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THE “EQUATOR PRINCIPLES”:

IMPROVED SOCIAL RESPONSIBILITY IN THE PRIVATE FINANCE SECTOR

by Miki Kamijyo*

INTRODUCTION

In a time of growing need for emphasis on social issues in developing countries, a group of leading private financial institutions established common environmental and social standards for project financing called the Equator Principles (the “Principles”).¹ The Principles provide a voluntary set of guidelines in an effort to better manage socially and environmentally complex investments in emerging markets. June 2004 marked the one year anniversary² of this bank-led initiative, which has moved the global investment and finance industry a step forward in promoting sustainability. The Principles are innovative in that the guidelines bring the notion of prior informed consent into every private industry sector, from mining and forestry to manufacturing and construction.

This initiative is a constructive attempt for banks that have adopted the Principles, “Equator Banks”,³ to learn about social and environmental issues in project finance. This education in turn will lead to greater expertise in these issues across all industry sectors, which will better enable the Banks to control their risks. Equator Banks recognize that environmental and social controversies over a project can impact the bottom line, and the Principles are essentially good for business.

The private finance sector is critical to influencing major infrastructure projects. By establishing environmental and social standards in the finance industry, Equator Banks have the impressive ability to positively affect sustainable development and human rights principles at the international, national, and local levels.

HISTORY OF THE EQUATOR PRINCIPLES

The concept of the Equator Principles emerged in October 2002, at a meeting between the International Finance Corporation (“IFC”) and leading banks to discuss social and environmental issues in project finance.⁴ About five years ago, environmental groups and socially responsible investment funds started to focus on commercial banks and private institutions that funded controversial projects typically avoided by the World Bank and other public institutions.⁵ On June 4, 2003, ten leading banks from seven countries announced the adoption of the Principles⁶ and agreed to abide by the World Bank’s voluntary code of environmental standards. The name was originally the “Greenwich Principles”, but changed to reflect the global initiative in which the equator represented balance.⁷

COMPONENTS OF THE EQUATOR PRINCIPLES

The Principles include a Preamble, a Statement of Principles, and three exhibits: an environmental and social screening process, the International Finance Corporation (“IFC”) Safeguard Policies, and the World Bank Group Specific Guidelines.

THE PREAMBLE

The Equator Banks that have adopted the Principles pledge to only provide loans to projects which have undergone the screening process and are able to comply with the Principles’ policies and processes. The Preamble is a statement of commitment from financiers to address environmental and social policy issues in project financing.⁸ To uphold these Principles, these financiers agree to assess and manage environmental and social risk by carefully reviewing all proposals that request project financing.⁹

THE STATEMENT OF PRINCIPLES

The Statement of Principles is a set of concrete steps for the Equator Banks to classify projects into high, medium, and low risk categories.¹⁰ The Banks will then require the borrower to complete an environmental and social review in which they have demonstrated that they complied with the World Bank and IFC Policies and Guidelines as well as local host country laws.¹¹ The borrower is also required to make this review, the Environmental Assessment (“EA”), available to the public in the local language and in a culturally appropriate manner. The particularly high risk projects will be subject to independent expert review.¹² In a situation where the borrower is not complying with the environmental and social obligations of the loan agreement, lending institutions may declare the project loan in default.¹³

The Equator Principles include a screening process, based on the IFC’s environmental and social screening process, which describes the high, medium, and low risk classifications of proposed projects.¹⁴ This process determines the extent and type of EA a project should undergo according to the project’s level of risk and adverse environmental impacts.¹⁵ A high or medium risk project calls for an EA that examines negative and positive impacts, and also recommends measures needed to prevent, minimize, mitigate, or compensate for those adverse impacts.¹⁶ The purpose of the screening process is to require borrowers to reveal to the lending institution all possible and anticipated impacts, as well as considering any feasible alternatives including a “without project” situation.¹⁷

THE EXHIBITS

The exhibits in the Principles adopt the World Bank Group Guidelines and Policies,¹⁸ using the same terminology and categorization that the World Bank Group does, thereby creating consistent approaches to assessing a potential project’s risk.

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The Guidelines are sector-specific standards that apply to the technology and processes of specific industries, such as oil and gas, rail transit systems, or pesticide handling.¹⁹ On the other hand, the Safeguard Policies are a general approach to critical issues that apply to all sectors, such as assessing environmental impact and preserving cultural property.²⁰ In adopting both the Policies and Guidelines, the Principles provide a comprehensive approach applicable to almost any investment in the emerging markets.

