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# THE EQUATOR PRINCIPLES: TEN TEENAGE YEARS OF IMPLEMENTATION AND A SEARCH FOR OUTCOME

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**Olaf Weber and Emmanuel Acheta**

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## ABOUT THE AUTHORS

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## ABOUT THE PROJECT

The project plans to analyze the effect of the Equator Principles (EP) for project finance on both the sustainability impact of projects and on risk assessment procedures of financial institutions that have adopted the principles (EPFI). Based on the results, researchers will develop policy recommendations for improving the outcome of the EPs. Though the EPs are used by EPFIs globally their impact on both the sustainability of projects and on project assessment processes is still unclear. The project will contribute to an effective use of the EPs and to the environmental and social sustainability of assessed and financed projects.

**Project leader:** Olaf Weber

**Project member:** Emmanuel Acheta

## ACRONYMS

EBRD	European Bank for Reconstruction and Development
EP	Equator Principle
EPFIs	Equator Principles Financial Institutions
GHG	greenhouse gas
IFC	International Finance Corporation
IM & R	independent monitoring and reporting
LNG	liquefied natural gas
NGO	non-governmental organization
OECD	Organisation for Economic Co-operation and Development
SEIC	Sakhalin Energy Investment Company

## EXECUTIVE SUMMARY

The Equator Principles (EPs) for project finance were launched 10 years ago. These 10 years of existence can be equated to the phase of an adolescent still seeking to establish relevance in an atmosphere of flux and uncertainty. Equator Principles Financial Institutions (EPFIs) have increased from the original 10 founding members to 78 members as of November 2013, responsible for about 80 percent of the global project finance. This demonstrates that environmental and social assessment of projects is increasing in global adoption and scope. The analysis in this paper demonstrates that the EPs strive to redefine social and environmental assessment practices in order to integrate environmental and social needs into project assessments. On the other hand, critics reason that without fundamental implementation efforts and enforcement, the EPs are a mere window-dressing adventure and will not contribute to any change with respect to sustainable development. Of particular importance are gaps in how EPFIs address the implementation of the guidelines in project finance decision making, how they implement environmental and social assessment processes in practice and, perhaps more importantly, whether the implementation will have a positive effect on project sustainability. Future analyses and research should address these gaps.

## INTRODUCTION

EPs, launched 10 years ago, are a financial industry benchmark for managing environmental and social risks.<sup>1</sup> These 10 years of existence can be equated to the phase

<sup>1</sup> To learn more, see [www.equator-principles.com](http://www.equator-principles.com).

of an adolescent still seeking to establish relevance in an atmosphere of flux and uncertainty. This paper shows that as of November 2013, EPFIs have increased from the original 10 founding members to 78 members, which demonstrates that environmental and social assessment of projects is increasing in global adoption and scope; thus, prospective sustainability risks associated with project finance abound, taking three forms. The first is the risk to the environment, society and particularly the communities in which the projects are situated. Second are the environmental, social and sustainability risks that impact the financial performance of projects. Third are reputational risks for the financiers that are associated with financed projects. These risks drive and dominate the discussion agenda of EPFIs, non-governmental organizations (NGOs) and other stakeholders. The EPs, as also expected of recent private transnational regimes, continue to attract perspectives, debates and contestations in regard to implementation and compliance. This paper is based on a literature review comprising mainly academic literature, as well as a few non-academic sources. It outlines open questions about the EPs' characteristics for further, mainly empirical, research and discussion.

In recognition of a decade-long experience, application outcomes and stakeholder input, the EPs have undergone changes meant to share lessons learned, but also to proactively engage with evolving contemporary issues, concerns and stakeholders. Three changes have since evolved. First, from the EP Strategic Review Process, premised on the EP Association priorities and recommendations, such as climate change, changes in regard to EP scope and reporting have been made. Second, changes from the International Finance Corporation's (IFC) own evolving policies; the IFC being the other EP progenitor, in regard to sustainability issues and assessments thereof. Third, there are changes to address consistency and support implementation — specifically, information sharing, country designation and language clarification.

Unsurprisingly, therefore, the overall review of the EPs more than 10 years later is mixed. First, proponents argue that the EPs are touted as bold — if not visionary — principles that are on course to redefine social and environmental practices for the good of sustainable finance. In contrast, critics reason that without radical implementation and enforcement, the EPs are merely window dressing.

Even against the reservations identified in the literature, the EPs hold the promise and potential to contribute to social and environmental sustainability. For this to come to fruition, the present gaps in the EPs will need to be filled. Of particular importance are gaps in how EPFIs address the implementation of the guidelines in a project's finance decision making, how they implement it in practice and, perhaps more importantly, whether the implementation

will have a positive effect on project sustainability. Future analyses and research should address these gaps.

