

Equator Principles Strategic Review

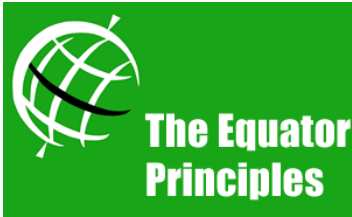
Final Report

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Executive Summary



The Equator Principles (EP) Association is embarking on a Strategic Review process with the purpose of developing a five-year strategic vision to ensure the Equator Principles continue to be the “gold standard” in environmental and social risk management within the financial sector. As its membership has increased, as the global scope of the EPs has expanded and as expectations on the EPs escalate, the review is timely in recognizing the need for change. The review is also taking place against the landscape of a changed project finance market from when the EPs were first launched in 2003.

The intended role for us, as consultants, in the Strategic Review is to facilitate a full airing of issues as well as offer perspectives and recommendations to help the EP Association respond to its evolving circumstances and chart its course.

Indeed, the time for change has come. To briefly summarize our Strategic Vision for the EPs:

The Equator Principles Association needs to advance as an organization and create a sustainable platform for its success and continued development, and to assert its leadership role in environmental and social risk management in the financial industry. It must excel at delivering its core mission, as contained in its Preamble, of ensuring that the projects that its members finance are developed in a socially responsible manner and using sound environmental management practices. At the same time, it must expand its membership to encompass new entrants in the project finance market, broaden its scope to accommodate the greater ambitions of its members, and address evolving environmental and social risk management needs.

To build a platform and advance, it must be supported with significantly enhanced funding and staffing that is consistent with the needs and challenges ahead. And its platform must be based on accountability with transparent and verifiable standards for adoption, implementation and reporting, and with regular communication to its members and stakeholders.

To face the reality and needs of an increasingly diverse financial community, the EP Association should adopt a tiered membership framework that can accommodate the legitimate ambitions for both its core mission of project finance and for more pioneering environmental and social risk management.

Our emphasis in this report is to propose the ingredients necessary to create such a platform as well as to point the direction for the continued evolution of the EPs.

“The Equator Principles Financial Institutions (EPFIs)... adopted these Principles in order to ensure that the projects we finance are developed in a manner that is socially responsible and reflect sound environmental management practices.”

“We will not provide loans to projects where the borrower will not or is unable to comply with our respective social and environmental policies and procedures that implement the Equator Principles”

- Preamble, The Equator Principles

The affiliation of Equator Principles Financial Institutions (EPFIs) has organically evolved from a loose collection of financial institutions each independently implementing the EPs to an organization that is looked to within the financial industry and by its stakeholders for leadership on environmental and social risk management. It is important to note that while the EPs

are limited to project finance, this leadership role extends well beyond project finance to broader leadership on environmental and social risk management in the financial industry. This leadership role has at times been difficult for the EPFIs to systematically embrace both because of limited capacity and because, for a variety of reasons, some of the membership are uncomfortable with this role.

While there continues to be debate internally about the appropriate leadership role for the EPs, we believe that EPFIs long ago implicitly accepted this role. EP members are routinely sought out to speak at conferences, participate in training events and be interviewed in the media about environmental and social risk management and leadership in the financial industry. This leadership role should be embraced and promoted not just informally, but systematically as part of the Strategic Vision. The leadership that is now needed has two dimensions, one external and the other internal:

- **External leadership** within the financial industry in outreach efforts and promoting high standards of environmental and social risk management and sustainability in banking activities.
- **Internal leadership** in evolving and innovating the EPs to remain a cutting-edge voluntary initiative both in financing project-based assets and, for those EPFIs with the additional capacity, to select other financial products.

Among some stakeholders and its members, there is disappointment with the EPs. This may be partially due to the EPs own early success. With the remarkable leadership and innovation that its initial members played in developing and launching the EPs, to the broad-based adoption of the EPs by financial institutions across the globe, expectations for the continued innovation of this group of bankers is high. The EPs quickly gathered wide support, or sustained interest, from a broad cross section of stakeholders: industry, legal experts, the financial industry, multilateral institutions, development agencies, governments, academia and civil society organizations. The EPs adherence to technical standards and process-based steps puts it in a league of its own among financial sustainability initiatives.