The Principles are the finance industry's approach to "promote responsible environmental stewardship and socially responsible development."²¹ Any endorsing entity of the Principles, including multilateral institutions, may establish internal policies and processes consistent with the Principles. The Principles are a significant step in implementing socially responsible principles at the private sector level. National governments, local communities, and indigenous people will benefit from the Equator Banks' proactive movement to minimize environmental and social risk. At the same time, borrowers and industries will benefit from the positive move away from harmful and high-risk projects. The Equator Banks themselves gain the advantage over peer institutions by introducing better corporate practices and providing their clients with improved accountability and sound financial management.

IMPLEMENTATION AND EFFICACY OF THE PRINCIPLES

CRITICISMS OF THE PRINCIPLES

To date, twenty-five institutions in Europe, North America, Asia, Australia, and South America have voluntarily adopted these Principles.²² But critics point to the Principles' purpose as being one without substance. The Principles may be seen merely as good PR or an attempt by banks to manage their reputational risks with clients and shareholders. NGOs have argued that the Principles are inadequate because they lack accountability mechanisms,²³ contain critical loopholes, and are weak on social issues.²⁴ Banks in the past have funded controversial projects, and the goal of financial institutions is to reduce financial risk and liability. Nevertheless, both the Equator Banks and the NGOs should view the Principles as an opportunity for the financial industry to take a self-initiated step towards a globally responsible agenda.

EFFECTIVENESS WITHOUT ENFORCEMENT MECHANISMS

While there are no formal mechanisms to enforce the Principles, Equator Banks should utilize the Principles as a learning tool in which the Banks improve their portfolio of potential projects. The Principles are not simply a tool to exploit the project's problems after the project has already been completed. They should also not be used just as a compliance instrument by which to criticize banks. Instead, the goal of the Principles is to create a process for Equator Banks to scrutinize potential projects before agreeing to finance them.

By adopting these voluntary standards as an accepted methodology to establish sustainable development practices,

banks will not only realize anticipated financial gains, but also receive intangible benefits such as improved relations with investors, a more conscientious corporate goal, and decreased exposure to liability. In setting environmentally sound practices, companies recognize that such practices bring value to company identity and future stability in the marketplace, ultimately helping to strengthen the economy.²⁵

SELF – IMPOSED ENFORCEMENT MECHANISMS

An effective social and environmental standard will be one that requires financial reporting, regular periodic compliance audits, and staff resources. In the Statement of Principles, environmental assessment of a possible project will report a long list of issues, including major hazards, use of dangerous substances, and consideration of environmentally and socially preferable alternatives. With this list of issues, Banks can set practical standards by which to reject unsuitable projects. These Banks should incorporate the Principles as a natural learning loop and create self-imposed fiscal responsibility and transparency. The Banks should not use the Principles to avoid public scrutiny and self-evaluation, but use it to create a viable and efficient implementation mechanism within the Banks' everyday financial practices.

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THE PRINCIPLES' EFFECT ON INDIGENOUS PEOPLES

In its list of Safeguard Policies, the Principles address the concerns surrounding effects on indigenous peoples.²⁶ The Principles call for an EA that considers socioeconomic impacts as well as impacts on indigenous peoples and communities.²⁷ The Principles call for participation of affected parties in the design, review, and implementation of the project.²⁸

The Equator Banks' adoption of the Principles is in response to mounting pressure from those who publicly accuse large entities of "poisoning the air and water, denuding the forests, and destroying the livelihood of locals who get in the way."²⁹ In its Safeguard Policies, the World Bank emphasizes that issues pertaining to indigenous peoples must be based on the "informed participation [sic] of the indigenous peoples themselves."³⁰ By adopting these Safeguard Policies, the

Equator Banks have acknowledged the unique anthropological and sociological status that indigenous peoples and tribal groups possess.