## HISTORY AND DEVELOPMENT OF THE EPs

Project finance is often used for financing large projects such as infrastructure- or energy-related projects. Because of their size, these projects — including power plants, chemical processing plants, mines and transportation infrastructure — often have a significant effect on the environment and communities located nearby, although the share of project finance in the total lending portfolio of finance institutions is rather small. Well-known examples of projects discussed in this paper, with respect to their environmental and societal impacts, are the Chinese Three Gorges Dam Project (Jackson and Sleigh 2000; Wu et al. 2004), the Turkish Ilisu Dam Project (Morvaridi 2004) and the Baku-Tbilisi-Ceyhan pipeline (Balch 2012). The discussion about such projects frequently centres on the trade-off between economic and developmental benefits on the one hand, and ecological and societal risks on the other hand.

In order to encourage responsible and sound environmental and social policies in project finance, major project financiers created the EPs in 2003. They are a credit risk management framework for determining, assessing and managing environmental and social risk in project finance transactions, and are an example of a voluntary code of conduct that is a direct offshoot of the environmental and social standards of the World Bank Group. The IFC, the World Bank Group's private sector lending arm, provided and continues to provide through internal policy revisions much of the present base of the EPs' environmental and social sustainability architecture.

It is worth noting that prior NGO attempts and the beginning of advocacy campaigns denouncing the excesses of financial institutions for social and environmental oversights began with the 2003 birth of the Collevocchio Declaration on Financial Institutions and Sustainability, widely considered an EP progenitor. The Declaration lists six commitments to be incorporated into financial operations: sustainability; “do no harm”; responsibility; accountability; transparency; and sustainable markets and governance. Financial institutions were requested to integrate these commitments into their business (O'Sullivan and O'Dwyer 2009).

As a response to NGO pressure, some of the biggest project finance institutions met in 2002 in order to draft environmental and social risk management principles for project finance (O'Sullivan and O'Dwyer 2009). The EPs were launched in 2003 by the banks presented in Table 1 (see also Balch 2012).

**Table 1: Founding EPFIs**

Founding Equator Banks	Country
ABN AMRO	The Netherlands
Barclays	UK
Citigroup	US
WestLB	Germany
Credit Lyonnais (Calyon)	France
Credit Suisse	Switzerland
HypoVereinsbank (Unicredit)	Germany
Rabobank	The Netherlands
The Royal Bank of Scotland	UK
Westpac	Australia

Source: O'Sullivan and O'Dwyer (2009).

Currently, 78 EPFIs have signed the principles. According to Paul Watchman (2006), when there were only 40 EPFIs, these institutions accounted for at least 80 percent of the worldwide project loan market. Thus, the 2013 market share of the EP signatories should be even higher. Table 2 demonstrates that 76 percent of the global project arrangers are signatories of the EPs. Consequently, we may state that globally the majority of project assessment should follow the EP guidelines where applicable.

The EPs are based on the IFC's performance standards of environmental and social sustainability (IFC 2011; 2012), and are structured in eight performance standards to be met by IFC clients. These standards are:

- assessment and management of environmental and social risks and impacts;
- labour and working conditions;
- resource efficiency and pollution prevention;
- community health, safety and security;
- land acquisition and involuntary resettlement;
- biodiversity conservation and sustainable management of living natural resources;
- indigenous peoples; and
- cultural heritage (IFC 2012).

The similarity between the IFC performance standards and the EPs can be seen in the following abbreviated list of the 10 EPs in their most current version. The following principles are process-oriented and a guideline in how to assess environmental and social issues. They do not, however, regulate the outcomes of the assessment.

The 10 EPs are (in abbreviated version):

1. Review and categorization: EPs describe three risk categories (A, B and C)<sup>2</sup> as categorized in IFC's social and environmental screening criteria.
2. Environmental and social assessment: A mandatory prerequisite for the client seeking financing and required to be done to the satisfaction of an EPFI.
3. Applicable environmental and social standards: For projects located in non-Organisation for Economic Co-Operation and Development (OECD) countries, and in those not designated as high income, the assessment will refer to the applicable IFC performance standards and the applicable industry specific Environment, Health, and Safety Guidelines.
4. Environmental and social management system and EPs action plan: Drawing upon results of EP III and conclusions thereof, the client/borrower must prepare action plans describing and prioritizing between mitigation measures, monitoring and corrective actions, the appropriate details of which align with the potential severity of anticipated risks.
5. Stakeholder engagement: This is required for category A and B projects. It requires the client, host country or third party expert to engage with affected communities in a culturally appropriate manner, seeking their free, informed and prior consent about the project.
6. Grievance mechanism: The EPs require that the client establish a grievance mechanism appropriate to the level of risks and adverse impacts of the projects and whose existence should be brought to the attention of the affected communities.
7. Independent review: The EPs require an "independent expert" — independent of the borrower — to review documents on social and environmental assessment, environmental and social management systems, and environmental performance assessment procedures to inform on the due diligence process.
8. Covenants: This refers to covenants with the host country, compliance with the assessment procedure, periodic reports and, where applicable and necessary, a decommissioning plan.