Yet, with project finance a smaller portion of the business of many of its members, with perceived lack of consistency of application, and with the inability to assess EP performance because of limited transparency, the EPs have come under criticism. Its critics, through regular public communication, appear to be dominating the global discussion on the EPs. For the most part, individual EPFIs are actively assessing projects and managing risks, but the EP Association does not have the data or the resources to tell the EP story. In the words of one stakeholder who has worked closely with EPFIs and knows that *“many of them are doing a lot of good work behind the scenes... and “just want to get on with the job [and do not feel it is their role to tell the story], the irony is that the continuous lack of substantial transparency and disclosure... has the counter-effect of making some external stakeholders perceive this as being indicative of inadequate levels of EPFI responsibility and accountability.”*

Feedback Highlights

We engaged in a detailed consultation process with EPFIs and stakeholders to understand the EPs success, its challenges and its potential. Through dozens of interviews, survey responses and input to the EP website, respondents generously provided thoughtful and perceptive comments. It is revealing of the importance of the EPs that so many individuals and associations were willing to spend considerable time in preparing their responses. We appreciate their input.

These responses, coupled with the discussion in Beijing, provide a comprehensive overview of the challenges and opportunities facing the EPs. It should be noted that for the most part in sharing feedback, we focus on the challenges facing the EPs. There also are many good examples of banks achieving high implementation and reporting standards but the nature of our effort was to draw out the collective challenges to help focus on the needs and define the vision for the future. It is not our intention to minimize the considerable achievements of the EPs and of individual EPFIs, but to outline the findings that help frame the requirements for Equator’s strategic direction.

EPFIs: The interviews and survey uncovered a broad range of perspectives among EPFIs on all issues, but also highlighted several key challenges facing the

Association. EPFIs are concerned about the EPs losing their leadership position and diminishing in brand value. Institutions report strong benefits from adopting the EPs, but many express frustration about inconsistent EP implementation among EPFIs in light of very minimal adoption and reporting requirements.

Most agreed that Equator must expand its membership in emerging markets to remain globally relevant, but perceive a tension between “broadening” the membership and “deepening” it through more robust implementation requirements for members.

EPFIs express concern about whether the narrow definition of project finance has diminished the relevance of the EPs to a small and declining portion of their financial portfolios, especially in light of general financial market trends of recent years. Although new Governance Rules were enacted within the last year, a number of EPFIs indicate a desire to revisit aspects of the organization’s governance framework, especially with respect to membership criteria and the size and composition of the Steering Committee. Other issues include access to information by non-SC members and the Association’s approach to stakeholder engagement.

Stakeholders: While the EPs are widely seen by stakeholders as having achieved considerable success, there is general disappointment with the lack of transparency and a prevailing view that the limited and inconsistent reporting of EPFIs make it difficult to evaluate their performance. Diverse stakeholders would like to see a more robust governance framework for the EP Association, with actual capability for training and capacity building among members. At the present time, some civil society organizations undertake more analysis on the EPs than the EP Association itself with the consequence that the EP Association is seen to be losing control of its message.

Some stakeholders urge also that the EP Association do more to act as a platform and convening vehicle for discussion around issues of social and environmental risk management in the financial sector. There is considerable interest in the work of the EP Association and opportunities for partnership with industry organizations, clients and civil society on knowledge

sharing and good practices in addressing mutual interests, yet the EP Association has not pursued such opportunities.

The discussions with consultants working with the EPs “on the ground” highlighted differences among the EPFIs in their capacity to assess and manage due diligence, the tendency for some to focus on managing the EP process rather than project risk, and the generally more stringent and hands-on implementation approach applied by multilateral development banks compared to EPFIs.

Challenges and Opportunities

The EPs have done a great deal to catalyze the creation of better environmental and social risk management systems within banks, not just in the project finance area but also across business units. At the same time, the EPs have challenges on a number of fronts:

- Scope and going beyond project finance
- Outreach and expanding membership
- Improving consistency of implementation across members
- Promoting transparency.

To many both inside and outside the organization, addressing these challenges is seen as a series of mutually exclusive choices, i.e., the debate about broadening membership versus deepening implementation, or the priority of focusing on improving implementation or accountability before doing anything else.

It is our assessment that these “either/or” choices are borne of lack of EP Secretariat capacity and an inadequate EP Association structure to accommodate them, rather than insufficient vision or will to implement them. The dichotomy between broadening the membership of the EPs and deepening the implementation capacity is a false one, and it obscures the opportunity.

