple: banks with less reputational risk are those who are not scrutinized very much, and possess less recognizable reputations or brands.

For these low reputational risk banks, adopting the EP comes without much cost at all. For banks that possess high reputational risk, meaning they are watched more closely by NGOs and have a more recognizable brand (i.e. Citigroup), despite having their actions scrutinized more due to adopting the EP, they can still reduce their reputational risk if they comply with its standards. Close scrutiny prevents these banks with high reputational risk from merely adopting the EP and benefiting from it immediately; they must show credible signs of compliance (or accusations of green washing become apparent). Smaller banks (or banks with less reputational risk) are not usually exposed to such levels of scrutiny before and after adoption of the EP. Therefore, for a bank with high reputational risk, the cost of adopting the EP may actually be the cost of compliance (or appearance thereof). Without appearing to comply, a high reputational risk bank that adopts the EP would be asking for more trouble.

Turning attention now to the EP's compliance costs, most authors have commented on how these costs are actually quite high for ordinary banks. Amalric (2005), in examining this issue of compliance costs, finds that rejecting projects that don't meet the EP's criteria to be

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extremely costly.[23] In other words, the opportunity costs are high for banks that choose to accept only projects that meet the EP's requirements. By committing itself to adopt and comply with the EP, banks are betting that the cost of turning down such a project is less than the value gained in receiving less reputational risk. If there's a chance that banks have miscalculated this cost benefit analysis, then compliance can obviously be a cost to the firm.

Amalric (2005) also identifies due diligence, categorization of projects, monitoring compliance, and client engagement as other costs arising from bank compliance with the EP.[24] The aggregate cost of performing all these tasks should not be taken lightly. In order to show credible commitment in complying with the EP, a bank with high reputational risk would have to "amend existing policies, and/or create new systems, tools and procedures to facilitate Equator implementation," according to BankTrack.[25] It is simply not enough for an EP bank to merely discuss its experience with the EP; it needs to specifically address how it is implementing the EP into its credit review process and other environmental management processes. BankTrack identifies four key areas it looks for in determining whether an EP bank is implementing the changes necessary to its project finance review and monitoring processes[26]:

- ✓ *external reporting and transparency (was the bank open and transparent in its implementation of and compliance with the EPs, or did it fail to provide evidence and reporting to the public?)*
- ✓ *policy development: the adoption and application of the EPs (did the bank formally adopt the EPs, and make the appropriate changes to existing policies to accommodate this new commitment?)*
- ✓ *procedures and standards: changing business as usual (how do bankers have to do things differently post-equator?)*
- ✓ *review and improvement: EP implementation challenges (what are the current challenges*

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[23] Amalric, Frank. "The Equator Principles: A Step Towards Sustainability?" Working Paper No. 01/05, Center for Corporate Responsibility and Sustainability at the University of Zurich, January 2005.
[24] Ibid.
[25] BankTrack (2005). "Unproven Principles. The Equator Principles at Year Two. An Anniversary Assessment."
[26] Ibid.

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of EP implementation and what goals have been set to improve implementation and compliance)
- ✓ *impacts: a [sic] different with the EPs? (what has been the impact of the EPs?)*

For most people, simply finding out whether a bank hired new people, trained its existing people, and amended its credit policies would be an easy way to determine if it making an honest, credible attempt at complying with the EP. Therefore, the costs of compliance can be said to be fairly high – a high reputational risk bank must spend a significant amount of money to adequately display credible commitment to implementing the EP.

IX. Motivation for Adoption

This paper's section covering reputational risk and costs of adoption and compliance already seems to imply that some banks will adopt the EP because they can free-ride on the benefits of being an EP member without actually contributing to the costs necessary for actual compliance. Again, we can assume that these banks possess low reputational risk because civil society groups like BankTrack actually check for signs of credible compliance; so any heat a bank may be experiencing before adopting the EP will not go away if it chooses merely to become an EP member without showing signs of compliance. Additionally, banks with high reputational risk will not only adopt the EP, but choose to comply with its guidelines if the benefits in lowering its reputational risk is greater than the costs it must bear in complying (or appearing to comply) with the principles.

Academic scholars studying this area have also introduced plausible explanations on a bank's motivation for EP adoption. Amalric (2005), for instance, offers three hypotheses on why the EP was created, its objective, and the "economic rationale" for why banks participate. His contribution to the literature here is invaluable, as he uncovers more costs (not presented in the

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previous section) and convincingly argues that the EP serves to do the following[27]:

- "level the playing field in the industry among players facing different reputational risks,"
- "screen[s] projects for social and environmental risks," and
- "counter[s] critics of large development projects."

With regard to the first hypothesis, Amalric reasons that because larger banks are more susceptible to reputational risk, they must therefore adopt higher corporate standards, disadvantaging them with respect to cost. Thus, these larger banks who are more exposed to reputational risk will adopt the EP in order to "restore a level playing field by imposing an industry standard on all actors." Furthermore, since large project finance transactions operate mainly on syndications with lead arrangers, and because the larger EP banks with high reputational risk comprise a sizable portion of the project finance market, a bank who is not a member of the EP and takes the role of a lead arranger will have a hard time forming a syndicate that isn't composed of at least one EP member. What this suggests is that free-riding possibilities are extremely limited if the non-EP bank desires to assume the role of an arranger; needing other banks to form a syndicate (one of which will likely be an EP bank that is limited in the type of projects it can accept), the non-EP bank will have to sacrifice any potential of being an arranger. Greenfield's (2004) analysis succinctly encapsulates these ideas, as he states that the collaboration between EP-banks "reduce[s] the ability for corporate clients to shop around for a bank that has lower environmental and social standards."[28]

As for the logic behind his second hypothesis, Amalric suggests that because multilateral

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[27] Almaric (2005).
[28] Greenfield, Zev. "The Equator Principles: A New Industry Framework for Environmental and Social Standards in Global Project Finance Lending." Corporate Social Responsibility (CSR) and Sustainability Paper Awards, Columbia Business School (2004).

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development banks (MDBs) were withdrawing from their traditional role as a monitor for projects, banks must now screen the projects themselves – which can be costly. The significance of screening a project stems from the potential environmental and social risks that each project can carry: if a project is not carefully screened, certain risks become reality, decreasing the probability that banks will recoup their investment or financing costs. Therefore, with MDBs "retreating" from their role, banks look to shift more of the screening costs onto their project sponsors, which the EP essentially does. Amalric argues that this setup works because individual sponsors (borrowers) face a collective action problem[29], and so are forced to accept these costs. They may attempt to find other banks but it is unlikely that they can; if non-EP banks are prevented from assuming a lead arranger role (described previously), then a project big enough to require syndication will ensure participation of an EP bank (who will need to comply with the EP's requirements). Also, these sponsors have an incentive to accept lending from EP banks because it "signal[s] the quality of their projects and thus reduce[s] the price of credit."

