NATURAL ENVIRONMENTAL RISK MANGEMENT IN FINANCIAL SECTOR: A STUDY ON EQUATOR PRINCIPLES

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ABSTRACT

Natural environmental risk management is not a new agenda in financial sector business activities. It has received great attention worldwide through the critics of financial sector that involve directly in natural environmental issues. Because of this development, in 1992 United Nation (UN) had introduced United Nation Environmental Programme as code of conduct containing principles that banks should follow if they are to deal with natural environmental issues in the running of their business. Due to this development, in 2002, ten commercial banks held a meeting in London to discuss environmental and social issues in project financing. Four banks, ABN Amro, Barclays, WestLB, and IFC, presented case studies on past projects which had attracted controversy because of environmental and social issues. The meeting led to establishment of Equator Principles (EPs) known as code of conduct for financial institution to deal with natural environmental issues in project financing. From the study, it showed that natural environmental issues has big impact towards financial sector and realizing this phenomenon, financial sector has taken proactive role by introducing EPs.

Keywords: *Natural environmental risk management, Equator Principles, Environmental management*

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INTRODUCTION

Natural environmental risk management is not a new agenda in financial sector business activities. It has received great attention worldwide through the critics of financial sector that involve directly in natural environmental issues. Because of this development, in 1992 United Nation (UN) had introduced United Nation Environmental Programme as a code of conduct containing principles that banks should follow if they are to deal with natural environmental issues in the running of their business.

Due to this development, in 2002, ten commercial banks held a meeting in London to discuss environmental and social issues in project financing. Four banks, ABN Amro, Barclays, WestLB, and IFC, presented case studies on past projects which had attracted controversy because of environmental and social issues. The meeting led to establishment of Equator Principles (EPs) known as code of conduct for financial institution to deal with natural environmental issues in project financing.

The study is descriptive in nature in order to explore on the development of natural environmental risk management in the financial sector that led to the establishment of EPs. For that purposes, the study will explore issues such as frameworks for natural environmental management in financial sector, historical development of EPs, the EPs guidelines, and benefit of the EPs from financial sector perspective. From the study, it showed that natural environmental issues has big impact towards financial sector and realizing this phenomenon, financial sector has taken proactive role by introducing EPs. However, the study found that none of the Malaysian banks participated in EPs.

FRAMEWORKS ON NATURAL ENVIRONMENTAL PROTECTION IN FINANCIAL SECTOR

According to Hill (2007), the World Bank led the way for the incorporation of environmental and social policies into lending decisions in the late 1980s, when it reformed its lending policies and began focusing on increasing transparency and accountability. In 1997, the World Bank announced an innovative set of guidelines aimed at responsible lending and sensitivity towards environmental and social welfare. These guidelines required borrowers to attend consultations, conduct monitoring, and report on their progress in meeting these requirements. This development strengthened in 1998 when the IFC formally adopted these policies and, as a result, they became the foundation for the IFC's work in environmental and social areas and for the assessment of IFC compliance and accountability. The change in the attitude of the World Bank and IFC had a dramatic influence on private sector lending. The guidelines used by the IFC are used by Equator Banks in project financing implementation (Hill, 2007).

Government laws for social and environmental protection are provided by each country but such laws have different standards and variable implementation quality. For example, a developing country has less stringent implementation rates than a developed country. Blackman (2008) reported that policy makers in developing countries face an array of barriers to enforcing mandatory regulations, including weak institutions, incomplete legal foundations, and limited will.

Sinclair (1997) and Stoeckl (2004) argued that the attraction for self-regulation results from a 'natural tendency' amongst individuals and organisations to prefer to act on their own initiatives rather than be forced into a particular course of action. Also, firms facing a choice between self-regulation and government-imposed regulation may choose self-regulation because government regulations are more costly and inflexible (Lenox and Nash, 2003).

In Coulson's (2009) study of European banks, participants felt international standards were hard to enact in practice. In their view, different legislative environments obstructed consistent global standards and led to banks' global policies being implemented differently in each operating country. Banks were arguably being forced to act in unison to find solutions to the problem of environmental governance and defend their market practice.

EQUATOR PRINCIPLES (EPS)

The Equator Principles (EPs) were originally announced on June 4, 2003. The EPs comprise a set of guidelines for managing social and environmental issues related to the financing of projects. They consist of a common and coherent set of environmental and social policies and guidelines that can be applied globally and across all industrial sectors.