<sup>2</sup> The categories are as follows: category A — projects with potential significant adverse social or environmental impacts that are diverse, irreversible or unprecedented; category B — projects with potentially limited adverse social or environmental impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures; and category C — projects with minimal or no social or environmental impacts (The EPs 2013).

**Table 2: Biggest Mandated Project Arrangers in 2012**

Project Arranger	Country	EP Member
Mitsubishi UFJ Financial Group	Japan	Yes
State Bank of India	India	No
Sumitomo Mutsui Financial Group	Japan	Yes
Mizuho Financial Group	Japan	Yes
Korea Development Bank	South Korea	No
HSBC Holdings PLC	UK	Yes
Crédit Agricole CIB	France	Yes
Société Générale	France	Yes
BNP Paribas SA	France	Yes
BBVA	Spain	Yes
Lloyds Bank	UK	Yes
Commonwealth Bank of Australia	Australia	No
ING	The Netherlands	Yes
National Australia Bank	Australia	Yes
Standard Chartered PLC	UK	Yes
IDFC Ltd	India	Yes
UniCredit	Italy/Germany	Yes
ICICI Bank Ltd	India	No
Axis Bank Ltd	India	No
ANZ Banking Corp	Australia	Yes
Citigroup	USA	Yes
RBC Capital Markets	Canada	Yes
KfW IPEX-Bank GmbH	Germany	Yes
Santander	Spain	Yes
Oversea-Chinese Banking	China	No

Source: Thomson Reuters (2013).

9. Independent monitoring and reporting (IM & R): A client will retain an IM & R expert for category A and B projects where “appropriate.”
10. Reporting and transparency: The EPFIs will annually report on their implementation outcomes or report frequently or scaled to the severity of potential risks. For example, EP III requires online reporting (The EPs 2013).

The magnitude of the potential impact of a project is categorized in three classes as EP 1 constitutes (The EPs 2013). In order to illustrate environmental and social issues to be addressed in a project assessment, the EP document lists a number of potential issues (ibid.), such as baseline social and environmental conditions, consideration of environmental and social alternatives, human rights, regulations, laws and treaties, and sustainable management and use of renewable natural resources. The list, however, only includes examples and is neither exhaustive nor exclusionary.

## PROJECT FINANCE

The EPs focus on project finance, which may take the form of financing the construction of a new capital installation or the refinancing of an existing installation, with or without improvements. A non-recourse debt is often used for capital investing. In such transactions, the lender is usually paid solely, or almost exclusively, out of the capital generated by the contracts for the projects output, such as the electricity sold by a power plant.

The borrower is usually a special purpose entity, also called a legally independent project company, which 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 its assets. Additionally, the loan sum of projects is usually very high; about 50 percent of financed projects cost more than US\$1 billion. Consequently, they are financed mostly through syndicated loans with more than one lender.

Globally, project finance-related loans were US\$197.5 billion in 2012, down from US\$223.4 billion in 2011 (Thomson Reuters 2013); were this amount a country's GDP, it would be ranked around fiftieth globally. The share in the total financial product portfolio, however, is rather small given that, for instance, global banking assets in 2010 were higher than US\$10 trillion.

Though the portion of project finance in the financial market may be small, the impact of projects may be caused by their size and their sectors. The biggest project completed in 2012 was Ichthys LNG Pty Ltd in Australia, an offshore natural gas field with US\$16 billion. Five out of the 10 biggest projects in 2012 were in the oil and gas sector, followed by two projects in transportation, and one in leisure and property, power, and industry, respectively. In total, the 10 biggest projects globally comprised a package of US\$55 billion. The average project proceeds in 2012 were US\$365 million with power, transportation, leisure and property, oil and gas, and mining as the five biggest sectors (Thomson Reuters 2013). Other studies mention natural resources — such as mines, pipelines, oil fields and infrastructure (toll roads, bridges, telecommunications systems and power plants) — as the most common applications of project finance (Esty 2004).

## PROJECT FINANCE SUSTAINABILITY RISKS

What are project finance sustainability risks? In order to understand the type and the scope of these risks, we discuss the controversial Sakhalin II project. It is by no means a typical or representative project, but illustrates the complexity, impact and size of a project funded by project finance. A systematic analysis of sustainability risks of projects is still to be conducted.