Amalric's last hypothesis, which is in line with the section on reputational risk and parallels the academic literature describing the rationale behind voluntary environmental programs by large firms, suggests that because of a growing concern over sustainable development from NGOs and other stakeholders, banks find it necessary to adopt the EP. The adoption of the EP allows banks "an entry into the debates" and "a way to resist the upgrading of standards in a way that would run against the banks' interest." Of course, implicit in this argument is idea that as stakeholders continue to examine the role banks play in sustainable development the following events occur to the detriment of lenders: the World Bank Group

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[29] The collective action problem comes from Olson's work (1965), which Amalric cites in his paper: Olson, Mancur (1965). "The Logic of Collective Action: Public Goods and the Theory of Groups." Cambridge, MA.: Harvard University Press.

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(WBG)—under heavy pressure from an array of stakeholders—declines involvement in large development projects; developing countries, cognizant of the growing concern over sustainability and of the decreasing role of the WBG, have less of an appetite for development projects with drastic environmental and social ramifications; and the probability of more activist campaigns against the banks increases. Concluding his paper, Amalric allows the reader to decide which hypothesis is more convincing, although he notes that none are mutually exclusive and a combination of all three hypotheses could be in play.

While it seems that this section has covered most of the possible motivations for adoption, Wright and Rwabizambug (2006), in focusing generally on the motivation behind adopting a voluntary codes (i.e. not just the EP), find reasons that may pertain to this discussion. They suggest that "corporate codes of conduct can help differentiate an individual firm's reputation from the malpractices of competing firms or clients, and boost its credibility relative to critics."[30] This idea relates a little bit to this paper's ideas on reputational risk, but differs slightly in suggesting that this strategy is motivated by the desire for differentiation (or green marketing). In regard to whether banks are motivated to adopt the EP for this reason, it is entirely possible, but its influence in ultimately deciding whether a bank will adopt the EP at this or not should be minimal. Because the number of firms who have adopted the EP now cover over 80% of the project finance market, the benefit of differentiation is not applicable anymore. It's possible that a bank like Citigroup, one of ten banks that first adopted the EP, was thinking in these terms. But in analyzing their history with RAN (described earlier) and what led to their adoption of the EP, a much stronger case can be made about Citigroup's desire to reduce its reputational risk.

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[30] Rwabizambuga and Wright (2006).

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Another motivation Wright and Rwabizambug cite is that adoption of a voluntary code "can provide a mechanism for firms to manage the social and ecological footprints of their activities, and enable them to identify cost-efficiency measures related to energy and waste management, the integration of new technologies, process intensification, and business expansion into green "niche markets." This reason here does not really apply to our case for obvious reasons – lenders are strictly focused on the financial sector and most of their products are intangible services where energy and waste management are not as relevant as they are for firms that manufacture physical products. However, interpreted as a risk management strategy, this motivation would apply for the reasons Amalric cites in his second hypothesis.

Both authors also suggest that adopting a voluntary code is "motivated by the anticipation that irresponsible practices in a given industry may attract the attention of domestic regulators or civil society groups." This idea has already been fully explored in this paper, except the notion that banks (collectively) may believe that they can halt or delay government regulation by adopting a voluntary code. In terms of how plausible this is in motivating banks to adopt the EP, right now it does not seem very plausible at all. Banks in this sector have not had noticeable hardship conducting their project financing activities. Instead, a better argument can be made that banks have had their way with governments, illustrated by the number of projects in different parts of the world, and the size of many of these projects (such the BTC pipeline, to be discussed in a later section).

Lastly, for some banks with low reputational risk, Wright and Rwabizambuga (2006) show that there may be no real motivation behind adoption of the EP. Performing a statistical regression using a variable they call "Voice and Accountability," a measure of the political, civil, and human rights in a country, and "Government Effectiveness," the "bureaucratic competence

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and quality of public service delivery, ” they show that EP-banks are “typically based in countries characterized by high levels of political, civil, and human rights” (plotted regression below).[31] They conclude their paper by asserting that “weak regulatory pressure, and more significantly, reduced civil society scrutiny, removes a major impetus for adopting a code of conduct such as the Equator Principles.” In other words, banks with little reputational risk do not have as much motivation for adopting the EP than their peers do. Reconciling this finding with an earlier observation made in the section on reputational risk, we can posit that banks who choose to adopt but not comply with the EP must possess some minimum degree of reputational risk that can be lowered through EP adoption. Perhaps then, those banks with little reputational risk who choose not to adopt – despite the opportunity to free-ride – are indifferent to the EP because the difference between the benefits and costs of adoption are so slim.

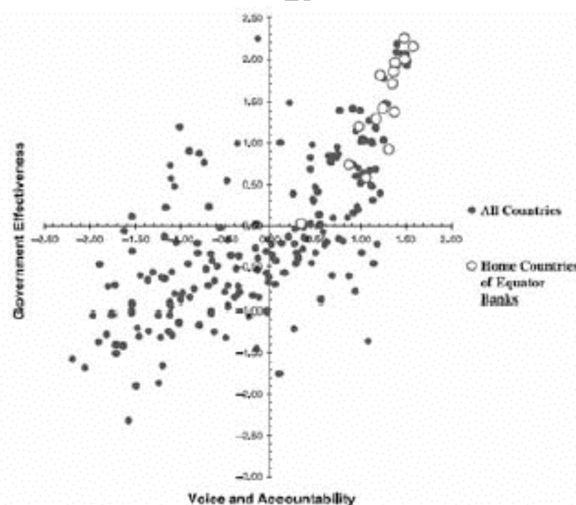

Fig. 3: Governance Levels in Home Countries of Equator Banks [from Wright and Rwabizambuga (2006)][32]

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[31] Ibid

[32] Ibid.

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X. Incentives/Disincentives for Compliance

This paper accepts the idea that incentives/disincentives are strongly influenced by the expected costs of compliance. While the preceding sections have already advanced (explicitly or through implication) the incentives/disincentives to EP compliance, this section will review and underscore the ones most compelling in influencing a firm's decision to comply.

Concerning incentives to comply, this paper has already noted that large banks (in terms of the size of its project financing activities and visibility of its brand) cannot simply adopt the EP. Reputational risk can only be diminished for these banks through a perceived credible commitment to complying with the EP. Mere adoption of the EP (without any credible signs of compliance) simply opens the bank up to more scrutiny (increasing its reputational risk). In addition, most of these larger banks should have the capacity or resources to comply with the EP's provisions. . Another incentive for compliance, as pointed about Amalric, is the ability to shift screening costs onto the borrower. For a number of large banks who desire to reduce their reputational risk through compliance with the EP, this is an added benefit that can be realized by complying with the EP to formalize this mechanism. Sponsors have little recourse to this predicament due to collective action problems. In sum, the benefits of complying for some banks will outweigh its costs

As for the disincentives to comply, for banks that face little reputational risk, the costs of complying will be greater than the possible aggregate benefits gained through compliance with the EP. Essentially, banks that possess minimal reputational risk find no need to show a credible commitment to applying the principles. Besides this disincentive, a lack of transparency, implementation, and enforcement requirements allow some banks to simply free-ride; that is, they can enjoy the benefits of being an EP member without paying their fair share of the