The Equator Principles are the financial industry's response to external and internal pressures from governments, governmental agencies, socially responsible investment funds, international advocacy groups, and NGOs, to fulfil its corporate social responsibility (CSR) obligation by accepting responsibility for assessing and monitoring the environmental and social impacts of financing major projects. Pressure exerted on financial institutions by stakeholders for sustainable and responsible banking has been led by several prominent socially responsible investors, such as F&C Asset Management, Insight Management, and the Calvert Group of Funds. NGOs which have exerted pressure include organisations like *Banktrack*, the World Wildlife Fund for Nature (WWF), and Friends of the Earth (FoE).

The EPs comprise a voluntary set of guidelines for promoting social and environmental responsibility in project financing. That is to say, the Principles specifically address the negative effects of project financing. Wright and Rwambizambuga (2006); Richardson (2005); and Scholtens and Dam (2007) classified EPs as a third party code of conduct. Therefore, banks adopt and implement these Principles voluntarily and independently.

The EPs provide a framework, based on International Financial Corporation (IFC) safeguard policies, which commit each of the Equator Banks to develop its own individual policies, practices and procedures to ensure proper assessment and evaluation of social and environmental issues in project financing. The banks pledge to apply the EPs' framework to all projects with a capital cost above US$10 million, in all industries globally, and commit not to provide loans directly to projects where the borrowers are unable to comply with the EPs' environmental and social policies.

HISTORICAL DEVELOPMENT OF THE EQUATOR PRINCIPLES (EPS)

Misbach (2004) has stated that in the 1990s there was a dramatic change in the composition of financial flows. Private financial institutions outstripped governmental and multilateral development financing as they provided finance for the building of large dams, oil pipelines, and large infrastructure projects, which had previously been financed by the World Bank and other multilateral development banks. Wright and Rwambizambuga (2006) reported that between 1990 and 1997, the number of commercial banks financing infrastructures in developing countries increased nine-fold, and the annual amount of project finance deals exploded from less than US$5 billion to over US$50 billion.

This scenario attracted the attention of NGOs, especially when the World Bank rejected the financing of projects due to environmental and social concerns, for example, the OCP-Pipeline in Ecuador, the Three Gorges dam in China, and the Ilusu dam in Turkey. The ABN Amro Bank experienced problems when financing a mining project in Papua New Guinea that severely contaminated the local water supply (Scholtens and Dam, 2007). In 2001, the Rainforest Action Network (RAN) began campaigning against Citigroups' funding of old growth logging projects and an oil pipelines through an Ecuadorian nature reserve (Richardson, 2005).

Coulson (2009) has contended that the above situations urged financial institutions to establish environmental thresholds. In addition, the absence of adequate public regulation at an international level, differing environmental legislation, and inconsistency in global standards led to banks' global policies being implemented differently in each operating country. As a result, banks had to act in unison to find a solution to the problem of lack of consistent environmental governance and to defend their market position. According to Scholtens and Dam (2007), such action began when ABN Amro approached the IFC with concerns that there were no established principles to guide lending decisions when it came to social and environmental risk, concerns that had arisen during the course of its financing of a mining project in Papua New Guinea.

As a result, ten commercial banks and the IFC held a meeting in London in October 2002 to discuss environmental and social issues in project financing. Four banks, ABN Amro, Barclays, WestLB, and IFC, presented case studies on past projects which had attracted controversy because of environmental and social issues. The meeting led to the decision to develop a framework to deal with environmental and social issues for consideration by other banks and then produce a set of guidelines on environmental and social risk in project financing.

In the draft version, guiding principles were labelled the Greenwich Principles. The draft version was sent out for comments by other banks, the IFC, NGOs, and clients (Scholtens and Dam, 2007). Finally, on 4th June 2003, ten leading banks from seven countries announced the adoption of the EPs, a voluntary set of guidelines developed by banks for managing social and environmental issues related to project financing.

In 2006, the EPs were revised, addressing several of the deficiencies and critiques which had undermined the effectiveness of the first version. The US$50 million benchmark was reduced to US$10 million. The EPs were also applied to expansions or upgrades of existing projects and not just to new projects since changes to the scale or scope of projects had the potential to create significant social and environmental impacts or significantly change the nature or degree of the existing impact (Allens Arthur Robinson, 2006). The revised version of the EPs also addressed widespread concern regarding lack of transparency in the original Principles; it included a commitment to periodic reporting.

THE EQUATOR PRINCIPLES' GUIDELINES

The EPs are a voluntary set of guidelines for promoting social and environmental responsibility in project financing especially in emerging markets (Misbach, 2004; Amalric, 2005; Scholtens and Dam, 2007;Coulson, 2009 and Basah & Yusuf,2013b). These Principles act as a framework for developing internal practices and policies. The EPs are based, in large part, on the policies and guidelines of the International Finance Corporation (IFC), a member of the World Bank Group. The EPs also emphasise a commitment to environmental assessment based on compliance with host country laws, regulations and permits applicable to the project, specific World Bank and IFC guidelines, IFC Safeguard Policies and IFC Pollution Prevention and Abatement Guidelines for the relevant industrial sector (Coulson, 2009). The EPs are applicable to all projects with a capital of US$10 million or more.