### THE SAKHALIN II PROJECT

Sakhalin II is the second phase of the biggest integrated oil and gas project, and it includes the largest liquefied natural gas (LNG) processing facilities ever built. The first phase (Sakhalin I) began in 1999, before beginning its second phase 10 years later. Sakhalin II is operated by a consortium that consists of Gazprom Sakhalin (50 percent plus one), Shell Sakhalin (27.5 percent minus one), Mitsui Sakhalin (12.5 percent) and Diamond Gas (10 percent), and is better known as Sakhalin Energy Investment Company (SEIC) (see Table 3). The Sakhalin II project embodies a degree of complexity because its host country, Russia, strives to position itself as an energy player under the state-owned energy company Gazprom. True to the EPs' definition of project finance as large, complex and expensive projects, Sakhalin II was initially estimated at US\$10 billion but doubled to US\$20 billion in 2005, pending full and complete costing of residual incoming contract costs (Bradshaw 2007).

The oil and gas development is located on the 76,400 km<sup>2</sup> Sakhalin Island off the coast of Russia, between the Sea of Okhotsk and the Sea of Japan. Sakhalin II is made up of three offshore platforms, offshore and onshore pipelines, a processing facility on the island, an LNG facility and an oil export terminal.

SEIC's investments, along with its proposed expansion into Sakhalin III, are under discussion due to serious social and environment assessment issues and potential impacts (Bradshaw 2007). In a 2006 report by UK-based Friends of Earth and World Wildlife Fund, the key concerns of environmental activists is the danger posed to endangered western gray whales (Friends of the Earth 2006). For example, the report argues that the pipelines have a disruptive effect on whales' breeding and feeding stream beds, and the salmon's spawning streams and migratory pathways (*ibid.*).

Furthermore, environmental NGOs argue that Aniva Bay, the home base of the oil and gas field's export terminal, falls under the course of toxic oil and gas effluents from project activities, affecting the area's ecosystem and, particularly, fishing activities. In addition to these concerns are the potential of disruptive seismic activities to subterranean oil pipelines in the area and the increased marine traffic facilitating oil shipment. NGOs argue that these would facilitate circumstances for a future oil spill disaster. Another continuing issue is the unknown and incalculable impact on endangered species, including 11 bird species listed in the Red Book of the International Union for the Conservation of Nature, 22 listed in the Red Book of the Russian Federation and 39 species listed in the Red Book of the Sakhalin Region.<sup>3</sup> The report indicates that fishing is a source of food for the Nivkh peoples, but since 1999, the locals suggest that they have seen the fish stocks fall dramatically, an incidence they attribute to Sakhalin project activities.

In the course of the development of this integrated oil and gas project, SEIC has encountered criticism from multiple stakeholders. European Bank for Reconstruction and Development (EBRD) — then a potential funder — characterized SEIC's 2003 environmental and social impact assessment as unacceptable and pulled out of the project.

In contrast to NGO criticism, project financiers and investors argue that the Sakhalin project adds 4.5 percent to the world's LNG capacity, meeting 9.5 percent of Japan's and six percent of South Korea's gas needs.<sup>4</sup> Furthermore, Gazprom (one of the major project sponsors) argues that it takes social responsibility and nature conservation seriously, actively working with all stakeholders in

3 See [www.banktrack.org](http://www.banktrack.org).

4 See [www.shell.com/global/aboutshell/major-projects-2/sakhalin.html](http://www.shell.com/global/aboutshell/major-projects-2/sakhalin.html) for more details.

**Table 3: Financial Institutions Involved in Sakhalin Project Financing and Advising**

Financial Institution	Product/Service	Sum (in US\$ billion)	EPFI
Bank of Tokyo Mitsubishi UFJ, Japan	Corporate loan	358	Yes
Barclays, UK	Corporate loan	19.1	Yes
BNP Paribas, France	Corporate loan	3.825	Yes
Credit Suisse Group, Switzerland	Advising, corporate loan	1.7	Yes
Mizuho, Japan	Corporate loan	0.358	Yes
Royal Bank of Scotland, UK	Corporate loan	7.45	Yes
Société Générale, France	Corporate loan	2	Yes
Standard Chartered, UK	Corporate loan	0.3	Yes
Sumitomo Mitsui Banking Corporation, Japan	Corporate loan	0.7*	Yes

Source: [www.banktrack.org](http://www.banktrack.org).