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compliance costs. For convenience and clarity, the incentives/disincentives just mentioned are outlined below:

Incentive to Comply

1) Large banks can't simply adopt; reputational risk is diminished only through a perceived credible commitment (and adoption opens bank to more scrutiny)

a) Larger banks have capacity/resources to comply (institute new environmental monitoring/screening reviews; train and hire new staff)

2) Banks want to shift screening costs onto sponsor (borrower); complying with EP formalizes this mechanism (sponsors have little recourse due to collective action problem)

Disincentive to Comply

1) Costs exceed benefits (banks with low reputational risk)

a) If reputational risk is low, there's little need to show credible commitment

2) Lack of transparency, implementation, and enforcement requirements allows free riding for many players

XI. Credible Signs of Compliance

This paper has already established that complying with the EP requires lenders to change or adopt new credit policies and project review processes. The addition of new staff, and the training of existing ones should accompany EP adoption. Examining EP banks for credible signs of compliance, what do we find?

Both BankTrack and the Ethical Investment Research Services (EIRIS) find mixed

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results when it comes to showing credible signs of EP compliance. In analyzing nine banks that they classify as having medium or high exposure risk (what this paper terms as reputational risk), EIRIS finds that only 5 were "committed to drawing up an environmental management plan or to conduct an environmental impact assessment" despite the importance of these activities in screening for the environmental and social risk found in a project.[33] Banktrack, in looking at the number of EP banks that created new EP policies, tools, and procedures internally, found only 10 of 26 (about 38% of EP banks in its survey) accomplishing this.

In other areas like external disclosure, banks have normally argued that they are in a bind as to the project financing details that many NGO groups demand and their own obligation to guard the privacy of their client. Although the sponsor behind projects that were rejected, categorized, and put through the whole EP review process is still hidden, BankTrack cited Citigroup, HSBC, HVB, ING, and Westpac among the nine banks that actually addressed the need for 'better external disclosure.' To BankTrack, "publicly discussing challenges and goals" are important because it "allows stakeholders to identify where common problems may be occurring.

Overall, this mixed result in showing credible signs of compliance lends further support to this paper's notion that because banks face different reputational risks, some have the incentive to comply while others decide to free-ride. In fact, many of BankTrack's findings from its analysis of the each individual EP bank in its survey substantiate our theoretical model. For example, it should come as no surprise that Citigroup, as the world's largest commercial bank, was lauded by BankTrack for being "one of the leadership banks that have committed to go beyond the EPs by essentially applying them to corporate credits," and having "taken significant

[33] EIRIS (2006).

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steps to embed the EPs into core business practices." In contrast, Bank of America, whose reputation/brand is on-par with Citigroup but has little project financing activities (lowering its reputational risk), was chided for "not [providing] any updates as to its implementation of or compliance with the EPs.[34]

XII. Case Study: The Baku-Tbilisi-Ceyhan Oil Pipeline

While theoretical models have helped to clarify the incentives for a bank in choosing whether to comply with the EP, real case studies would be more illustrative in demonstrating actual compliance. However, due to the EP's lax requirements on transparency and disclosure, and how wording in the EP can lead to subjective assessments on compliance, finding a proper case study can be tricky. Nonetheless, the Baku-Tbilisi-Ceyhan (BTC) pipeline project serves as an excellent example because of its sheer size, which garnered the project much media attention. Moreover, members of the press covering this project have brought up issues that are clearly antithetical in nature to the spirit of the EP (ensuring that environmental or social concerns related to the project are addressed). Also, because there are public financial institutions involved in the project, such as the IFC, public documents about the project are also available.

Concerning the BTC project, the total project cost is said to be at $3.6 billion USD.[35] Nine EP banks were identified as providing financing to the project. Despite their participation, a number of big issues, such as the pipeline running through wetlands with endangered animals, displacement of individuals as a result of the pipeline's construction, and potential leakage that would cause havoc on the environment, were apparently not resolved. In covering the pipeline's

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[34] BankTrack, 2005.

[35] "IFC Board Approves Investments in Caspian Oil and Pipeline Projects Expected high development impact with environmental, social, and transparency safeguards." IFC News, Press Release. 4 Nov. 2003. <http://ifc.org/ifcext/media.nsf/content/SelectedPressRelease?OpenDocument&UNID=87B904CEA7A55BF585256DD4004FFBA3>

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construction, PBS (the Public Broadcasting Service) took issue with how close the pipeline would run to national wildlife:

> "Yet another problem spot in the construction of the BTC pipeline in Georgia can be found where the pipeline skirts the edge of Borjomi-Kharagauli National Park. The Borjomi region is famous for its pristine wilderness, and its spas have drawn visitors since they were first developed under the patronage of 19th-century Russian czars. Borjomi is also the source of renowned mineral water. Borjomi water is a major source of revenue both locally and within the greater Georgian economy, where it makes up as much as ten percent of Georgia's total export trade. The BTC pipeline will run as close as 16 kilometers from the Borjomi springs."[36]

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Obviously, the pipeline's dangerous proximity to the Borjomi-Kharagauli National Park suggests that environmental concerns were subverted in the project financing process. It would be hard for most experts to argue that an oil pipeline poses no threat to a natural spring if that pipeline were as close as 16 kilometers away!

Adding to the environmental threat posed by the pipeline, recently leaked documents (February 2007) from the U.S. Overseas Private Investment Corporation's (OPIC) Accountability Office reveal that the coating used in building the pipeline could lead to leakage. News agencies with access to the document report that cracks were found in the pipeline in November of 2003 but were not disclosed of immediately, and consultants to the lenders had

[36] "Extreme Oil, The Journey." PBS (Online). Accessed 3/2/07. <http://www.pbs.org/wnet/extremeoil/journey/georgia.html>.

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concerns about the coating and its effect on the durability of the pipeline.[37] Here, another big environmental issue emerges that challenges the credibility of EP banks involved in this project. If cracks were occurring and faulty coating was known to be used in the process, shouldn't EP banks have been responsible for actively getting the pipeline recoated correctly, or walking away from financing the project completely?

On the issue of displacement by individuals who were affected by the project, the Observer (UK) published a piece from an activist working for the Kurdish Human Rights Project who argued that many Kurds (affected by the project) were not even notified about the construction of the pipeline:

> "A Fact Finding Mission to the pipeline areas conducted by the Campaign in August this year found massive discrepancies between BP's claims about the consultation and compensation plans it must by law compile, and reality. Fewer than one quarter of our sample of concerned parties had been officially informed about BTC; one village, HaËibayram, listed by BP as consulted by telephone, was an abandoned wreck of shattered walls. Many of those who had received information remained confused and unsure of their rights."[38]

While BP's alleged failure in notifying Kurds of the project is significant, for the purposes of this paper, the more noteworthy aspect is how those 9 EP banks could either allow

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[37] "BP's BTC pipeline needs extra monitoring-US agency." MarketWatch. 12 Feb. 2007. <http://www.marketwatch.com/news/story/bps-btc-pipeline-needs-extra/story.aspx?guid=%7B14D0E706-AA20-4FBC-864C-74ABD51AF5E5%7D>

[38] "Why campaigners oppose the pipeline." Observer.co.uk. 1 Dec. 2002. http://observer.guardian.co.uk/business/ethics/story/0,12651,851000,00.html

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such negligence too occur or decide to finance the project if the event happened before they were involved.

