



THE EQUATOR PRINCIPLES

Do They Make Banks More Sustainable?



The UNEP Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance policy options to improve the financial system's effectiveness in mobilizing capital towards a green and inclusive economy—in other words, sustainable development. Established in January 2014, it published its final report, The Financial System We Need, in October 2015.

More information on the Inquiry is at: www.unep.org/inquiry or from: Ms. Mahenau Agha, Director of Outreach mahenau.agha@unep.org.

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About this report

This working paper results from a workshop the UNEP Inquiry and CIGI held on 2-3 December 2014 in Waterloo, Canada to discuss options for a sustainable global financial system. The workshop included participants from a range of academic and research institutions from the Waterloo region and abroad, including the University of Waterloo, the University of London, Harvard University, and the University of Gothenburg.

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Abstract

The Equator Principles (EPs) are a voluntary code of conduct and a risk management framework for determining, assessing and managing environmental and social risks in projects, such as energy or infrastructure projects. Since their foundation in 2003, the EPs were lauded for integrating social and environmental assessment practices into project assessments. Critics reason, however, that without fundamental implementation efforts and enforcement, the EPs will not contribute to any change with respect to effects of projects on sustainable development. To analyse the effects of the EPs, a literature analysis, interviews with project financiers and stakeholders, and an analysis of EP signatories' reports were conducted. The results suggest that the EPs are mainly adopted because of reputational benefits and risk management and that they do not create significant changes in project financing institutions. Our conclusions are that criteria should be implemented that define sustainability thresholds for projects to be financed and that enforcement mechanisms are needed to guarantee the compliance of the signatories with the principles.

Introduction

The Equator Principles (EPs), launched in 2003, are a financial industry benchmark for managing environmental and social risks (see www.equator-principles.com). These 12 years of existence can be equated to the phase of an adolescent still seeking to establish relevance in an atmosphere of flux and uncertainty. This paper shows that as of December 2015, Equator Principles Financial Institutions (EPFIs) have increased from the original 10 founding members to 83 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 are taking three forms. The first is the risk to the environment, society and particularly the communities in which the projects are situated (project impacts or inside-out connections). Second are the environmental, social and sustainability risks that impact the financial performance of projects (downside risks or outside-in connections). 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 will analyse the different types of risks and ways that they are managed through the application of the EPs.

Though they have undergone a number of changes in order to adapt to new developments with respect to environmental, societal, and sustainability, the overall review of the EPs more than 10 years after their foundation is mixed. Proponents argue that the EPs are visionary principles that are able to redefine social and environmental practices for the good of both sustainable finance and society. In contrast, critics reason that without radical implementation and enforcement, the EPs are merely window dressing and do not have any effects on project sustainability or the sustainability of the financial sector.

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. Our analyses and research have addressed these gaps.

1 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 per cent 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). 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 an offshore natural gas field in Australia 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 is often connected with sustainability risks. Conversely, three types of sustainability risks are usually 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 project itself may be impacted by environmental or societal risks. This refers to the "outsidein relation" (Porter and Kramer, 2006). 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 the Internet 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, as project financier, financial consultant or others.¹

¹ 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/. A Google search for Credit Suisse and Sakhalin creates more than 80,000 hits.

2 The Equator Principles as an Example of a Private Code of Conduct

For a long time and without exception, public regulatory bodies issued regulations. The traditional position was that the nation-state commands the means and capability to supervise business activities and backs them 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: international regulations occur in order to regulate issues of international impact that are increasing as a result of globalization; NGOs and businesses introduce private codes of conduct and regulations in order to self-regulate, and to design and enforce rules on themselves (Abbott and Snidal, 2009; Haufler, 2013). Accordingly, various organizations have set regulatory architectures and standards to self-regulate.

Industrial self-regulation covers many issues (such as quality standards or assurance, reporting standards or environmental issues) and actors, for example the International Organization for Standardization, the Global Reporting Initiative, Responsible Care (a regulatory scheme for the Chemical Industry (Barnett and King, 2008; Bernstein and Cashore, 2007)) and the Carbon Disclosure Project, which published a database of corporate carbon emissions (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 (Principles for Responsible Investment, 2012), for banks and the insurance business (UNEP Finance Initiative, 2012) and the EPs for project finance. All of the codes of conduct are process oriented instead of outcome oriented and most of them do not impose any consequences on their signatories in case of non-compliance.

By subscribing to private codes of conduct, organizations can respond to reputational challenges or preclude regulations by demonstrating compliance to self-imposed rules (Thistlethwaite, 2012; Wright and Rwabizambuga, 2006). 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, called the instrumentalist view, states that voluntary codes help shape corporate objectives towards some altruistic ends, the ultimate outcome of which being profit. The past and current spectre of human rights abuse associated with outsourcing, as well as the 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 the behaviour of companies and enable them to manage different political, social and economic cultures in international business. Therefore, 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 *et al.*, 2004; Bondy, Matten and Moon, 2008). Consequently, voluntary codes, such as the EPs, typically signal an intention towards corporate social responsibility and have certain stakeholders as intended targets. The voluntary codes, then, are often couched in blanket statements lacking in specificity. It is therefore not uncommon for an infrastructure project, especially located in developing countries, to build a school or a health facility in order to demonstrate corporate citizenship, instead of focusing on the environmental, social and sustainable performance of the project itself.

3 Theory

Stakeholder theory may be used as a theoretical background for explaining the existence of the Equator Principles. It explains corporate activities based on the interaction with stakeholders (systems, persons, or groups that either affect or are affected by organizations). Consequently, organizational strategies are often based on stakeholder management (Freeman, 1984). Donaldson and Preston (1995) distinguish three approaches to stakeholder theory: descriptive, instrumental, and normative.

The descriptive approach describes an organization as a "constellation of cooperative and competitive interests" (Donaldson and Preston, 1995). In this case, the EPs and their development can be described through the interaction between projects financiers, projects and their stakeholders, and NGOs. The instrumental approach to stakeholder theory applies the theory to examine the interactions between stakeholders and the organization and how the management of these interactions helps to achieve the organization's goal. With respect to the EPs, studies on the interactions between project financiers and different stakeholders were conducted. Some of them state that the establishment of the EPs helped project financiers to achieve their goals such as an increase in reputation, environmental and social risk management, and compliance (O'Sullivan and O'Dwyer, 2009). Finally, the normative approach accepts that stakeholders have a legitimate interest in organizational activities. They can be identified by their interests in the organization that are of intrinsic value (Donaldson and Preston, 1995). In the case of project finance, communities affected by projects that, for instance, use water needed by neighbouring communities, have a legitimate interest in the activities of project financiers. In addition to the three main approaches, stakeholder theory can also be management.

Based on the stakeholder theory, Figure 1 describes the EPs and their stakeholders.

Figure 1: Equator Principles' stakeholders



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