Responsible Banking

Working Paper 4

PARTNERS IN CHANGE
Promoting Human Rights in Business

Whither sustainability? Indian banks and the Equator Principles[1]

February 2018

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Abstract

This working paper introduces some key aspects of the Equator Principles, their purpose and function. Highlighting certain requirements of member institutions of the Equator Principles Association, the paper attempts to identify some reasons for lack of uptake in India and other emerging economies. It closes with suggestions for regulators as well as for decision-makers within financial institutions.

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Recently, representatives of more than 60 banks from around the world met in Sao Paolo. The occasion, held on 24-25 October of this year, was the annual meeting of the Equator Principles Association. The Equator Principles (EPs) acknowledge that financial institutions, through unscrupulous financing and lending practices, can literally bankroll ventures and companies that do considerable harm to human rights and the environment.

When established in 2003 the EPs were claimed to be "far and away the biggest response by the private sector to the globalization debate" by Peter Woicke, then VP of the International Finance Corporation, which sets the performance standards on which the Principles are based. Whilst such a claim might have been expected from IFC, the reference to the globalization debate is pertinent. The Equator Principles arose shortly after the launch of the Collevechio Declaration on the role and responsibility of financial institutions, a civil society statement coordinated by BankTrack.

Clearly, the EPs are of critical interest to those concerned with sustainable and equitable development. They support financial institutions to identify, assess and manage a wide array of risks associated with project finance, encompassing labour and working conditions;

[1] An abridged version of this article, *Counting the Costs? The Equator Principles and Indian Banks* is available on the India Responsible Business Forum blog, at http://responsiblebiz.org/equator-principles/

community health and safety; displacement and resettlement; indigenous peoples and their Free, Prior and Informed Consent; and conservation and natural resource management.

A necessary standard, if not sufficient

However, EPs as they exist currently are far from perfect. The framework provides guidance on assessment of risks but does not ensure that the results of assessments are properly evaluated. They lack any third party auditing or enforcement mechanism, with its guiding body comprising EP members themselves. As a private sector code of conduct, the EPs also possess no intergovernmental mandate. They fall short of the standards of accountability anticipated by frameworks such as the UN Guiding Principles on Business and Human Rights, by seeking to locate grievance mechanisms related to human rights impacts within companies that members finance, rather than within the financial institutions themselves. Since the EPs are not 'policed' effectively, it is quite possible for member institutions to fail to uphold the very principles that they claim to abide by. Further, they are limited to project finance and associated activities, which means that the great majority of financial sector activity globally is beyond their reach and remit.

Doubts thus persist about the EPs' impact on the *practice* of project finance. It may not always be clear whether a Financial Institution that adopts them does so in order to make its environmental and social risk assessment more rigorous or to more effectively communicate existing practice to interested stakeholders.

Country	**Number of FIs that have adopted the EPs**
Brazil	5
Russia	0
India	1
China	2
South Africa	4
Nigeria	2
Japan	5
USA	5
UK	7
Germany	3
France	4
The Netherlands	6
Source: http://equator-principles.com/	

There are concerns, too, about the strength of the EPs' commitment to addressing the contemporary crises of human rights, the environment and climate change. Around the same time as the meeting in Brazil, there was a 3 day protest across 44 cities globally, with strong representation from indigenous groups. The protests drew attention to the failure of the Equator Principles to align with the Paris Agreement on Climate Change and uphold the right of indigenous communities to Free, Prior and Informed Consent. To their credit, the EP Institutions have now embarked on a journey to revise the EPs and develop a fourth iteration of the framework, 'EP4', which will consider key issues of applicability, human rights (inclusive of the rights of Indigenous Peoples), and Climate Change, amongst others. It remains to be seen, though, if EP4 will represent a leap from a minimum requirement to a sufficient global standard for responsible project finance.

Notwithstanding their limitations the EPs do represent an important set of benchmarks in relation to project finance and associated services. In the absence of adequate legal frameworks, voluntary instruments such as these provide a critical role in both guiding more responsible practice and in communicating what is practiced. They are necessary - if not yet sufficient to guarantee respect for human rights and the environment.

The Equator Principles and India

The Reserve Bank of India has recognized the value of the EPs in the Indian context. Ten years ago, the RBI issued a statement to financial institutions identifying their role in supporting sustainable development, including through respect for human rights. The note spoke of the need for banks to make urgent efforts in this area, developing plans of action with Board approval. Banks were exhorted in particular to refer to IFC Principles on project finance - the Equator Principles - as well as carbon trading guidelines.

In the intervening period since that 2007 RBI notification many Indian financial institutions - and foreign banks operative in this country - have funded projects that have had negative impacts on human rights and on the environment. A large number of these harmful projects have been documented by civil society organizations, such as BankTrack and, in India, the Centre for Science and Environment and Programme for Social Action. At the same time, the responsibility of the financial sector has been called into question time and again with the unfolding of the NPA crisis, with failures of social and environmental due diligence cited as contributory factors behind at least a proportion of so-called bad loans.