Due to all these apparent failures by the 9 EP banks to address the environmental and social concerns present in construction of the BTC pipeline, the case study adequately demonstrates that not all banks are complying with the EP's guidelines. This is unsurprising, given what the preceding theoretical models have shown: banks with low reputational risk have less incentive to comply given the high costs of compliance and opportunities to free-ride. In grading how the principles fared in this project then, BankTrack is not far off the mark:

> "The Equator Principles can be used in three ways – to exclude financing of projects which fail to meet certain minimum standards, to set markers for improving projects' design and performance, and to hold clients accountable for meeting environmental and social performance standards. In the BTC case, which the Equator banks themselves touted as a key test of the Principles, the banks failed all three parts of the test."[39]

XIII. Establishing the Counterfactual and Investigating Alternatives

Recognizing the EP's weakness in forcing all lenders to comply with its guidelines, and how some EP banks will not address the environmental and social impact of a project as a result of this weakness, it's interesting to note what other alternatives to the EP are out there, and how the project finance field would function without the EP. Thus far, the only real alternative to the EP that has emerged has been the Collevecchio Declaration.

The problem with the Collevecchio Declaration (CD) is that its guidelines are so

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[39] BankTrack (2004).

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ambitious (compared to the EP) that lenders will not even really consider it, making it less of real alternative to the EP. While Richardson (2005) notes that the CD "presents itself as a more objectively and independently determined voluntary code," it is also "too radical and threatening to the status quo" in the eyes of financial institutions.[40] A look at the full text of the CD's provisions (provided in the appendix of this report) show although the text has many "should" statements (similar to the EP), its overall message is much stronger in conveying a clear sense of what is required of lenders, especially in areas such as disclosure and implementation. But despite the 101 organizational backers, if financial institutions view the CD's guidelines as being based on "naïve or inaccurate understanding of the workings of financial institutions" (as Richardson implies they might), then any real improvements the CD has over the EP is meaningless because there's no chance that it will be adopted by any banks. Accordingly, we can assume that while certain banks desire to reduce their reputational risk as much as possible, they prefer the EP over the CD because in the tradeoff between control over their financing activities and the benefits to gain from reducing reputational risk, control is more important. Besides, if the status quo, as Richardson points out, is currently meeting their interests, than switching over to a more extreme voluntary code is simply too risky, and could invite even harsher scrutiny if full compliance cannot be met.

The counterfactual to the EP, or what the conditions would be like without the EP, is debatable. Some may argue that the existence of an EP provides a false sense of security – a greater share of the public believes that banks are actually paying attention to environmental and social concerns when they are not. But looking at what some banks have accomplished with the EP, a more acceptable conclusion is that while the EP has its obvious flaws, it has helped bridge

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[40] Richardson (2005).

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the divide between NGOs and financial institutions. Another positive that has been described is the number of large banks that have been encouraged to go beyond the EP's requirements, incorporating environmental and social concerns into other areas of its credit policies. According to the law firm of Freshfields Bruckhaus Deringer (2005), whether this would have happened without the EP is unlikely:

> "Although the Equator Principles may be voluntary, their genesis is not due to voluntarism. There were undoubtedly a number of important drivers, such as the commitment of many Equator Bank chairmen and chief executives to sustainable development and responsible banking."[41]

The law firm goes on to imply that the EP inspired a number of positive developments, many of which would not have resulted inevitably. While its difficult to assess what would have or wouldn't have occurred without the EP, this paper takes the position that the EP provided a way for some banks and NGOs to engage with one another. Banks wanted to address many NGO concerns to reduce reputational risk, and NGOs had to present something feasible that banks could follow. Without the EP, it's unlikely that something like the CD would have brought such stakeholders together.

XIV. BankTrack

Before concluding this paper, a section on BankTrack is presented here since the organization has proven to be at the forefront in monitoring bank compliance with the EP. But it

[41] Freshfields Bruckhaus Deringer (2005).

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should be understood that BankTrack does not certify compliance, nor is it formally connected to the EP (meaning that it has not been designated as an official EP monitor or watchdog). More accurately, BankTrack is a consortium of NGOs. The consortium is broken down into 17 members and 6 partners (whom BankTrack says it "share[s] resources and information [with]" comprise this organization.[42] BankTrack claims that it unites organizations with a "proven track record in monitoring and campaigning on the *private* financial sector." Examining a sample of BankTrack's members (visiting their website, reading their mission statement, and skimming through their annual report) confirms that members are related to the project finance field in some way. For example, International Rivers Network is focused on protecting rivers around the world, which it does by campaigning against dam projects that it finds destructive. Pacific Environment, another BankTrack member, takes an even broader approach, working to protect all facets of the environment by attempting to stop, delay, or amend an environmentally destructive project.

For NGOs, the BankTrack network provides them a wider channel to receive information and research about a specific project; it also gives each member more voice or power in engaging with a lender. Whereas an EP bank may have shrugged off a single NGO that had problems with its lending policies, now it must contend with the possibility that there is strong coalition behind that NGO, and not engaging with them can lead to a major campaign against the lender's project and operations.

Since it's imperative that individuals question claims made by any organization, this section now attempts to answer why BankTrack's publications or claims against an EP bank or project can be trusted to be reliable. Without fully understanding the process through which

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[42] According to BankTrack's website, this information is accurate as of 2007. <http://www.banktrack.org/?show=18&visitor=1>

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BankTrack receives its information, it's easy to say that because the organization lacks the organizational capacity to research a project and its impact on the environment adequately, its publications and claims are unlikely to be very accurate. Its 2005 annual report describes a measly 3 full-time workers it plans to have the following year![43] But this really shouldn't matter. The three full-time individuals it employs primarily serve a secretariat role, such as maintaining the website and email lists, arranging meetings with members, managing online publication of documents written by members, and marketing the organization to the public. The writing in the publications and the claims made on behalf of BankTrack come from its members, which also have small staff (anywhere from possibly 6 to 12 people). But while BankTrack members may do research, on-site investigation, and hard environmental impact analysis, but most of what they rely upon in determining a project's environmental impact or an EP bank's compliance is located in the public domain. Again, EP banks have the privilege of not having to disclose information on their project or how they implement the EP. Accordingly, most (if not all) of a BankTrack member's source of information comes from government reports, press clippings, people affected on the ground, public financial records, and other information sources that cannot be closed off from the public. Therefore, many of its claims can easily be verified through online fact-checking. Because of this scenario and the large number of stakeholders with knowledge and involvement in a project, it's unlikely that claims would be intentionally misrepresented. Because it's so easy to determine the whether a claim made against a lender or project is accurate and complete, a BankTrack member has no incentive to risk its reputation based on a fabrication.