In the first step, banks will categorise a project into one of three groups: high (A), medium (B), or low (C) in environmental or social risk as a precondition for financing. The customer is required to supply environmental impact assessment (hereinafter EIA) if the project is category A or B, taking into account issues such as pollution prevention, sustainable development, involuntary resettlement, and socioeconomic impact.

For categories A and B, the customer is also required to prepare an Action Plan (AP) and implement an Environment Management System (EMS). The AP may range from a brief description of routine mitigation measures to a series of documents, such as a resettlement action plan, indigenous people plan, emergency preparedness and response plan, or a decommissioning plan. The EMS will incorporate social and environmental assessment, a management programme, organising capacity, training, community engagement, monitoring, and reporting. There will be compulsory expert reviews and an independent expert review of the EIA, AP, and EMS, in order to assess compliance with the EPs.

WHY A BANK MAY ADOPT THE EQUATOR PRINCIPLES

From the macroeconomic perspective, Scholtens and Dam (2007) stated that financial institutions are likely to adopt the EPs because perceived benefits exceed the associated cost. In line with recent CSR theory, (Bansal and Roth, 2000; Baron, 2001; McWilliams and Siegel, 2001; Bagnoli and Watts, 2003; Heal, 2005) similarly suggested that firms engage in profit-maximising CSR based on anticipated benefits from their activities. If a bank does not engage in CSR, the non-market costs in the form of negative externalities will potentially be charged back to the firm, such as consumer boycotts, environmental scandals, employee actions, NGO pressures, negative publicity, and lawsuits.

Specifically in project financing, there is one pressure group known as *BankTrack* that monitors and tracks the operations of the private financial sector and their effects on the environment. One of the objectives of *BankTrack* is to educate the civil society about how financial sector activities such as project financing affect people and the environment. Additionally, *BankTrack* works together with other NGOs to form a strong network to influence bank activities in project financing.

Saunders and Allen (2002) stated that the EPs increase assessment and evaluation in project financing, reduce reputational risk, and enhance the security and reliability of a project. Moreover, since the EPs are seen as embedded in reputational risk management, other benefits will be obtained. First, banks will gain corporate benefit and reputation associated with the EPs as they are recognised as defining the best practices in project financing. Second, the EPs can help to differentiate an individual firm's reputation from the malpractices of other banks and boost its credibility relative to critics. Last, adoption of the EPs can be perceived as a form of pre-emptive action motivated by the anticipation that irresponsible practices may attract the attention of domestic regulators (in the form of intrusive legislation and environmental audit), and civil society groups (Wright and Rwambizambuga, 2006).

According to Amalric (2005), Equator banks or high reputation risk banks use the EPs as a strategy to achieve a level playing field with their less exposed competitors. Differences in terms of reputational risk explain why banks in developed countries are more likely to sign-up to the EPs. For example, ABN Amro, Barclays, Citigroup, The Royal Bank of Scotland, and WestLB have widespread activities and are based in countries with strong NGOs. For Wright and Rwambizambuga (2006), the high rate of adoption of the EPs among banks headquartered in Western Europe and North America illustrates how the EPs primarily function as tools for maintaining and enhancing corporate reputation in institutional environments where it is threatened. If this were not so, the strategic motivation for adopting them would decrease and the gap between developed and developing countries' implementation of natural environmental management would also likely decrease.

Adoption of the EPs may also arise from the specific nature of project financing. Project financing requires loan syndication where a lead arranger brings together a group of banks that together provide the finance needed for a project. For example, Misbach (2004) indicated that 21 banks had signed-up to the EPs and these banks represented 70% of the market share in project financing. Since main signatories to the EPs are major players in project financing, their participation attracts that of other banks who may potentially lose business if they do not adopt them.

Adoption of the EPs also leads to better social and environmental risk management in project financing. Amalric (2005) indicated that social and environmental risk can affect financing in two ways. First, it may shorten the life expectancy of project financing since a project that faces local resistance may have to delay construction and normal operations; and, second, in project financing, banks have a high credit risk due to limited recourse to revenue other than that generated by the project, together with a lower collateral arrangement. For these reasons, in project financing, banks have to undertake costly and in-depth environmental and social risk assessment, but with the adoption of EPs, the social and environmental risk is delegated to a third party which is more efficient and at the same time shifts the cost of screening and managing social and environmental risks to the project sponsor/customer.

