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Regulating the Impacts of International Project Financing: The Equator Principles Resulting the Impacts of International Project Financing

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By Cynthia A. Williams[*]

I would first like to join my co-panelists and thank Edith Brown Weiss for her thoughtful introduction to this panel, and also thank Nienke Grossman for putting this panel together. The initiative my talk focuses on is the Equator Principles (EPs), which are a global banking initiative first promulgated in 2003, then revised in 2006, and under revision again now in 2013. My co-author John Conley and I have conducted approximately 30 interviews with bankers, government officials, scientists, and people working for NGOs about the Equator Principles, as part of a larger qualitative research project investigating corporate social responsibility.[1] In this talk I will briefly describe the Equator Principles; discuss the role of banks as global sustainability regulators by virtue of the EPs; talk about some evidence that participating in the EPs is leading to broader changes in some parts of Equator banks; and then develop some of the implications and caveats to which this study gives rise. Two themes that emerge are the irony of private banks playing a positive regulatory role, given their central contributions to the global financial crisis begun in 2007; and the challenges to that positive regulatory role now observed with China, in particular, beginning to make increasingly important contributions to infrastructure finance.

History and Overview of the Equator Principles

A number of developments have contributed to the trend that has culminated in the Equator Principles. In the 1980s and 1990s, the structural adjustments demanded of many developing nations by the World Bank and International Monetary Fund led to the increasing privatization of public and state-owned services such as energy, water, resource extraction, and basic industries. Simultaneously, effective activism by environmental nongovernmental organizations led the World Bank Group and other multilateral public development banks to begin to withdraw from such large, high-profile infrastructure projects as the Three Gorges Dam project in China and the Narmada Valley dams in India. These trends set the stage for private banks to play a much larger role in infrastructure investment globally than they had previously.

These developments were viewed with dismay by a number of global environmental NGOs such as Friends of the Earth and the World Wildlife Foundation. One reason for their dismay was that these NGOs had worked throughout the late 1980s and early to mid-1990s to require public funding agencies such as the World Bank, the IFC (the part of the World Bank that lends to private parties for public-enhancing development), regional development banks, and export-import credit agencies to impose explicit social and environmental standards on projects that they supported. Now, with the entrance of Wall Street and City of London banks into the development market, the NGOs feared that that work would need to be done again, this time without the public-regarding official mandate of the World Bank and the IFC to use as leverage.

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[1] The results of our inquiry are reported in John M. Conley & Cynthia A. Williams, *Global Banks as Global Sustainability Regulators? The Equator Principles*, 33 Law & Pol'y 542 (2011), and form the basis for my comments.

But this same privatization that the NGOs so feared has had an unintended—indeed, wholly unanticipated—consequence: private banks with global reach have begun to play a quasi-regulatory role by introducing developed-country social and environmental sensibilities, procedures, and standards across the entire range of the world's industries and development activities. The mechanism for this has been the EPs, first promulgated in 2003, then revised in 2006 and again being revised now, and set to launch in 2013. The EPs, which are a voluntary agreement among banks, set financial industry-wide standards for assessing and managing environmental and social risk in infrastructure investment that were taken directly from IFC Performance Standards on Environmental and Social Sustainability. The IFC standards, in turn, are quite specific about social and environmental requirements and quite protective, so if well-implemented, will mitigate the potential harm of large infrastructure development. Given that our analysis has been at the bank global management level, and not the project level, we have no data on which to base any conclusions about how rigorously the EPs have been implemented, nor are we aware of academic research that has been conducted at the project level. This is a major gap that should be addressed by further, in-depth ethnography and case study research.

Until the 2013 revisions, the EPs applied only to "project finance," which is the method used to provide private capital for large, privately sponsored infrastructure projects such as dams, oil and gas pipelines, mines, electrical power plants, and telecommunications facilities. (In 2013 the scope of the EPs was broadened to include project-related corporate loans and bridge loans, applicable to projects going forward in 2014.) In important ways the structure of project finance motivated and shapes the EPs. Project finance loans are non-recourse, meaning that lenders are repaid only through the revenues generated by the project. So even if the project sponsor, which is the borrower, is one of the world's most profitable companies, the lending banks face particularized financial risks from anything that might slow down or derail the project.

As a result, the banks have become concerned about human rights and labor issues, community relationships, indigenous people's rights, environmental issues, and political turmoil generally. The EPs emerged in part as a way to manage these concerns. In the language of economics, project finance requires companies to internalize the negative externalities generated by company action, since those "externalities" can affect whether the loan is successful and the bank is repaid. One important implication can be drawn from this observation: when entities, here banks, are forced to take account of the types of harm that are typically treated as "negative externalities," they develop risk mitigation measures to ameliorate those harms. This suggests that efforts to reform accounting such that companies' profit and loss statements take account of negative externalities may enhance social welfare by affecting management priorities.