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[43] "Right on Track." BankTrack. Annual Report 2005. <http://www.banktrack.org/doc/File/internal%20documents/presentation%20material/060401%20Annual%20report%202005.pdf>

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Since large financial institutions overwhelm a typical BankTrack NGO in financial resources that can be used to effect public opinion (TV commercials, online ads, etc.), it is better for the BankTrack member to rely on the truth to deliver its message instead waging a war of words that would favor the financial institution.

XV. Conclusion

In attempting to assess compliance with the EP, this paper has relied on theoretical models that explain how reputational risk and costs provide incentives/disincentives for individual firms to adopt and/or comply with the EP. Examining these models and studying the BTC pipeline project, we see mixed results from EP banks in complying with the EP's guidelines. This does not come as a surprise given that banks differ in the level of reputational risks they face, which affect their cost of adopting and/or complying with the EP.

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XVI. Discussion Questions

1. Consider the origins of the Equator Principles. Why were they formed?

2. Discuss the motivations for adoption. Do you agree with the argument that this private regulatory scheme is an attempt to prevent and/ or shape future governmental regulation? Or is the scheme an attempt to hedge reputational risks? Does the adoption of the principles help banks "boost their credibility relative to their critics"?

3. Discuss the incentives and disincentives for compliance. Who does the Equator Principles benefit? How does that influence compliance?

4. Do the Equator Principles give you confidence that those who adopt them are funding global sustainable development projects? How should the guidelines be strengthened? Should the guidelines be institutionalized into a formal organization? Is it possible to do so?

5. Discuss the three ways BankTrack says the Equator Principles can be used and how they actually used, with respect to the Baku-Tbilisi-Ceyhan Oil Pipline. Who should be held accountable for the ecological destruction and human displacement caused by the project?

6. Who are the main stakeholders in the project finance? Which actors have the most power? Who has the least? Where do the pressures for change stem from?

7. Discuss the credibility of BankTrack. Do you agree with the author that this consortium of NGOs can be trusted? Do you think a formal watchdog organization can help pressure banks to adopt and comply with the Equator Principles? Why or why not?

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XVIII. Appendix

Appendix A

July 2006

The "Equator Principles"

A financial industry benchmark for determining, assessing and managing social & environmental risk in project financing

www.equator-principles.com

PREAMBLE

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.[1] 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 Financial Institutions (EPFIs) have consequently adopted these Principles in order to ensure that the projects we finance are developed in a manner that is socially responsible and reflect sound environmental management practices. By doing so, negative impacts on project-affected ecosystems and communities should be avoided where possible, and if these impacts are unavoidable, they should be reduced, mitigated and/or compensated for appropriately. We believe that adoption of and adherence to these Principles offers significant benefits to ourselves, our borrowers and local stakeholders through our borrowers' engagement with locally affected communities. We therefore recognise that our role as financiers affords us opportunities to promote responsible environmental stewardship and socially responsible development. As such, EPFIs will consider reviewing these Principles from time-to-time based on implementation experience, and in order to reflect ongoing learning and emerging good practice.

These Principles are intended to serve as a common baseline and framework for the implementation by each EPFI of its own internal social and environmental policies, procedures and standards related to its project financing activities. We will not provide loans to projects where the borrower will not or is unable to comply with our respective social and environmental policies and procedures that implement the Equator Principles.

[1] **Project finance** is "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. This type of financing is usually for large, complex and expensive installations that might include, for example, power plants, chemical processing plants, mines, transportation infrastructure, environment, and telecommunications infrastructure. Project finance may take the form of financing of the construction of a new capital installation, or refinancing of an existing installation, with or without improvements. In such transactions, the lender is usually paid solely or almost exclusively out of the money generated by the contracts for the facility's output, such as the electricity sold by a power plant. The borrower is usually an SPE (Special Purpose Entity) that is not permitted to perform any function other than developing, owning, and operating the installation. The consequence is that repayment depends primarily on the project's cash flow and on the collateral value of the project's assets." Source: *Basel Committee on Banking Supervision*, International Convergence of Capital Measurement and Capital Standards ("Basel II"), November 2005. http://www.bis.org/publ/bcbs118.pdf.

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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, while the Principles are not intended to be applied retroactively, we will 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.

STATEMENT OF PRINCIPLES

EPFIs will only provide loans to projects that conform to Principles 1-9 below:

Principle 1: Review and Categorisation
When a project is proposed for financing, the EPFI will, as part of its internal social and environmental review and due diligence, categorise 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 (IFC) (Exhibit I).

Principle 2: Social and Environmental Assessment
For each project assessed as being either Category A or Category B, the borrower has conducted a Social and Environmental Assessment ("Assessment") process[2] to address, as appropriate and to the EPFI's satisfaction, the relevant social and environmental impacts and risks of the proposed project (which may include, if relevant, the illustrative list of issues as found in Exhibit II). 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
For projects located in non-OECD countries, and those located in OECD countries not designated as High-Income, as defined by the World Bank Development Indicators Database, the Assessment will refer to the then applicable IFC Performance Standards (Exhibit III) and the then applicable Industry Specific EHS Guidelines ("EHS Guidelines") (Exhibit IV). The Assessment will establish to a participating EPFI's satisfaction the project's overall compliance with, or justified deviation from, the respective Performance Standards and EHS Guidelines.

The regulatory, permitting and public comment process requirements in High-Income OECD Countries, as defined by the World Bank Development Indicators Database, generally meet or exceed the requirements of the IFC Performance Standards (Exhibit III) and EHS Guidelines (Exhibit IV). Consequently, to avoid duplication and streamline EPFI's review of

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[2] **Social and Environmental Assessment** is a process that determines the social and environmental impacts and risks (including labour, health, and safety) of a proposed project in its area of influence. For the purposes of Equator Principles compliance, this will be an adequate, accurate and objective evaluation and presentation of the issues, whether prepared by the borrower, consultants or external experts. Depending on the nature and scale of the project, the assessment document may comprise a full-scale social and environmental impact assessment, a limited or focused environmental or social assessment (e.g. audit), or straight-forward application of environmental siting, pollution standards, design criteria, or construction standards. One or more specialised studies may also need to be undertaken.

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these projects, successful completion of an Assessment (or its equivalent) process under and in compliance with local or national law in High-Income OECD Countries is considered to be an acceptable substitute for the IFC Performance Standards, EHS Guidelines and further requirements as detailed in Principles 4, 5 and 6 below. For these projects, however, the EPFI still categorises and reviews the project in accordance with Principles 1 and 2 above.

The Assessment process in both cases should address compliance with relevant host country laws, regulations and permits that pertain to social and environmental matters.