UNLIKELY ALLIES: GLOBAL FINANCIAL INSTITUTIONS & INDIGENOUS PEOPLES

Affected indigenous peoples have now found an ally in the unlikelyst of places: large, global financial institutions. In applying the Principles to bank financing, the Equator Banks have provided powerful support for developing social standards. For example, Citigroup strengthened its policies on respecting indigenous rights³¹ and did not renew its financial advising contract with a controversial Camisea Gas Project in Peru.³² The Camisea Gas Project exposed indigenous peoples to diseases such as small pox and influenza, killing an estimated 50% of the indigenous Nahua population.³³ Bank of America, another leading U.S. bank, has a lending criteria for developing countries in which it will evaluate not only a borrower's capacity for repayment, but also the purpose of the transaction and the impact on the local populace.³⁴ Bank of America also recently adopted new environmental initiatives, which include refusals to lend to projects where indigenous land claims are unresolved.³⁵

ENSURING THE PARTICIPATION OF INDIGENOUS PEOPLES

The Principles acknowledge that issues concerning the rights of indigenous peoples and local communities arise in a variety of sectors, including dams, extractive industries, tourism, education, and use of dangerous substances. The Principles detail prerequisites of a development plan for indigenous peoples.³⁶ These prerequisites necessitate a thorough and qualified study of the indigenous peoples affected by the project: taking into account, for instance, local patterns of social organization, religious beliefs and resource use, the legal status of the affected groups in the host country's legislation, and the government institutions assigned responsibility for the groups.³⁷ These prerequisites listed here are not exhaustive, and Equator Banks are free to implement policies that best fit their own company infrastructure. But the clear purpose of the Principles is to ensure full local-level participation of indigenous peoples in project preparation and development. The borrower must ensure that indigenous peoples benefit from development investments, and the Banks do not even have to appraise potential projects until the borrower develops suitable mitigation plans.³⁸

The Principles obligate the borrower to implement a development plan, and banks are given benchmarks that can be monitored during supervision of the project.³⁹ This gives the Banks constructive control over large-scale projects, but most impor-

tantly, involves indigenous peoples more prominently in the project's development. As with many social policies, the Principles' objective is to foster full respect for indigenous peoples' dignity, human rights, and cultural uniqueness.⁴⁰ In embracing this objective, global financial institutions have now lent their support and influence to the same cause. Human rights has become an integral part of global finance and development.

STRENGTHENING THE PRINCIPLES

NGOs have assessed the implementation and effectiveness of the Principles and recommended various measures to ensure they are implemented in a meaningful and transparent way.⁴¹

CREATING ACCOUNTABILITY

To enforce the Principles, one option is to require that Equator Banks create an annual reporting format to demonstrate they are implementing the Principles, and to measure how the

Principles are making a difference. In this way, stakeholders and investors of Equator Banks can hold these banks accountable for upholding the Principles. Applying the Principles to bank projects will minimize risk liabilities and ultimately affect financial profits. However, as with any policy implementation, there is a need for transparency in order to monitor and ensure proper compliance. Public disclosures, internal controls, and external reporting are some of the

approaches to establish this transparency so that endorsing institutions and the public may observe the Equator Banks' implementation processes.

Multilateral and global institutions have used independent inspection mechanisms to facilitate public reporting of violations.⁴² However, the emphasis in the Principles is not on the recourse measures, but on a bank's ability to operate responsibly from the initial onset of a project, thereby avoiding violations down the line.

AVOIDING POLITICAL EXPLOITATION

As more banks and institutions adopt the Principles and join the group of Equator Banks,⁴³ some may see opportunities for powerful joint lobbying or political exploitation of their association.⁴⁴ However, adoption of the Principles should not entitle Equator Banks to hold any type of lobbying position that might undermine the Banks' good faith efforts and progress. Nor should Equator Banks take advantage of borrowers and countries that legitimately need project loans. It is important to remember that the Principles and their implementation are designed to protect the natural environment and indigenous and cultural populations. The Equator Banks must exercise judgment in determining how best to utilize its social policies. This

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heavy burden will inherently cause the Banks to seriously evaluate their financial goals and the means used to achieve those goals. The Principles are a way to reflect on the socially useful value of a project and how it will improve markets and countries that strive to advance and compete in the global economy.