Japan Bank for International Cooperation is involved as an export credit agency; Sumitomo Mitsui Bank loan is estimated. \*Estimated on the basis of involvement in Sakhalin I.

order to achieve a balance between social, economic and environmental factors.<sup>5</sup> These activities contributed to Sakhalin Energy's win of the People-Investor Contest 2013, which awards best and innovative practices of socially responsible business.<sup>6</sup>

The Sakhalin project description and its financing institutions demonstrate that nearly all involved financiers are EPFIs and, therefore, should have followed the EP guidelines. It seems, however, that the application of the EPs does not create a much clearer picture with regard to project sustainability. The questions are why the project is criticized significantly by environmental NGOs and why some financial institutions, such as EBRD, have pulled out of the project on the one hand, and why it is rewarded with corporate social responsibility awards and supported by other significant financiers on the other. The Sakhalin project demonstrates the global nature of project finance. The syndicate financing Sakhalin consists of financiers from four countries that are regulated differently and investing in a project located in a third country. The project fulfills characteristics that are typical for project finance: large size; significant social, economic and environmental impacts; international collaboration; different, and sometimes conflicting, interests of stakeholders; and long-term effects.

As the description of the Sakhalin project demonstrates, project finance is often connected with sustainability risks. There are usually three types of sustainability risks associated with project finance:

- Financed projects have an impact on the environment and communities in the region where the project is implemented, termed the "inside-out relation" (Porter and Kramer 2006). This is valid for many business activities. Big projects, however, create more significant impacts than smaller business activities.
- The projects itself may be impacted by environmental or societal risks. This refers to the so-called "outside-in relation" (ibid.). The income of a project may suffer from environmental risks, such as extreme weather events, strikes by people working for projects, or NGO or government blockades. Consequently, these risks have an impact on the project's financial return and on the project financier.
- Projects are subject to reputation risks. Controversies in the news or on websites may not only affect project sponsors, but project financiers as well. Nearly all EP signatories have already been criticized on popular websites and news channels, with respect to their involvement in controversial projects, in the roles of project financier, financial consultant or others.<sup>7</sup>

Having introduced the main sustainability risks of project finance, we will describe the EPs as a private code of conduct founded to help managing sustainability risks.

<sup>5</sup> See [www.gazprom.com/nature/ecology/](http://www.gazprom.com/nature/ecology/) for more information.

<sup>6</sup> See [www.sakhalinenergy.ru/en/media-centre/news/item.wbp?article\\_id=0854a25a-2172-4df2-93c7-80b4f0f998b0&date=05%C2%A0December%C2%A02013](http://www.sakhalinenergy.ru/en/media-centre/news/item.wbp?article_id=0854a25a-2172-4df2-93c7-80b4f0f998b0&date=05%C2%A0December%C2%A02013) for more information.

<sup>7</sup> For example, Credit Suisse was criticized for its role as a financial advisor for the Sakhalin project. See [http://wwf.panda.org/wwf\\_news/press\\_releases/special\\_coverage/sakhalin/](http://wwf.panda.org/wwf_news/press_releases/special_coverage/sakhalin/). A Google search for Credit Suisse and Sakhalin returns more than 80,000 hits.

## THE EPs AS AN EXAMPLE OF A PRIVATE CODE OF CONDUCT

Regulations were issued without exception by public regulatory bodies for a long time. The traditional position has always been that the nation-state commands the means and capability to superintend business activities and backs it up with coercive power in necessary circumstances. Recent regulatory examples and crises, such as the last financial crisis, show, however, that public regulation can fail, may be too weak or does not interfere deliberately.

In addition to public, state-based regulation, two other forms of governance exist. On the one hand, international regulations occur in order to regulate issues of international impact that are increasing as a result of globalization. On the other hand, NGOs introduce private codes of conducts and regulations in order to self-regulate, and to design and enforce rules on themselves (Haufler 2013; Abbott and Snidal 2009). Accordingly, various organizations have each set regulatory architectures and standards to self-regulate.

Industrial self-regulation comprises a variety of issues, such as quality standards or assurance (i.e., the International Organization for Standardization), reporting standards (i.e., The Global Reporting Initiative) or environmental issues (i.e., Responsible Care, a regulatory scheme for the Chemical Industry [Barnett and King 2008; Bernstein and Cashore 2007] and the Carbon Disclosure Project, whose members commit to publish their carbon emissions in a database [PWC and Carbon Disclosure Project 2013]). Within the financial industry, a response to this governance evolution has taken the form of voluntary codes of conduct or, more accurately, transnational private regulations for institutional investors (i.e., the Principles for Responsible Investment [2012]), for banks and the insurance business (i.e., the UNEP Finance Initiative [2012]) and for project finance (i.e., the Equator Principles [The EPs 2013]). All of the codes of conduct are process oriented instead of outcome oriented. Most of them do not impose any consequences on their signatories in case of non-compliance.