Principle 4: Action Plan and Management System
For all Category A and Category B projects located in non-OECD countries, and those located in OECD countries not designated as High-Income, as defined by the World Bank Development Indicators Database, the borrower has prepared an Action Plan (AP)[3] which addresses the relevant findings, and draws on the conclusions of the Assessment. The AP will describe and prioritise the actions needed to implement mitigation measures, corrective actions and monitoring measures necessary to manage the impacts and risks identified in the Assessment. Borrowers will build on, maintain or establish a Social and Environmental Management System that addresses the management of these impacts, risks, and corrective actions required to comply with applicable host country social and environmental laws and regulations, and requirements of the applicable Performance Standards and EHS Guidelines, as defined in the AP.

For projects located in High-Income OECD countries, EPFIs may require development of an Action Plan based on relevant permitting and regulatory requirements, and as defined by host-country law.

Principle 5: Consultation and Disclosure
For all Category A and, as appropriate, Category B projects located in non-OECD countries, and those located in OECD countries not designated as High-Income, as defined by the World Bank Development Indicators Database, the government, borrower or third party expert has consulted with project affected communities in a structured and culturally appropriate manner.[4] For projects with significant adverse impacts on affected communities, the process will ensure their free, prior and informed consultation and facilitate their informed participation as a means to establish, to the satisfaction of the EPFI, whether a project has adequately incorporated affected communities' concerns.[5]

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[3] The **Action Plan** may range from a brief description of routine mitigation measures to a series of documents (e.g., resettlement action plan, indigenous peoples plan, emergency preparedness and response plan, decommissioning plan, etc). The level of detail and complexity of the Action Plan and the priority of the identified measures and actions will be commensurate with the project's potential impacts and risks. Consistent with Performance Standard 1, the internal **Social and Environmental Management System** will incorporate the following elements: (i) Social and Environmental Assessment; (ii) management program; (iii) organisational capacity; (iv) training; (v) community engagement; (vi) monitoring; and (vii) reporting.

[4] **Affected communities** are communities of the local population within the project's area of influence who are likely to be adversely affected by the project. Where such consultation needs to be undertaken in a structured manner, EPFIs may require the preparation of a Public Consultation and Disclosure Plan (PCDP).

[5] **Consultation** should be "free" (free of external manipulation, interference or coercion, and intimidation), "prior" (timely disclosure of information) and "informed" (relevant, understandable and accessible information), and apply to the entire project process and not to the early stages of the project alone. The borrower will tailor its consultation process to the language preferences of the affected communities, their decision-making processes, and the needs of disadvantaged or vulnerable groups. Consultation with Indigenous Peoples must conform to specific and detailed requirements as found in Performance Standard 7. Furthermore, the special rights of Indigenous Peoples as recognised by host-country legislation will need to be addressed.

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In order to accomplish this, the Assessment documentation and AP, or non-technical summaries thereof, will be made available to the public by the borrower for a reasonable minimum period in the relevant local language and in a culturally appropriate manner. The borrower will take account of and document the process and results of the consultation, including any actions agreed resulting from the consultation. For projects with adverse social or environmental impacts, disclosure should occur early in the Assessment process and in any event before the project construction commences, and on an ongoing basis.

Principle 6: Grievance Mechanism
For all Category A and, as appropriate, Category B projects located in non-OECD countries, and those located in OECD countries not designated as High-Income, as defined by the World Bank Development Indicators Database, to ensure that consultation, disclosure and community engagement continues throughout construction and operation of the project, the borrower will, scaled to the risks and adverse impacts of the project, 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
An important strength of the Principles is the incorporation of covenants linked to compliance. For Category A and B projects, the borrower will covenant in financing documentation:

a) to comply with all relevant host country social and environmental laws, regulations and permits in all material respects;

b) to comply with the AP (where applicable) during the construction and operation of the project in all material respects;

c) to provide periodic reports in a format agreed with EPFIs (with the frequency of these reports proportionate to the severity of impacts, or as required by law, but not less than annually), prepared by in-house staff or third party experts, that i) document compliance with the AP (where applicable), and ii) provide representation of compliance with relevant local, state and host country social and environmental laws, regulations and permits; and

d) to decommission the facilities, where applicable and appropriate, in accordance with an agreed decommissioning plan.

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.

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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.[6]

DISCLAIMER

The adopting EPFIs view these Principles as a financial industry benchmark for developing individual, internal social and environmental policies, procedures and practices. As with all internal policies, these Principles do not create any rights in, or liability to, any person, public or private. Institutions are adopting and implementing these Principles voluntarily and independently, without reliance on or recourse to IFC or the World Bank.

[6] Such reporting should at a minimum include the number of transactions screened by each EPFI, including the categorisation accorded to transactions (and may include a breakdown by sector or region), and information regarding implementation.

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Exhibit I: Categorisation of projects

As part of their review of a project's expected social and environmental impacts, EPFIs use a system of social and environmental categorisation, based on 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.

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Exhibit II:
Illustrative list of potential social and environmental issues to be addressed in the Social and Environmental Assessment documentation

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

a) assessment of the baseline social and environmental conditions
b) consideration of feasible environmentally and socially preferable alternatives
c) requirements under host country laws and regulations, applicable international treaties and agreements
d) protection of human rights and community health, safety and security (including risks, impacts and management of project's use of security personnel)
e) protection of cultural property and heritage
f) protection and conservation of biodiversity, including endangered species and sensitive ecosystems in modified, natural and critical habitats, and identification of legally protected areas
g) sustainable management and use of renewable natural resources (including sustainable resource management through appropriate independent certification systems)
h) use and management of dangerous substances
i) major hazards assessment and management
j) labour issues (including the four core labour standards), and occupational health and safety
k) fire prevention and life safety
l) socio-economic impacts
m) land acquisition and involuntary resettlement
n) impacts on affected communities, and disadvantaged or vulnerable groups
o) impacts on indigenous peoples, and their unique cultural systems and values
p) cumulative impacts of existing projects, the proposed project, and anticipated future projects
q) consultation and participation of affected parties in the design, review and implementation of the project
r) efficient production, delivery and use of energy
s) pollution prevention and waste minimisation, pollution controls (liquid effluents and air emissions) and solid and chemical waste management

Note: The above list is for illustrative purposes only. The Social and Environmental Assessment process of each project may or may not identify all issues noted above, or be relevant to every project.

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Exhibit III: IFC Performance Standards on Social and Environmental Sustainability

As of April 30, 2006, the following list of IFC Performance Standards were applicable:

- Performance Standard 1: Social & Environmental Assessment & Management System
- Performance Standard 2: Labor and Working Conditions
- Performance Standard 3: Pollution Prevention and Abatement
- Performance Standard 4: Community Health, Safety and Security
- Performance Standard 5: Land Acquisition and Involuntary Resettlement
- Performance Standard 6: Biodiversity Conservation and Sustainable Natural Resource Management
- Performance Standard 7: Indigenous Peoples
- Performance Standard 8: Cultural Heritage

Note: The IFC has developed a set of **Guidance Notes** to accompany each Performance Standard. While not formally adopting the Guidance Notes, EPFIs or borrowers may use the Guidance Notes as useful points of reference when seeking further guidance on or interpretation of the Performance Standards. The IFC Performance Standards, Guidance Notes and Industry Sector EHS Guidelines can be found at www.ifc.org/enviro

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Exhibit IV: Industry-Specific Environmental, Health and Safety (EHS) Guidelines

EPFIs will utilise the appropriate environmental, health and safety (EHS) guidelines used by IFC which are now in place, and as may be amended from time-to-time.