The EP Association has reached a point where its ambitions exceed its current capacity to deliver on those ambitions. It simply needs more resources and more structure to address its challenges and more capably fulfill its vision.

At this point, the Association is dependent on bare bones fees and the generosity of EPFI members willing to contribute their limited time to the work of the Association. Eight years out, with broad membership and many demands, the EP Association's capacity to continue to run itself in the spare time of its members and on a minimal budget is unsustainable. Of all voluntary organizations reviewed, the EP Association has the lowest annual fees and the smallest secretariat. The EP Association needs additional dedicated professional resources to continue to flourish and sustain momentum.

As importantly, EPFIs must overcome the ongoing internal debate about each EPFI having independence in adopting, implementing and reporting on the EPs as they see fit. *Equator as a brand and financial institutions as members have a reputation to protect if they are to remain a credible force in environmental and social risk management.* Standards for adoption, implementation and reporting are needed, transparency is required, and independent verification of adoption, implementation and reporting is necessary.

The EP organization needs accountability, resources and structure to achieve its potential and be sustainable. Hence, there are two components to our recommendations as detailed in the box that follows.

Overview of Key Recommendations

- 1) It is essential that the EP Association build the necessary platform that will sustain the organization into the future and enable it to achieve the Strategic Vision that emerges from this Strategic Review process.**

We recommend that three legs of that platform should be:

- a. Adequate fees and professional staffing
- b. Enhanced communication and knowledge sharing with its membership and stakeholders
- c. A transparency and accountability framework.

As other voluntary organizations have learned, to ensure the long-term viability of their initiative, it is essential to put in place a lasting structure that can facilitate achievement of objectives and protect its brand. Much of the frustration with the pace of accomplishment of the EPs can be sourced back to the reliance on the spare time of EPFI members to implement its agenda. The EPs have the lowest fee structure and smallest level of staffing of any comparable voluntary organization that we could identify. This low budget approach served the organization well up to a point, and considering the resources devoted to the EPs; its achievements to date are extraordinary. But, the organization is now beyond the point that this model is working.

The EP Secretariat needs dedicated professional resources to develop training materials, organize the work to establish membership standards and assistance for new members and a transparency framework, develop and maintain a website, publish an EP Association annual report, establish reporting guidelines, to name just a few items.

As a voluntary initiative, the EP Association has certain responsibilities. Comparable initiatives bestow their organizations with standards, implementation support, and the responsibility to ensure accountability. While the EPFIs do not want to judge one another, they do have a responsibility to ensure that the EPs are appropriately implemented across institutions and that their brand is not undermined by non-performance or free riders. They have a responsibility to set entry standards and ensure that they are met. And they have a responsibility to make sure that there is adequate information about how the business of the EPs is conducted. Based on our review, we find that such assurance and accountability is insufficient at this time.

Overview of Key Recommendations (continued)

- 2) The Strategic Vision of the Equator Principles should allow it to accommodate both the breadth of financial institutions across the globe engaged in project finance and those pioneering financial institutions ready to expand the boundaries on social and environmental risk management beyond project finance.**

To accomplish this vision, we recommend that the EPs should:

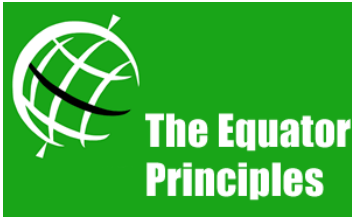
- a. Formalize an outreach strategy that focuses on new emerging market players in project finance
- b. Develop verifiable, performance-based membership standards and provide capacity building support
- c. Agree procedures to accommodate broader application of the EPs to more products and to higher disclosure standards for those higher capacity EPFIs
- d. Introduce tiered membership to accommodate the diversity and capacity of its members

The impetus for the EPs remains as important today as it was when the EPs were formed: leveling the playing field for financial institutions engaged in project finance to eliminate competition on E&S risk management practices and facilitate sustainable outcomes in the projects that they finance. As Chinese, Indian and other emerging market financial institutions play a larger role in financing projects, their adoption of the EPs is vital and *sustained, proactive outreach* to them is crucial. But, reaching the new players in this market is more challenging and their implementation capacity may be more limited. Nonetheless, to level the playing field within the framework of a minimum established baseline for environmental and social risk management for project finance, the EPs should accommodate these emerging market financial institutions. To facilitate membership, the EP Association should *assist those with more limited capacity* get basic EP training and advice in implementation and capacity building.