Voluntary codes of conduct reflect an organization or firm's attempt to convey a positive image by subscribing to a conduct that is responsive to a normative socio-environmental gap. Thus, by subscribing private codes of conducts, organizations can respond to reputational challenges (Wright and Rwabizambaga 2006; Thistlethwaite 2012). The literature on voluntary codes points to two streams of scholarships — the first suggests a normative persuasion, as when corporations adopt generally accepted behaviour, which earns trust among stakeholders (Bondy, Matten and Moon 2004), and, consequently, legitimizes corporations to conduct their business (Suchman 1995). This stream is called the normative view.

The second stream, called the instrumentalist view, of voluntary codes states that voluntary codes help shape corporate objectives towards some altruistic ends, the ultimate outcomes of which are profits. The past and current spectre of human rights abuse associated with outsourcing, as well as negative environmental impacts of large projects, are some rationales for adopting voluntary codes.

Other scholars assert that codes of conduct are a formalization of corporate values or practices designed to guide behaviour of business and enable them to manage different political, social and economic cultures in international business. Consequently, signing private codes of conduct comes from a desire to control stakeholders instead of a motivation to become more environmentally, economically and socially responsible (Bondy, Matten and Moon 2008). Bondy, Matten and Moon (2004) further assert that voluntary codes, such as the EPs, typically signal an intention towards corporate social responsibility and have certain stakeholders as intended targets. The EPs, then, are often couched in blanket statements lacking in specificity. And so it is not uncommon for an infrastructure project, especially situated in poor countries, to build a school or a health facility in order to demonstrate corporate citizenship, instead of focussing on the environmental, social and sustainable performance of the project itself.

## EP REVISIONS

Since their launch in 2003, the EPs have undergone three revisions (see Table 4). The first was conducted in 2006 (EP II), the second in 2012 and the third in June 2013 (EP III). These revisions were motivated by three drivers. First, they are a result of priorities and recommendations from the EPs' strategic review, with substantial input provided by project finance players, facilitators and civil society. Second, revisions were conducted due to changes in the IFC performance standards, which deliver the environmental and social criteria for the EPs. Third, changes were applied in order to address consistency and to support EP implementation. As indicated in this paper, the impetus for these revisions is also due to public pressures by NGOs such as BankTrack and the Berne Declaration.<sup>8</sup>

It is perhaps fair to observe that the first revision in 2006 may have been backward looking in the sense that the EPs had been operational for three years. As such, much of its first revision was conducted as a response to the "first test" of implementation. The second revision went beyond the lessons and experiences of the first review to include both contemporary and rapidly evolving issues, such human rights and climate change. Table 4 and the following sections present these changes in detail.

<sup>8</sup> See [www.banktrack.org](http://www.banktrack.org) and [www.evb.ch/en](http://www.evb.ch/en), respectively, for more information.

**Table 4: Changes in the EPs Versions I, II and III**

Topics	Version I	Version II	Version III
	<b>Changes reflecting priorities and recommendations from the EP strategic review</b>		
<b>Scope</b>	Lending	Lending, project finance advisory	Project finance, advisory, project-related corporate loans, bridge loans
<b>Reporting</b>	No format required	High-level reporting: number of transactions screened and closed	Minimum requirements: number of projects closed, including categorization, sector, region and whether an independent review has taken place. Project names for project finance deals (subject to client consent)  Online summary of environmental and social impact assessment
	<b>Changes to align with updated IFC standards</b>		
<b>Sustainability Issues</b>	Environmental assessment (no social risks, climate change not mandatory)	Social risks due diligence, free prior informed consultation.  Climate change as part of World Bank guidelines and general due diligence	Social and relevant human rights due diligence  Free prior informed consent. Addressing human rights  Guiding principles on Business and human rights and UN Protect Respect and Remedy Framework  Climate change: Attention in due diligence for high emitting projects
	<b>Changes to address consistency and support implementation</b>		
<b>Information Sharing</b>		Informally	Formalized approach to share information related to environmental and social matters with other mandated financial institutions
<b>Country Designation</b>	Assessment in high-income OECD countries equivalent to IFC standards	Assessment in high-income OECD countries a substitute for IFC standards	Assessment process in designated countries (EP list) equivalent to IFC standards
<b>Glossary of Terms</b>			Glossary of terms for loan documentation
<b>Implementation Notes</b>	*Best practice	For loan documentation	For loan documentation.  Under development — implementation notes for climate change reporting requirements, and questions and answers on scope.

Source: Authors, EPs.

\*As per internal EPFI procedures and policy.

## CHANGES REFLECTING PRIORITIES AND RECOMMENDATIONS FROM THE EP STRATEGIC REVIEW

Regarding their scope, the 2012 revision (which culminated in EP III) expanded the 2006 requirements to include project-related loans and bridge loans. The EPFIs perhaps realized that these modes of financing, despite their relatively short maturity and size, could potentially aid in abating unsustainable social and environmental project finance activities. It was also, however, an ultimate recognition on the part of EPFIs, and to some extent an appeasement to civil society, especially BankTrack. BankTrack had argued incessantly that EPFIs needed to widen their assessment and compliance activities to include these hitherto untouched areas, including the need to respect human rights and climate change. The response was to additionally disclose the number of transactions screened.