IFC is using two complementary sets of EHS Guidelines available at the IFC website (www.ifc.org/enviro). These sets consist of all the environmental guidelines contained in Part III of the World Bank's Pollution Prevention and Abatement Handbook (PPAH) which went into official use on July 1, 1998 and a series of environmental, health and safety guidelines published on the IFC website between 1991 and 2003. Ultimately new guidelines, incorporating the concepts of cleaner production and environmental management systems, will be written to replace this series of industry sector, PPAH and IFC guidelines.

Where no sector specific guideline exists for a particular project then the PPAH's General Environmental Guidelines and the IFC Occupational Health and Safety Guidelines (2003) are applied, with modifications as necessary to suit the project.*

The table below lists both the World Bank Guidelines and the IFC Guidelines as of March 1, 2006.

Industry Specific EHS Guidelines:

World Bank Guidelines (PPAH)	IFC Guidelines
1. Aluminum Manufacturing	1. Airports
2. Base Metal and Iron Ore Mining	2. Ceramic Tile Manufacturing
3. Breweries	3. Construction Materials Plants
4. Cement Manufacturing	4. Electric Power Transmission and Distribution
5. Chlor-Alkali Plants	5. Fish Processing
6. Coal Mining and Production	6. Food and Beverage Processing
7. Coke Manufacturing	7. Forestry Operations: Logging
8. Copper Smelting	8. Gas Terminal Systems
9. Dairy Industry	9. Geothermal Projects
10. Dye Manufacturing	10. Hazardous Materials Management
11. Electronics Manufacturing	11. Health Care
12. Electroplating Industry	12. Life & Fire Safety
13. Foundries	13. Occupational Health and Safety
14. Fruit and Vegetable Processing	14. Office Buildings
15. General Environmental Guidelines	15. Offshore Oil & Gas
16. Glass Manufacturing	16. Polychlorinated Biphenyls (PCBs)
17. Industrial Estates	17. Pesticide Handling and Application
18. Iron and Steel Manufacturing	18. Plantations
19. Lead and Zinc Smelting	19. Port and Harbor Facilities
20. Meat Processing and Rendering	20. Rail Transit Systems
21. Mini Steel Mills	21. Roads and Highways
22. Mixed Fertilizer Plants	22. Telecommunications
23. Monitoring	23. Tourism and Hospitality Development
24. Nickel Smelting and Refining	24. Waste Management Facilities
25. Nitrogenous Fertilizer Plants	25. Wastewater Reuse
26. Oil and Gas Development (Onshore)	26. Wildland Management
27. Pesticides Formulation	27. Wind Energy Conversion Systems
28. Pesticides Manufacturing	28. Wood Products Industries

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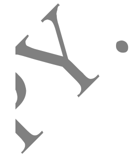
29. Petrochemicals Manufacturing	
30. Petroleum Refining	
31. Pharmaceutical Manufacturing	
32. Phosphate Fertilizer Plants	
33. Printing Industry	
34. Pulp and Paper Mills	
35. Sugar Manufacturing	
36. Tanning and Leather Finishing	
37. Textiles Industry	
38. Thermal Power Guidelines for New Plants	
39. Thermal Power Rehabilitation of Existing Plants	
40. Vegetable Oil Processing	
41. Wood Preserving Industry	



* Exception (the following are World Bank Guidelines not contained in the PPAH and currently in use)

Mining and Milling - Underground
Mining and Milling - Open Pit

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COLLEVECCHIO DECLARATION ON FINANCIAL INSTITUTIONS AND SUSTAINABILITY

Financial institutions (FIs) can and must play a positive role in advancing environmental and social sustainability. This declaration, endorsed by over 200 civil society organisations, calls on FIs to embrace six commitments, and take immediate steps to implement them as a way for FIs to retain their social license to operate. These commitments reflect civil society's expectations of the role and responsibilities of the financial services sector in fostering sustainability.

The Role and Responsibility of Financial Institutions

The financial sector's role of facilitating and managing capital is important; and finance, like communications or technology, is not inherently at odds with sustainability. However, in the current context of globalization, financial institutions (FIs) play key roles in channeling financial flows, creating financial markets and influencing international policies in ways that are too often unaccountable to citizens, and harmful to the environment, human rights, and social equity.

FIs have played a role in irresponsibly channeling money to unethical companies, corrupt governments, and egregious projects. In the Global South, FIs' increasing role in development finance has meant that they bear significant responsibility for international financial crises, and the crushing burden of developing country debt. However, most FIs do not accept responsibility for the environmental and social harm created by their transactions, even though they may be eager to take credit for the economic development and benefits derived from their services. And relatively few FIs, in their role as creditors, analysts, underwriters, advisers, or investors effectively use their power to deliberately channel finance into sustainable enterprises, or encourage their clients to embrace sustainability.

Similarly, the vast majority of FIs do not play a proactive role in creating financial markets that value communities and the environment. As companies FIs concentrate on maximizing shareholder value, while as financiers they seek to maximize profit; this dual role means that FIs have played a pivotal role in creating financial markets that predominantly value short-term returns. These brief time horizons create intense pressure for companies to put short-term profits before longer-term sustainability goals, such as social stability and ecological health.

Finally, through the work of international public policy bodies such as the Bretton Woods institutions, the power of FIs has increasingly expanded as countries have deregulated, liberalized, and privatized their economies and financial markets. Financial institutions have not only actively promoted these policies and processes, but they have benefited from them through increased profit and influence.

In too many cases, FIs have unfairly benefited at the expense of communities and the environment. For example, during financial crises, many FIs charged high risk premiums to indebted countries, while at the same time benefiting from public bail-outs. Some FIs have spoken out against innovative solutions to the debt crisis, such as the sovereign-debt restructuring processes proposed by civil society groups and now being discussed in the International Monetary Fund. And FIs' voices have been absent in efforts to address tax havens, a problem that blocks progress towards equity and sustainability.

As a result, civil society is increasingly questioning the financial sector's accountability and responsibility, and challenging FIs' social license to operate. As major actors in the global economy, FIs should embrace a commitment to sustainability that reflects best practice from the corporate social responsibility movement, while recognizing that voluntary measures

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alone are not sufficient, and that they must support regulations that will help the sector advance sustainability.

Six Commitments to Key Principles

Acknowledging that FIs, like all corporations, exist as creations of society to act in the public interest, FIs should promote the restoration and protection of the environment, and promote universal human rights and social justice. These principles should be inherent in the way that they offer financial products and services, and conduct their businesses.