Indeed, whilst there are powerful human rights and ecological reasons for adopting the EPs, it goes without saying that there are also sound business reasons. The large scale of projects and associated impacts means that project finance very often has a considerable degree of credit risk connected to it. Further, the ‘standalone’ nature of the projects being financed means that the lender is typically repaid almost entirely out of funds generated from the project output. This makes the lender highly dependent on the economic viability of the project. Social and environmental risks that have the capacity to - for example - delay or disrupt project cash flow, are thus especially material from the financing perspective, requiring careful investigation and management. Today, the majority of project finance debt in emerging markets is managed by Equator Principles Financial Institutions (EPFIs).

And yet, among these 92 financial institutions that have signed up the EPs, there is just one Indian financial institution. This is not because Indian banks are not involved in project finance: of the 50 biggest mandated project arrangers globally during the first half of 2017, 5 were Indian financial institutions: State Bank of India (the fourth largest arranger), Axis

Bank, Yes Bank, IDFC and ICICI Bank[i]. Of these 50, 32 are EP signatories, demonstrating that most of the largest mandated arrangers globally have found EP adoption to be feasible from a business perspective. Yet only one of the five Indian financial institutions in the top 50 – IDFC – is an EP signatory. It remains the only Indian signatory to date.

India is not alone in its tepid embrace of the Equator Principles. Only 2 Chinese Financial Institutions are represented among the signatories, and, as in the Indian case, the very biggest players remain outside. Southeast Asia is also poorly represented. Among the BRICS, only Brazil, with 5 signatories, and South Africa, with 4, can count themselves as well represented. Overall, there is a highly disproportionate share of members from OECD countries, with European Financial Institutions making up the largest single regional share.

To adhere to EP requirements, a financial institution needs to establish an Environmental and Social Risk Management framework that is mainstreamed into its credit risk appraisal and monitoring. In the case of IDFC, its adoption of the Principles is partly to do with its institutional history. Set up as Infrastructural Development Finance Company in 1997, from the outset it had a focus on infrastructure and on project finance. Over the years, in light of its relatively robust E&S risk management framework, systems and procedures, IDFC has managed various green lines of credit from a number of development finance organizations, such as Proparco and KfW. It has thus been able to integrate aspects of social and environmental risk management into key dimensions of its business model.

For the financial sector in India to more widely integrate ESG practices, and adopt the Equator Principles, in nature and in name, there needs to be awareness about the business benefits of E&S risk management as ingredient to holistic risk management and sustainable investment. Currently for many Indian banks, the need is either not clear, has not been explored in terms of long term business impacts, or the costs are considered too great – since EPFIs need to develop the internal architecture and systems required to integrate more rigorous non-financial risk assessment into their business. This will necessitate building the human resources and systems to carry it out.

Another factor is reputational risks, or the lack thereof. A key reason for embedding ESG standards such as the Equator Principles into financing practices is that, apart from addressing risks to the financial performance of the institution, and risks to society and environment, they also help to manage reputational risks. This is an area in which circumstances in India, Asia and elsewhere in the developing world are quite different from regions in which the distribution of EPFIs is much more concentrated, such as Europe and North America. Reputational risks are the product of broader social and environmental expectations. Without adequate expectations, the reputational consequences of ethical shortcomings simply fail to materialize. The result, in emerging markets such as India, is diminished reasons for adopting risk assessment practices in the first place. Thus for the time being, in India - according to one source within the financial sector - ESG integration of the level required by the Equator Principles is widely seen more as a threat than an opportunity.

What next?

Clearly, from the perspective of the Sustainable Development Goals, and indeed from the human rights perspective which runs right through these Goals, the Equator Principles, suitably strengthened, signal a way forward. Respectful engagement with the most excluded stakeholders and changes to the way that business is done in order to meet climate targets is, quite frankly, our only hope as a global community. This means a role for all of us, including financial institutions.

Sensible social and environmental risk assessment is thus the most sustainable approach for financial institutions. Yet the imperatives of the broader business space in India and other developing economies, and low prevailing levels of commitment to responsible practices, is likely to mean that many financial institutions see social and environmental risk assessment as a risk in and of itself: a financial risk, since there is a danger of excluding business opportunities in the short-term.

The need for regulatory action

This is where government and regulatory agencies must step in. To facilitate more rapid change, stringent integration of environment and social risk assessment into credit risk appraisal should become a regulatory requirement; as Centre for Science Environment has previously argued, the RBI has a clear role here. And in terms of reporting, with the National Voluntary Guidelines on the Social, Environmental and Economic Responsibilities of Business under review, SEBI now has an opportunity to update the Business Responsibility Reporting (BRR) framework so that it explicitly invites financial institutions to comment on whether they extend their human rights and environmental policies to entities they finance. In the current SEBI BRR format, this expectation is missing: whereas other businesses are asked to report on the integration of these policies to their supply chain, financial institutions are let off the hook with respect to profit-making activities within their own value chains.

For more responsible financing, boards and senior management of financial institutions need to also take a step back and identify the opportunities and the materiality of adopting E&S safeguards like the EPs in their respective business lines. They need to recognize the value of a proactive approach to due diligence that the EPs enshrine, as well as the relevance of a human rights lens when assessing risks. This will require courage; but developing these capacities as a critical minimum is an investment that more Indian financial institutions should make. This will serve at least three important functions. It will help to lay the foundations for long term stability of financial institutions; it will support a flow of information on social and environmental issues to relevant stakeholders, including interested depositors; and it will help to ensure that these businesses' decisions do not have unwanted impacts on human rights and the environment.

The views expressed in this article are personal

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