The adoption of the EPs also serves to counter the criticism of large development projects. In 1998, the World Bank and NGOs launched a multi-stakeholder initiative known as 'The World Commission on Dams'. In its final report, the World Commission on Dams (2000) did not dismiss the possibility that large dams can be beneficial for sustainable development, but defined stringent conditions under which this would be the case. It notably drew attention to the importance of public acceptance for key decisions, and the carrying out of a comprehensive assessment of other alternatives to the building of dams. Further, in 2000, the World Bank published the Extractive Industries Review (EIR) which insists on sustainable development. However well designed and implemented a project may be, it is unlikely that it will make a positive contribution to sustainable development unless that review's conditions are in place.

Based on the above, it becomes clear that the purpose of the EPs is to provide banks with an entry into debates on the sustainable development effectiveness of large projects. Wright and Rwambizambuga (2006) also indicated that the adoption of the EPs acts as a signalling device for demonstrating positive credentials with the aim of strengthening corporate reputation and organisational legitimacy. There are many other reasons why banks have signed up to the EPs: protection of reputation, management commitment, preservation of the business from potential loss of retail customers, creation of a level playing field by adopting an industry standard for social and environmental assessment, creating a virtual circle in project financing activities, good corporate governance, and reducing political risk. The Freshfields Bruckhaus Deringer Report (2005), referred to ten reasons: reputation, business as usual, high level of commitment, stakeholder and NGO activism, market share, competition, industry standard, virtual circle, sustainable development, and financial risk rating.

Watchman et al. (2007) defined the EPs as a detailed set of enforceable legal forms which can be classified as a voluntary framework of ten broad principles applicable to project finance transactions. Scholtens and Dam (2007) also described the EPs as self-regulation in the form of a code of conduct. Richardson (2005) also viewed the EPs as a voluntary code of conduct adopted by commercial and investment banks for environmentally responsible project financing, and prescribing norms to regulate polluters' or resource users' behaviour in relation to their interaction with the environment. The EPs can also be considered a voluntary code developed by third parties which organisations are invited to implement. For Richardson (2005), this voluntary approach is often described as corporate social responsibility (CSR) or business self-regulation.

Wright and Rwambizambuga (2006) referred to third party codes of conduct as codes of conduct developed by an external group and adopted by multiple firms. They can be categorised as 'principle codes' or those that are mainly aspirations and typically lack specific implementation provisions; 'commitment codes' or those that formulate aspirations and specify intended actions or behaviour; and 'punitive codes' or those that operate in a quasi legal fashion in corporate practices and specify intended actions and specific sanctions for non-compliance.

The contents and aims of codes of conduct vary greatly. Codes can be distinguished as performance based and process oriented or a combination of both. Performance based codes dictate a substantive goal for the improvement of participants' environmental performance, such as the reduction of waste. Process oriented codes concern the procedures by which businesses manage their interactions with the environment without setting specific targets for environmental performance. They may include, for example, expectations for participants to publicly report on their environmental activities. Codes of conduct also differ based on their regulatory functions and policy scopes. Some perform several regulatory functions, such as rule making (e.g. target setting), administration (e.g. reporting and monitoring), and enforcement. Voluntary codes can be considered voluntary to the extent their adoption is not formally obliged by the authorities.

CONCLUSION

Form his study, it showed that natural environment issues are not new issues in the financial sector (Basah and Yusuf, 2013a). It has been discussed earlier and in 1990s United Nations has introduce UNEP's statement that act as a guideline for financial sector dealing with natural environment. This development further strengthens up by coalition of major banking players that introduced as a code and conducts to deal with natural environmental issues in project financing.

The study found that, financial sector are indirectly linked to activities that contribute huge damage to the natural environment (Cowton and Thompson, 2000). Environmental risk can pose a dual threat to their loan portfolio. For example, environmental regulations can impact a company's cash flow by affecting the markets of its products. Moreover, the banks often take land as security for their loans, and its value can be significantly reduced where it is found to have been contaminated because of polluting activities. The Fleet Factor case in the United States of America (U.S.A.) illustrates this. An environmental issue not only reduced the value of the collateral but also made the bank liable for clean-up costs at a site owned by a defaulting client, since it was adjudged to have been in a position to influence the company's business decisions (Cowton and Thompson, 2000).

Due to this development, financial sector has taken proactive role by introducing EPs. However the study's investigations also showed that none of Malaysia's local banks participates in any codes of conduct programmes, such as the Equator Principles and United Nations' Environmental Programme (UNEP). It is advisable for local banks to participate in these as doing so will assist them in developing and improving their internal natural environmental management practices. It is also advisable for future study to investigate why there is no participation among Malaysian Bank in these programmes. This will further enhance good natural environmental management in Malaysian financial sector.

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