Finance and commerce has been at the center of a historic detachment between the world's natural resource base, production and consumption. As we reach the boundaries of the ecological limits upon which all commerce relies, the financial sector should take its share of responsibility for reversing the effects this detachment has produced. Thus, an appropriate goal of FIs should be the advancement of environmental protection and social justice rather than solely the maximization of financial return. To achieve this goal, FIs should embrace the following six commitments:

1. Commitment to Sustainability
FIs must expand their missions from ones that prioritize profit maximization to a vision of social and evironmenmental sustainability. A commitment to sustainability would require FIs to fully integrate the consideration of ecological limits, social equity and economic justice into corporate strategies and core business areas (including credit, investing, underwriting, advising), to put sustainability objectives on an equal footing to shareholder maximization and client satisfaction, and to actively strive to finance transactions that promote sustainability.

2. Commitment to 'Do No Harm'
FIs should commit to do no harm by preventing and minimizing the environmentally and/or socially detrimental impacts of their portfolios and their operations. FIs should create policies, procedures and standards based on the Precautionary Principle to minimize environmental and social harm, improve social and environmental conditions where they and their clients operate, and avoid involvement in transactions that undermine sustainability.

3. Commitment to Responsibility.
FIs should bear full responsibility for the environmental and social impacts of their transactions. FIs must also pay their full and fair share of the risks they accept and create. This includes financial risks, as well as social and environmental costs that are borne by communities.

4. Commitment to Accountability
FIs must be accountable to their stakeholders, particularly those that are affected by the companies and activities they finance. Accountability means that stakeholders must have an influential voice in financial decisions that affect the quality of their environments and their lives -- both through ensuring that stakeholders rights are protected by law, and through practices and procedures adopted by FIs themselves.

5. Commitment to Transparency
FIs must be transparent to stakeholders, not only through robust, regular and standardized disclosure, but also by being responsive to stakeholder needs for specialized information on FIs' policies, procedures and transactions. Commerical confidentiality should not be used as an excuse deny stakeholders information.

6. Commitment to Sustainable Markets and Governance
FIs should ensure that markets are more capable of fostering sustainability by actively supporting public policy, regulatory and/or market mechanisms which facilitate sustainability and that foster the full cost accounting of social and environmental externalities.

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Appendix B

OPY.

Implementing the Collevecchio Declaration

This document provides guidance for financial institutions (FIs) on implementing the Collevecchio Declaration on Financial Institutions and Sustainability. The Delcaration calls for broad commitments, and FIs may have differing interpretations regarding how to implement them. This document provides clarification of what civil society currently (2003) expects from FIs commited to implementing the six key principles of the Collevecchio Declaration.

FIs can work with stakeholders to take the following immediate steps:

1. Commitment to Sustainability

a) Measurement of environmental and social impacts
FIs should measure the environmental and social impacts of their portfolios in core business areas, including lending, investing, underwriting and advising.

b) Continuous improvement based on environmental & social impacts of portfolios
Although some FIs embrace the concept of continuously improving their management systems, all FIs must assess the sustainability challenges and issues facing their portfolios; and create objectives, strategies, timetables and performance indicators to increase the sustainability profile of their portfolios.

c) Fostering sustainability
FIs must actively seek to shift their businesses to proactively sustainable practices which improve environmental and social conditions. This might include, for example, reducing the carbon footprint of their portolios by shifting investments from fossil fuel to renewables; or the capitalization of sustainable enterprises. FIs should use their influence to ensure that companies and projects in which they invest or support act in line with best practice. FI should set clear timetables for improving their clients' sustainability performance, and if neccessary, withdraw their support of non-performing clients.

d) Implementation and capacity building
FIs should take all necessary steps to ensure that staff are trained and capacity is built to ensure that sustainability objectives are met and that procedures, policies and standards are implemented. Staff performance reviews and bonuses should be linked to the acheivement of sustainability targets and timetables.

2. Commitment to 'Do No Harm'

a) Sustainability procedures
On the basis of the Precautionary Principle, FIs should create transactions-based procedures that screen and categorize potential deals on the basis of environmental and social sensitivity. Based on a transaction's sensitivity, the FI should perform appropriate levels of due diligence, stakeholder consultation, and assessment. FIs should also create processes for influencing, legally enforcing and monitoring sensitive transactions.

b) Sustainability standards
FIs should adopt internationally recognized, sector-specific, best practice standards that can serve as the basis for financing or refusing to finance a transaction (e.g. World Commission on Dams guidelines, Forest Stewardship Council standards)

Banks should also establish supplementary sectoral standards with stakeholder input and guidance. Some such standards exist already for the forests sector and others are being developed for other issues/sectors such as Minerals and Dams projects. These standards will vary, but should as a minimum cover issues such as: respect for international conventions, no-go zones, gender equity issues, supply chain issues, human rights, etc.

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3. Commitment to Responsibility

a) Bear full responsibility for the impacts of transactions
FIs must pay for their full and fair share of risks that they accept and create. This means FIs should not help engineer country bail-out packages that aggravate the debt burden of developing countries. It also means that FIs should bear full repsonsbility for the environmental and social costs that are created by their transactions but borne by communities. This includes using their influence and resources to address the needs of communities whose livelihoods and ways of life are compromised by the adverse environmental or social impacts of their transactions.

b) Recognize their role in developing country debt crisis
FIs should recognize that the ability of countries to service external debt depends on the maintainance of social and ecological systems, and that developing country debt burdens are socially, environmentally, and economically unsustainable. FIs should refrain from lobbying against innovative solutions to the developing country debt crisis, and support calls for significant debt relief/cancellation.

4. Commitment to Accountability

a) Public Consultation
FIs can advance accountability by consulting civil society groups when creating sustainability policies, objectives, procedures, and standards. FIs should incorporate the views of stakeholders affected by their credit, lending, underwriting or advisory functions. This includes respecting the right of affected communitites to "say no" to a transaction.

b) Stakeholder Rights
FIs must also support regulatory efforts that increase the rights of stakeholders in having a more influential voice in the governance of FIs and their transactions.

5. Commitment to Transparency

a) Corporate Sustainability Reporting
FIs should publish annual sustainabilty reports according to an internationally recognized reporting format supported by civil society. FIs should further include disclosure on the sustainability profile of the FI's portfolio, a breakdown of core business activities by sector and region, and the implementation of the FI's sustinability policies and objectives.

b) Information Disclosure
FIs should make assumptions in favour of information disclosure. Particularly for completed transactions, but also for those in the pipeline,
FIs should publicly provide information on companies and significant transcations in a timely manner, and not hide behind the excuse of business confidentiality.

6. Commitment to Sustainable Markets and Governance.

a) Public policy and regulation
FIs must recognise the role that governments must play in setting the market frameworks within which companies and FIs function. FIs should work to make markets are more capable of fostering sustainability by actively supporting public policy, regulatory or market mechanisms that foster the internalisation of social and environmental externalities.

b) Financial practices
FIs should avoid and discourage inappropriate use of tax havens or currency speculation that are unfair and that create instability. FIs should also strive to make financial decisions based on longer-term time horizons and reward clients that do the same.