LEADING THE FINANCE INDUSTRY

Through voluntary adoption of the Principles, the Equator Banks are compelling themselves to substantially change the way they conduct business. The Principles provide a framework for these Banks to critically evaluate how their financial decisions may harm or damage the environment and its local communities. Banks are accountable to their stakeholders, and their portfolio of bank projects will reveal the social value of a project in a developing country. We must understand that extractive industries, manufacturing, and dam projects will continued to be financed, and these projects will continue to present numerous environmental and social threats. Therefore, Equator Banks should not only minimize a single project's risk, but guide the financing industry towards more socially responsible goals, potentially persuading all financing institutions to adopt the Principles.

CONCLUSION: THE FUTURE OF THE PRINCIPLES

The Principles were intended to integrate social, environmental, and ethical decisions into global project financing and development. The Principles are by no means a complete solu-

tion to the development industry's questions, and the Equator Banks will not have the capability to remove all risk from future projects. However, in agreeing to enforce the Principles for all loans above \$50 million, these Banks are utilizing their influential roles to force borrowers to reconsider their project's viability. The executive vice president of the IFC has acknowledged that "this will change the rules of the road for about \$100 billion in global investment over the next 10 years."⁴⁵ By making such a bold move in the private sector, the Equator Banks are sending a clear message to developing countries, stakeholders, and local communities that they will only support those projects complying with these social policies and processes. Their majority in the market share⁴⁶ will also force other banks to adopt the Principles, which in turn will transform financial borrowing and dictate the social goals of the entire private sector financing community.

We should continue to closely watch the progress of the Equator Banks and keep open the dialogue between these institutions and the public community. But more importantly, we should optimistically anticipate the positive ripple effects that these Principles have already begun to create. The circle of Equator Banks will grow, support for the Principles will strengthen, and the global investment climate will reflect the move towards environmental, social, and economic sustainability.



ENDNOTES: The "Equator Principles": Improved Social Responsibility

¹ Michael M. Phillips and Mitchell Pacelle, *Banks Accept 'Equator Principles'*, THE WALL ST. J., June 4, 2003, available at 2003 WL-WSJ 3971837 [hereinafter *Phillips*].

² BankTrack, *Principles, Profits or Just PR? Triple P Investments Under the Equator Principles*, June 4, 2004, available at <http://www.bank-track.org/index.php?id=4> (last visited June 19, 2004).

³ See The Equator Principles website, at <http://www.equator-principles.com/index.html> (listing banks that have adopted the Equator Principles).

⁴ Frequently Asked Questions about the Equator Principles, The Equator Principles website, at <http://www.equator-principles.com/faq.shtml> (last visited June 19, 2004).

⁵ Vanessa Houlder and Demetri Sevastopulo, *Environment Groups Hold Banks To Their Green Promises*, THE FIN. TIMES, June 4, 2004, available at 2004 WL 80061573.

⁶ The banks included, *inter alia*, Citigroup Inc., ABN AMRO Bank N.V., and Barclays PLC. See *Phillips*, *supra* note 1.

⁷ Suellen Lazarus, *The Equator Principles: A Milestone or Just Good PR?*, GLOBAL AGENDA, 2004, available at <http://www.globalagendazine.com/2004/suellenlazarus.asp> (last visited June 19, 2004).

⁸ The "Equator Principles" Preamble, available at <http://www.equator-principles.com/principles.shtml> (last visited June 19, 2004).

⁹ *Id.*

¹⁰ The "Equator Principles" Statement of Principles, available at <http://www.equator-principles.com/principles.shtml> (last visited June 19, 2004).

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ The "Equator Principles" Exhibit I: Environmental and Social Screening Process, available at <http://www.equator-principles.com/exhibit1.shtml> (last visited June 19, 2004).

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ The "Equator Principles" Exhibit II: IFC Safeguard Policies, June 4, 2003, available at <http://www.equator-principles.com/exhibit2.shtml> (last visited June 19, 2004); see also The "Equator Principles" Exhibit III: World Bank and IFC Specific Guidelines, June 4, 2003, available at <http://www.equator-principles.com/exhibit3.shtml> (last visited June 19, 2004).

¹⁹ For a complete list of sectors to which standards are adapted, see World Bank and International Finance Corporation, Environmental, Health and Safety Guidelines, available at <http://ifcln1.ifc.org/ifcext/enviro.nsf/Content/EnvironmentalGuidelines>

(last visited June 19, 2004).

²⁰ International Finance Corporation, Safeguard Policies, available at <http://ifcln1.ifc.org/ifcext/enviro.nsf/Content/Safeguardpolicies> (last visited June 19, 2004).