At the same time, the financial institutions that for many years have been working to *adapt the EPs to a broader portion of their business*, and are comfortable in *disclosing information about their EP activities to a higher standard*, should be accommodated in the EP structure, too. These pioneers are now seen as having evolved and left the EPs behind. The EPs should accommodate and facilitate the evolution of broader E&S risk management objectives of its members.

By instituting a *tiered membership structure*, the EPs could accommodate broader geographic diversification and financial institutions with more limited implementation capacity, as well as those institutions with greater capacity that are eager to push the envelope. In other words, tiered membership will allow EPs to encompass the diversity and capacity of its membership.

Appendix B – Summary of Findings and Recommendations



Findings	Recommendations
Transparency	
<ul style="list-style-type: none"> • Some EPFIs are very uncomfortable about additional disclosure requirements beyond Principle 10 • Due to lack of a reporting standard, implementation reporting is inconsistent and often limited and inadequate to provide information on how the EPs are being implemented by an institution • Reporting data is not verifiable except for those banks that have it audited. There are no agreed standards for audits • It is difficult to find reporting data and not possible to aggregate it • It is difficult to determine whether an EPFI is fulfilling its responsibilities under the EPs • Stakeholders cannot assess what the EPs are achieving 	<ol style="list-style-type: none"> 1. Raise disclosure requirements to include, at minimum, project names (with client consent) and related categorization, by financial close or before, in annual reporting 2. Create an independently managed Equator Principles League Table 3. Develop a detailed standard for consistent implementation reporting through use of a survey, a reporting template or a GRI protocol 4. Eliminate the one year grace period in reporting for new adopters and require reporting within the first year on implementation procedures 5. Develop an EP assurance standard to use for third party auditing of EPFIs' internal implementation processes. (Include development of audit procedure for verification of implementation capacity of new members.) 6. Publish an EP Annual Report highlighting the achievements and challenges of the year

Findings	Recommendations
Beyond Project Finance	
<ul style="list-style-type: none"> • Definition of project finance is interpreted differently across EPFIs resulting in inconsistent EP implementation • Application of EPs may be managed by some banks more than E&S risks • Projects with challenging issues may be disguised as corporate loans to avoid EP compliance • Project finance is a declining share of many banks' business • Inconsistent application of Equator to other financial products may result in brand confusion • "Equator light" application to other financial products is an emerging distinction and usage that may not reflect the EPs fundamental requirements 	<ol style="list-style-type: none"> 7. Extend the scope of the EPs to encompass both project finance and corporate loans where 50% or more of the proceeds of the loan are being used to finance a single asset 8. Longer Term Objective: Develop Guidance Notes for other financial products to which the EPs are being adapted or loosely applied
Implementation	
<ul style="list-style-type: none"> • Autonomy in implementation and capacity constraints has resulted in inconsistent EP implementation • Due diligence is front-loaded: <ul style="list-style-type: none"> – Limited ongoing project monitoring or follow up – Limited monitoring of client disclosure • In some institutions, Category B projects are not given the same treatment as Category A regardless of risk level • Dependence on consultants for guidance; little guidance provided to consultants; consultants adapt to banks' needs • E&S units may feel they lack authority within their institutions • Delisting does not relate to EP implementation performance 	<ol style="list-style-type: none"> 9. Direct a systematic effort by EP Association to facilitate knowledge sharing and membership capacity building, including developing <ul style="list-style-type: none"> • Case studies and training materials (May wish to outsource this work or seek partners that have developed similar materials) • Guidelines for use of consultants • Intranet site with on-line implementation tools and resources • Best Practices Working Group • Regional workshops • Donor funds for training for emerging market banks (work with partners) <p>See Recommendation 5 above: Develop an independent verification procedure for implementation</p> <ol style="list-style-type: none"> 10. Delist EPFIs that do not meet minimum required implementation threshold