Unlike with some other voluntary sustainability initiatives, there are no agreed-upon organizations or methods for certifying that a project meets EPs standards. Rather, the EPs rely on self-enforcement by the participating banks. Each institution that adopts the EPs declares that it has or will put in place internal policies and processes that are consistent with the EPs. Those processes include using a common framework to identify infrastructure investments as posing high, medium, or low environmental and social risk, on the basis of an Environmental and Social Impact Assessment that is typically done by outside consultants. For projects in developed countries, an environmental impact assessment will already have been required by law, but in many developing countries the social and environmental impact assessment will be performed only because the lending EP bank requires it. Where a project is identified as medium- or high-risk, participating banks must require their clients to have a management plan in place to mitigate the risks, and must require loan covenants for clients to comply with the management plan or be declared in default. There are also ongoing reporting requirements from the borrower to the lenders to ensure compliance with the management plan.

Forty-one international financial institutions agreed to implement the first EPs in 2003, including such global banks as ABN AMRO, Barclays, Citibank, Credit Suisse, Dresdner Bank, HSBC, ING Group, JP Morgan/Chase, Royal Bank of Scotland, and Wells Fargo.[2] In 2006, the EPs were revised to include stricter standards for social issues, including expanded protections for labor, community health, safety, and security; enhanced requirements for community consultation prior to a project's initiation; requirements to implement dispute resolution mechanisms; and some requirements for public reporting on implementation. In late 2009, the IFC initiated another review of its standards (completed in 2011), and the EPs membership followed suit a year later. The membership launched a formal update process in late 2011, and finalization and release of the EPsIII in draft form occurred in August of 2012. This version of the EPs will be formally adopted in June 2013, coinciding with the 10-year anniversary of the EPs. It expands coverage to project-related corporate loans and bridge loans; strengthens indigenous people's rights; and includes climate change recognition and possible mitigation for the first time.

As of 2013, seventy-nine international financial institutions have signed on to the EPs as revised. As a result of this broad adoption, the EPs website reports that they now cover more than 70% of project finance in emerging markets, and many of the bankers we have interviewed suggest that the true percentage is closer to 85% (although this may be changing due to the increasing involvement of China in infrastructure funding, as discussed below).

Implications of the Equator Principles

As a consequence of this market penetration, the EPs have the potential to import rule of law and developed-country business norms into the world's emerging economies, at least with respect to large development projects. As Robert Lawrence and William Thomas have noted, "[b]ecause project financing is often used outside of the world's developed economies and legal systems, it is not uncommon for the project documentation to form the principal legal framework for the transaction."[3] Thus it is that we can begin to think of EPs banks as global sustainability regulators, and the EPs themselves as a concrete example of the proliferating forms of global regulation that collectively are known as "new governance" or "soft law."

The potential future significance of the EPs goes beyond regulation of project finance, important as that might ultimately turn out to be. Even if 85% of project financings are now subject to the Equator Principles standards, project finance is only about 5% of a typical bank's book of business. What is particularly intriguing is that in some banks, such as Barclays, Citibank, HSBC, and JPMorgan Chase, the process of signing onto the EPs may be both evidence of and a further catalyst for cultural change within the bank. There is some early evidence that those banks have begun to apply the Equator social and environmental

[2] The EPs themselves and the list of signatories are available at http://www.equator-principles.com.

[3] Robert Lawrence & William Thomas, *The Equator Principles and Project Finance: Sustainability in Practice*, 19 Nat. Resources & Env't 21, 21–27 (2004).

standards for sustainable banking across product categories, including underwriting, commercial lending, and retail banking, and across industries. Evidence of this broader application is available on those banks' websites, and has been suggested to us in interviews. As one example: HSBC has withdrawn from any financing or debt or equity advising in weapons, persistent organic pollutants, or hazardous pesticides; and applies EP-influenced sustainability principles to all of its lending in energy, forestry and forest products, freshwater infrastructure, and mining and metals.[4] As one of our interviewees noted, once social and environmental risks become part of the credit review process for project finance, the credit committee at the bank eventually asks "Well, if these matters are risks for project loans, why aren't they risks for other lending? And if they are risks for other lending, why aren't we asking about them and considering them?" So the procedures at some banks are starting to change to incorporate a more encompassing set of social and environmental risks to be considered, with requirements to mitigate those risks being incorporated into lending agreements where the bank continues in a given industry or with a given client.

Moreover, bank financing for many kinds of large projects must be syndicated, with a lead lender joining with a number of others. Even where non-EPs banks are in the lead on a project, the EPs are becoming the standard that is being applied to social and environmental risk management. So what began as a change in lending procedures by a number of global banks in an important but limited arena—project finance—is spreading throughout the industry, and in some cases may be starting to transform the business practices of banks across a wider spectrum of lending and underwriting activities. We may thus be seeing not only self-regulation by banks, but the beginnings of social and environmental regulation of global business by the leading EPs banks.