²¹ The “Equator Principles” Preamble, *supra* note 8.

²² The Equator Principles website, *supra* note 3.

²³ Banktrack, *Good Faith, Good Practice: Implementation and Accountability of the Equator Principles*, December 2003, available at <http://www.banktrack.org/> (last visited June 19, 2004) [hereinafter *Banktrack*].

²⁴ William Baue, *Will Equator Principles Deliver Social and Environmental Responsibility From Banks?*, June 5, 2003, SocialFunds.com, available at <http://www.socialfunds.com/news/article.cgi/article1140.html> (last visited June 19, 2004).

²⁵ Liz Klein, *An Environmental Agenda for the Future: Preserving the Environment and Strengthening the Economy*, SUSTAINABLE DEV. L. & POL. 27, 28 (2004).

²⁶ The “Equator Principles” Exhibit II, *supra* note 18.

²⁷ The “Equator Principles” Statement of Principles, *supra* note 10.

²⁸ *Id.*

²⁹ Philips, *supra* note 1.

³⁰ The World Bank, *The World Bank Operational Manual, Operational Directive: Indigenous Peoples*, September 1991, at 2, available at <http://ifcln1.ifc.org/ifcext/enviro.nsf/> (last visited June 19, 2004) [hereinafter *The World Bank Operational Manual*].

³¹ Banktrack, *supra* note 2, at 8.

³² Banktrack, *supra* note 2, at 10.

³³ Friends of the Earth, *Camisea Oil and Gas Project*, available at <http://www.foe.org/camps/intl/institutions/camisea.htm> (last visited June 19, 2004).

³⁴ Bank of America, *2002 Environmental Report Developing Country Lending Criteria*, available at <http://www.bankofamerica.com/environment/2000epr/section2.html> (last visited June 19, 2004).

³⁵ Banktrack, *supra* note 2, at 9.

³⁶ The World Bank Operational Manual, *supra* note 34, at 3.

³⁷ *Id.*

³⁸ *Id.* at 2.

³⁹ *Id.* at 6.

⁴⁰ *Id.* at 2.

⁴¹ See Banktrack, *supra* note 2 (reviewing the previous year’s controversial projects financed by Equator Banks and recommending ways to better adopt the Principles).

⁴² These mechanisms include the World Bank Inspection Panel, the Asian Development Bank Accountability Mechanism, the European Bank for Reconstruction and Development’s Independent Recourse Mechanism, and the NAFTA Commission on Environmental Cooperation.

⁴³ See Unibanco Press Release, *Unibanco Becomes the First Emerging Market Bank to Adopt the Equator Principles*, June 1, 2004 (illustrating that the first Brazilian Bank to adopt the Principles, bringing the number of institutions applying the Principles up to 25), available at http://www.ri.unibanco.com.br/arq/link/Equator_ingles.pdf (last visited June 19, 2004).

⁴⁴ *New Letter Signals ‘Equator Bank’ Division*, CLEAR PROFIT, May 2004 (arguing that several Equator Banks refused to sign a letter to the World Bank out of fear that the Principles were being used as a platform for joint lobbying against the World Bank’s policy on the oil and gas industry), available at <http://www.clear-profit.com/issues/cpmay04.txt> (last visited June 19, 2004).

⁴⁵ International Finance Corporation, Prepared Statement of Peter Woicke, Executive Vice President of the International Finance Corporation, Equator Principles Press Conference, June 4, 2003, available at <http://ifcln1.ifc.org/ifcext/equatorprinciples.nsf/> (last visited June 19, 2004).

⁴⁶ See Natsuo Nishio, *Mizuho to Adopt Environmental Standards in Project Financing*, DOW JONES NEWSWIRES, October 26, 2003 (demonstrating that with the inclusion of Japan’s biggest banking group, Mizuho Financial Group, the Equator Banks control about 80% of the global project financing business, making the Principles a de facto standard), available at <http://www.equator-principles.com/cnn2.shtml> (last visited June 19, 2004). See also Mizuho Corporate Bank News Release, *The Adoption of “Equator Principles”*, October 27, 2003 (affirming that as an international financial institution, Mizuho will establish high environmental and social standards in accordance with the Principles), available at http://www.mizuhocbk.co.jp/english/company/release/news_20031027.html (last visited June 19, 2004).