Findings	Recommendations
<p>Membership</p> <ul style="list-style-type: none"> • Entry criteria are low and not verified • No requirement for executive management engagement in adoption and ongoing relationship with the EPs • Minimum membership criteria reflect a single-tier membership category and do not distinguish diverse membership capacities and ambitions • Outreach efforts lack strategic focus, are sporadic and largely driven by the effort of individual EPFIs • Banks and clients outside of Europe and North America have less awareness of EPs • Priority focus is outreach in China and India, yet different regional priorities and capacity limits affect membership appetite in these countries • Current membership platform does not encourage, accommodate or set standards for broader reporting or application of the EPs 	<ol style="list-style-type: none"> 11. Revise EP adoption standards to require demonstrated implementation capacity at the time of adoption and executive management commitment to the EPs 12. Develop and fund a comprehensive outreach strategy targeted to China, India and other priority markets with resources for capacity building in these markets and tools for all new adopters 13. Introduce tiered EP membership to accommodate varying levels of disclosure and/or product application
<p>Coverage Issues</p> <ul style="list-style-type: none"> • EPFIs are addressing coverage limits in IFC Performance Standards on climate change, thermal power and nuclear power in different ways and would benefit from a common approach <ul style="list-style-type: none"> – Of these, climate change is considered the priority issue • Some sectors/jurisdictions in High-Income OECD countries do not necessarily have high environmental & social standards and regulatory frameworks adequate to cover individual project risk • Some banks may not be following the EP's in evaluating E&S risk in High-Income OECD countries • Due to their business mix/geographic location, emerging market banks use the IFC Performance Standards more frequently than developed country banks 	<ol style="list-style-type: none"> 14. Actively consult with IFC to facilitate incorporation of the EPs perspective on climate change, human rights and biodiversity into the IFC Performance Standard update 15. If coverage issues remain in the revised IFC Performance Standards, incorporate a policy statement into the EP preface indicating commitment to addressing these risks 16. For select group of High-Income OECD countries and limited sectors, perform a gap analysis to determine the difference between EPs and national and provincial/state requirements 17. Develop guidance materials on treatment of projects in High-Income OECD countries to ensure thorough E&S risk management

Findings	Recommendations
Governance	
<ul style="list-style-type: none"> • Steering Committee (SC) challenges: <ul style="list-style-type: none"> – Large membership – Slow pace of perceived progress – Insufficient regional and emerging market representation – Information asymmetry between SC members and non-members • Regional banks’ needs and concerns not well understood by EP Association • EP Association communication to all EPFIs is insufficient • EP website is antiquated and uninformative and fosters impression of lack of transparency • Stakeholders see Equator as well positioned to serve as a platform for broader financial sector engagement around environmental & social performance • Members are stretched to assume more EP organizational responsibility <ul style="list-style-type: none"> – Annual fees and staffing of the Secretariat are the lowest of comparable voluntary organizations and unsustainable 	<ol style="list-style-type: none"> 18. Expand regional focus: <ul style="list-style-type: none"> • Use regional liaisons to facilitate information flow between the EP leadership and regions • Promote regional inclusion on the Steering Committee and in scheduling meetings and conference calls 19. Develop a fee structure to adequately fund and staff EP Secretariat to facilitate realization of EPs Strategic Vision. (Estimated staffing requirements of one full-time manager and one program officer in 2011, with a second program officer added in 2012.) 20. Create Strategic Review Task Force for oversight of the implementation of the Action Plan 21. In one year, review the size and composition of the Steering Committee for efficiency and regional diversity 22. Develop a state of the art website (with a Members’ only Portal) for communication with stakeholders and members
Relationship with Stakeholders	
<ul style="list-style-type: none"> • Relationship with IFC is informal and not coordinated with the EP Association strategically to achieve mutual objectives <ul style="list-style-type: none"> – IFC would like the EPFIs to place additional and consistent attention on outreach • Many clients are not familiar with the EPs. Client & industry outreach efforts have been minimal • Stakeholder engagement is not broad based and largely focused on advocacy groups. Many stakeholders would welcome the opportunity to engage more with the EP Association 	<ol style="list-style-type: none"> 23. Enter into an MOU with IFC to define cooperation efforts and priority initiatives 24. Develop a strategy for client engagement that utilizes engagement with Industry Associations and regional client forums 25. Create an EP Advisory Group with representatives from stakeholder groups 26. Create an EP Forum for engagement and leadership on banking industry sustainability issues