Caveats

However, there are a number of reasons to be reticent about these asserted positive effects of the EPs, which reticence we explore in some depth in our written work on the EPs. One major concern is that the same banks that are EP and sustainability leaders—HSBC, Barclays, Citibank and JP Morgan Chase—are also each implicated in the excessively leveraged, high-risk behaviors that caused the financial crisis (JP Morgan Chase to a lesser extent than others), and are each implicated in various scandals that emerged after the crisis, such as LIBOR manipulation, money laundering, and mortgage and insurance mis-selling.[5] This disjunction could be explained a number of ways. Perhaps the EPs generally are a fig leaf, allowing the banks to proclaim all that they do socially right (in 5% of their business), in order to draw attention away from all they do socially wrong elsewhere. Perhaps our theory of the cultural changes within some banks that can be attributed to participation in the EPs is just wrong, and there is no such shift. Or perhaps it is more accurate to speak of different cultures within different businesses within the banks—the explanation which we find most persuasive. The project finance guys (and as far as we can tell, most of them are guys) really feel pride that they "make things." They can point to windmills in Central America or the American midwest at the end of the day, and explain what they do to their children. We have heard this notion expressed in a number of ways by our informants. Their work is tangible, which also means that they can see how these projects affect the ecological systems

[4] *See* HSBC website at http://www.hsbc.com/citizenship/sustainability (Equator Principles and Sector Policies link).

[5] *See* Cynthia A. Williams & John M. Conley, *The Social Reform of Banking*, *available at* http://www.ssrn.com/author=133969.

and the lives of people near the projects. Thus, the effects of their financings are not as abstract as are the effects of investment bankers' mergers and acquisitions activities, for instance, or traders' millisecond-by-millisecond efforts to take advantage of arbitrage opportunities. As a result, the bankers involved can be persuaded to care about a wider range of stakeholders, not only because those stakeholders can create risks to repayment, although that was generally the primary impetus for caring, but also because the human and ecological costs of their actions are clearer—or can be clearer with evaluation and reporting procedures that bring those costs into focus. This observation about banking sub-cultures then gives rise to concerns that traders (investment bankers rather than commercial bankers) have become the leaders of many global banks after the Glass-Steagall separation of investment banking from commercial banking was rejected during the Clinton administration. By the nature of the business (and by the norms of the sub-culture),[6] investment bankers may well be less concerned with the social effects of their actions than commercial bankers or "project guys."

A second reason to be cautious about the potential of the EPs to produce positive infrastructure development is the increasing role of China in funding infrastructure in both South America and Africa. To date, only one Chinese bank—the China Industrial Development Bank—has adopted the EPs. Our informants were uniformly negative about the potential for Chinese banks generally to become EP-compliant. Three different informants—two sustainability specialists at EPs banks and a representative of an environmental NGO—cited the Three Gorges Dam in China as a prime example of what they all called the "money is fungible" problem. One of the bankers emphasized that China (and Russia) "don't need international money anymore" because "their projects get funded anyway." According to the other banker, Three Gorges was "financed entirely with China's internal reserves." The first banker pointed out that even when international money is needed, China can "strip money from schools" to fund a dirty project, then borrow for the schools, or, as the environmental activist pointed out, the China Development Bank can sell bonds and fund dirty projects with the proceeds.

None of our informants saw any prospect of Chinese and Russian banks becoming EP-compliant. According to one of the bankers just quoted, "Chinese banks are *not* signing up"; he has "yet to see a social policy of a Chinese bank." In his view, China's "big banks are essentially policy lenders at the discretion of the government." While the Chinese government now "recognizes the huge cost of pollution," at least in economic terms, social and labor issues are "much harder to address." An official at a government export bank summed it up: there is "no evidence of Chinese and Russian banks moving toward the EPs."

This development—China's increasing role in international infrastructure lending and its resistance to taking on the requirements of the EPs—brings into focus one of the major concerns with the EPs, and indeed with the proliferating number of global private regulatory initiatives understood as "new governance": Will they only affect the behavior of the "converted," and can they lead to a generalized raising of standards if important competitors don't join the club? We are at this point guardedly optimistic that the eventual outcome of the EPs will generally be positive, but that optimism is rooted less in the theory of new governance, and more in hard-nosed market realities. When banks are profiting from "other people's risk," they exacerbate the instabilities of modern financial markets, as with the "originate to distribute" model that securitization has enabled in banking. But when banks

[6] See KAREN HO, LIQUIDATED: AN ETHNOGRAPHY OF WALL STREET (2009), for further discussion of the norms of investment bankers in the United States, or *The Salz Review*, at www.salzreview.co.uk, for a discussion of the norms at Barclays and among investment bankers in London generally.

are operating with their own risk—when it is clear that they could be financially affected by future risk scenarios, even those risks derived from social, environmental, human rights, or political sources, as in project finance—they can exercise a moderating effect on the most destructive aspects of unconstrained finance and development.