With respect to reporting, the EPs no longer require only information on implementation, but also the structure and

staffing personnel involved with implementation. This includes mandatory details on training during the first year of EP adoption in order to demonstrate progress in addressing the EP assessment procedures and training events.

The third version of the EPs also addresses clients' public reporting. Prior to EP III, there was no requirement to do so. By public reporting, the EPs mean, "Online summary of Environmental and Social Impact Assessment, as well as [reporting] Greenhouse Gas (GHG) emission levels for projects emitting over 100,000 tonnes of CO<sub>2</sub> annually during operational phase" (The EPs 2013). This new guideline accepts the importance of addressing emissions of financial sector clients, so-called indirect, or financed, emissions (Collins 2012).

## CHANGES TO ALIGN WITH THE UPDATED IFC PERFORMANCE STANDARDS

Regarding social issues, in the second version of the EPs, two major subcategories were social risk due diligence

and free, prior, informed consultation (The EPs 2011). With the advent of EP III, more focus and emphasis are laid on the issue of human rights, reflecting their role as a contemporary and increasingly emerging issue. Instances of deleterious effects of projects on human rights are the Baku-Tblisi-Ceyan oil pipeline (Waters 2003), or the Kajbar and Dal hydropower projects in Sudan (Bosshard 2011). Perhaps it is the EPs' intention to reiterate that as affected by or as the affecting element of project finance, human beings are, after all, the focus of socio-environmental policies of project finance. It is this anthropocentricity of project finance that has led the EPFIs to expand social risks, indicating particular focus on relevant human rights due diligence such as free, prior and informed consent, instead of consultation.

In 2006, for the first time, changes were introduced regarding climate change. EPFIs were to report on climate based on the World Bank Group's environmental, health and safety guidelines and general due diligence. The revised EP III highlights in its preamble the need for heightened due diligence, requires alternative analysis of high-emitting projects in line with IFC's performance standard 3 and focusses on climate change issues. Finally, the EPs had integrated climate change issues into their agenda. Perhaps the most salient aspect with respect to climate change is a mandatory requirement for projects emitting more than 100,000 tonnes per year to report their GHG emission. Projects emitting at least 25,000 tonnes are encouraged, but not required, to report the GHG emission.

## CHANGES TO ADDRESS CONSISTENCY AND SUPPORT EP IMPLEMENTATION

Prior to 2013, EPFIs conducted information sharing informally, as might be expected in most competitive industries. Pagano and Jappelli (1993, 1693) argue, however, that "information sharing may increase the degree of competitiveness within credit markets, increase the efficiency in the allocation of credit, increase the volume of lending, and may also have policy implications." With the most recent EP revision, EPFI members agree to share social and environmental issues with other mandated financial institutions.

Changes were also conducted with respect to designated countries. These are countries with robust environmental and social governance, legislation systems and institutional capacity designed to protect their people and the natural environment (The EPs 2013). As per the last EP revision leading to EP II, these countries operated with assessment and approval processes that were seen as acceptable substitutes for the IFC performance standards. Thus, the noticeable change is that designated countries are high-income OECD countries, and the appropriateness of this list is a subject of current review.

First introduced in 2006 as guidelines for loan documentation, implementation notes are under development with regard to climate change and reporting requirements. These notes set the stage for internal EPFI orientation in this regard. They address the implementation of the EPs in their member institutions, an issue that has been neglected during the earlier years of the EPs.

The changes indicated above mean that the EPs continue to evolve against the background of a rapidly shifting socio-environmental landscape. Some changes or pressures for change have been civil society-driven, notably from BankTrack. Others have emanated from internal policy changes within the World Bank Group, particularly the IFC, which provides the basis for many of EP revisions. Undoubtedly, all of these changes have affected project communities in one way or another, but some important issues still remain unclear in the third version of the EPs. These issues are:

- Potential liabilities for environmental infractions involving, for example, pollution, would likely depend on the host country regulators. The disclaimer in the EPs, unfortunately, disavows this and any potential project liabilities. Project tracking of emissions may be a first step, but the question then would be, to what end? Would repeated violations of this requirement potentially lead to project decommissioning? How feasible is this alternative, given that it may set off domino effects leading to potential client default on loan obligations?
- A particular problem of the EPs' requirement to disclose CO<sub>2</sub> emissions is the validity of the estimation and the measurement of GHG emissions, if external auditors do not verify them. Another problem is the willingness of the project to disclose the emissions.
- Apart from required involvement in learning events to better internalize the EPs' requirements and to share mutual experiences, there is lack of specificity in exactly how EPFIs are to engage in information sharing. If EPFIs limit themselves with respect to information sharing, because of trade secrets or customers' privacy, of what value, then, is this arrangement? If it is unenforceable, as it is, does not sharing information constitute a breach of the EPs' governance rules, given that these are only voluntary codes?
- With respect to the new proposal on designated countries, this paper notes that even high quality standards, as those deemed in these countries, may not fulfill IFC criteria. Canada, for instance, is criticized for how it assesses and qualifies the risks of the oil sands business, and while the Royal Bank of Canada announced in 2004 that it has applied the

EPs to an oil sands project in Canada (Miles 2013), environmental regulations should already be in place that make the EPs' guidelines unnecessary.

## CONCLUSION: THE EPs — A SUCCESSFUL TOOL OR WINDOW DRESSING?

Almost a decade after the launch of the EPs, there is still a mixed verdict as to their implementation outcomes. On one end of the spectrum, proponents laud their usefulness, though in seemingly measured tones. At the other end, and this seems to be in the majority of papers and comments on the EPs, many authors state that the EPs, though constructed as bold and voluntary — if not visionary — suffer from timid implementation or seemingly slow learning on the part of EPFIs (Schepers 2011; Spitzack 2009). This often contrasts with other organizations and institutions that have the benefit of implementation experience, such as the World Bank Group. Consequently, these 10 years of existence can be equated to the phase of an adolescent still seeking to establish relevance in an atmosphere of flux and uncertainty.

A small research stream of scholars, however, straddles both worlds, asserting that the problems are not the EPs themselves, but rather the the EPFIs (Amalric 2005; Conley and Williams 2011; Wright and Rwabizambuga 2006; O'Sullivan and O'Dwyer 2009). The preamble to the EPs states that “[t]he Equator Principles are intended to serve as a common baseline and framework for the implementation of each EPFIs internal environmental and social policies, procedures and standards related to its project financing projects” (The EPs 2013, 2). Therefore, differences in implementing the respective procedures arising from variations of each EPFI's organizational, strategic management and lending practices create a variety of applications of the EPs inside the EPFIs. The existing implementation guidelines that can be found in the third version of the EPs attempt to mitigate some charges levelled against EPFIs for inconsistency in implementation and absence of unified monitoring efforts. The question is if it will ever be possible to create a benchmark for EP implementation. Without such a benchmark, however, it will not be possible to assess the performance of project financiers with regard to implementing the EPs.

Because of the size and the scope of projects that focus on energy, transportation, oil and gas, and mining, the economic, societal and environmental impact of projects and project finance is significant, though it is not a major part of the lending portfolios of many banks and other financial institutions. Projects are often financed in third-party countries through syndicated loans with international participants. Because of the international scope of project finance, national regulations are often

not applicable. The EPs, especially EP III, try to solve this problem.

Three main sustainability risks are connected with project finance: First, projects have an impact on the environment, society and communities affected by projects. Second, environmental, societal and sustainability risks may have an impact on the financial performance of projects. Third, projects are subject to reputation risks. It seems that the discussion around EPs mainly focusses on reputation risks. Though many EPFIs installed expert teams for social and environmental assessments, analyses of the implementation of the EPs and the impact on financing decisions on projects and on project financiers are still rare.

The EPs were founded as a reaction to NGO criticism in order to legitimate the activities of project financiers (O'Sullivan and O'Dwyer 2009). Thus, the question is still open whether they will stay a reactive measure to legitimate project finance and to enhance reputation, or whether they are an effective guideline to guarantee the sustainability of projects. To paraphrase Porter and Kramer (2006), will they stay an instrument that manages outside-in relations of financiers or will they be able to regulate the inside-out relations and therefore the societal impact of project finance?

The EPs' revisions erased inconsistencies, advanced the transparency and improved the applicability of the principles. NGO demands for compliance mechanisms in cases of non-compliance of EPFIs with the EPs, however, have not been addressed yet.

The analysis of the EPs conducted in this paper identified gaps in the literature that should be analyzed in the future. One such gap is the question about the implementation of the principles. How are the EPs implemented into the project finance decision-making process and how do they influence project assessment beyond social and environmental factors? A second gap exists with respect to the application of the principles. How do the EPFIs apply the principles and how do they inform stakeholders about the implementation process? If the EPs are applied, what consequences does the application have for projects? Do they become more sustainable and take environmental and social issues into account more than without the EPs? Lastly, an analysis should be undertaken on how the EPs, as a guideline for a relatively small part of the lending portfolio, influence the general sustainability of financial products and services of EPFIs beyond project finance. These gaps should be addressed in future analyses and research.

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