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# Environmentally Sustainable Finance

## The Equator Principles: The Voluntary Approach to Environmentally Sustainable Finance

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**Summary:** *This article considers the Equator Principles, a voluntary code for environmentally responsible project financing by commercial and investment banks. The value of voluntary environmental approaches is increasingly recognised in the European Union, and in its Sixth Environment Action Programme, the European Commission advocated a voluntary initiative with the financial sector to promote harmonised standards for green lending and investing. The article begins by explaining the broader relevance of financial institutions to sustainable development. The nature and effectiveness of voluntary environmental measures to engage the private sector is canvassed before looking at the Equator Principles in detail. The article explains what the Principles demand of lenders, assesses their implementation, and makes some observations on their adequacy for the promotion of environmentally sustainable finance.*

### I. A New Frontier for Environmental Law

The financial services sector is increasingly recognised by scholars and policy-makers as an economic sector that has a significant bearing on sustainable development. Comprising primarily lenders, investors and insurers, the financial sector is environmentally significant not so much because of its own, direct ecological footprint, but rather due to its indirect environmental effects through its loans to and investments in other businesses. Quite simply, many companies ranging from mining firms, industrial manufacturers to small retail businesses depend upon the financial services sector for funds to start or expand their operations.<sup>1</sup> Since the 1970s, companies in OECD countries have had to rely increasingly on external financing, rather than internal funds generated from their operations, to stay in business.<sup>2</sup> The growing dependence on the financial sector arises also from the support it provides businesses through insurance and financial advisory services. Thus, the

pollution and other environmental harms of those businesses are in a sense also partly the responsibility of their financiers.

While environmental activists and policy-makers have long recognised the nexus between financial markets and sustainability, until recently they were preoccupied with *public* development finance. In particular, multilateral development bank (MDB) lending from the World Bank and its sister organisations.<sup>3</sup> In addition to the conditions they attach to project-based development loans, the MDBs have attracted attention for their influence on the general economic policy of borrower countries through conditional structural adjustment and sector policy loans.<sup>4</sup> Since the 1980s, international economic institutions have experienced increasing public pressures to modernise their financial policies to address ecological and social risks. Some reforms have since been made to their operations, such as mandatory environmental assessment of some project financing proposals.<sup>5</sup>

While the environmental reform of intergovernmental development finance is obviously important, alone it is not enough. The private capital markets must also be reformed. Private financiers hold greater capital resources and influence over capital allocation than governments,<sup>6</sup> and their hold over capital funds is increasing in the context of the globalisation of financial markets.<sup>7</sup>

The relationship between financial markets and sustainable development is problematic. There is evidence that financial markets do not allocate capital efficiently, and that unsustainable, speculative bubbles suck in financial resources while inefficient under-investment arises at other times or in other sectors.<sup>8</sup>

<sup>1</sup> See generally F.S. Mishkin, *Financial Markets and Institutions* (2002); D.S. Kidwell, *Financial Institutions, Markets, and Money* (2002).

<sup>2</sup> R.L. Deaton, *The Political Economy of Pensions* (1989) pp. 210–14.

<sup>3</sup> See further Z. Plater, “Multilateral Development Banks, Environmental Diseconomies, and International Reform Pressures: The Example of Third World Dam-Building Projects” [1989] 9(2) *Boston College Third World Law Journal* 169; S. Hansen, “Macroeconomic Policies and Sustainable Development in the Third World” [1990] (4) *Journal of International Development* 533.

<sup>4</sup> See J. Warford and Z. Partow, “Evolution of the World Bank’s Environmental Policy” [1989] 26(Dec) *Finance and Development* 5.

<sup>5</sup> B.M. Rich, “The ‘Greening’ of the Development Banks: Rhetoric and Reality” [1989] 19(2) *Ecologist* 44.

<sup>6</sup> Organisation for Economic Cooperation and Development (OECD), *Institutional Investors in the New Financial Landscape* (1998).

<sup>7</sup> A. Harmes, *Unseen Power: How Mutual Funds Threaten the Political and Economic Wealth of Nations* (2001) chapter 6.

<sup>8</sup> *Ibid. passim.*

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Such capital flows may trigger undesirable social and environmental effects arising from specific company and project investment choices. Examples of the adverse environmental effects of financial institutions include speculative investments in real estate projects that blight urban landscapes, the financing of pesticides for farming, and loans and investments to energy-intensive companies that contribute to climate change.

Thus, the reform of investment, banking and other financial services to promote greater sensitivity to the environment offers a way to reduce the incidence of unsustainable developments. While financiers profit from such development, and have the means to influence it, there has been little policy intervention until recently.

So far, just a few tentative environmental reforms that target the financial sector have arisen.<sup>9</sup> European Union (EU) Member States are leading the world in reforms, and the European Commission sees the main challenge as improved information disclosure. In its Sixth Environment Action Programme, the Commission stated:

The financial sector's lending and investment activities have significant indirect environmental impacts by determining which companies and activities have access to finance and the conditions attached. Facilitating disclosure of relevant information by the financial sector and companies could create an incentive for "greener" behaviour. . . . The Commission will work to help the financial sector by encouraging the systematic incorporation of environmental cost elements into financial reports.<sup>10</sup>

Since 2000, legislation requiring pension funds to disclose their policies on environmental, social and ethical considerations has arisen in Australia, Austria, Belgium, France, Germany, Spain and the United Kingdom.<sup>11</sup> Also, the European Commission has amended the Eco-Label Regulation (2000) and Eco-Management and Audit Scheme (2001) to extend their reach to the financial sector.<sup>12</sup> Corporate environmental reporting obligations are also being revamped in many jurisdictions to encompass financiers.<sup>13</sup> Further, economic incentives, such as The Netherlands' Green Investment Directive, are providing tax concessions for environmental investment funds.<sup>14</sup> But bolder proposals, such as a proposed amendment to Britain's Financial Services and Market Act 2000 to include sustainable development as one of the principal considerations of the regulator's mandate, have been rejected so far.<sup>15</sup>

## II. Voluntary Environmental Measures

### The development of voluntary measures to promote corporate responsibility

In the absence of deeper regulatory intervention, much will hinge upon the willingness of lenders and investors to voluntarily make commitments to environmentally

sustainable finance. Codes of conduct, negotiated agreements, and unilateral declarations of commitment are some of the various means by which the private sector can take actions to support broader public policy goals on social and environmental causes.<sup>16</sup> While definitions of this phenomenon vary considerably, one general definition of voluntary environmental measures is that they are:

Commitments undertaken by one or more polluters or resource users, in the absence of an express legal requirement to do so, prescribing norms to regulate their behaviour in relation to their interaction with the environment.<sup>17</sup>

The voluntary approach, often described as corporate social responsibility (CSR) or business self-regulation,

<sup>9</sup> See B.J. Richardson, "Diffusing Environmental Regulation through the Financial Services Sector: Reforms in the EU and other Jurisdictions" [2003] 10(3) *Maastricht Journal of European and Comparative Law* 1; Council of Europe, DG III, Social Cohesion Development Division, *Examples of Economic Solidarity Supporting Regulations in the Member States of the Council of Europe and of the European Union* (2004).

<sup>10</sup> European Commission, Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions, *On the Sixth Environment Action Programme of the European Community. Environment 2010: Our future, Our choice*, 24 January 2001, 2001/0029 (COD) at p. 19.

<sup>11</sup> B.J. Richardson, "Pensions Law Reform and Environmental Policy: A New Role for Institutional Investors?" [2002] 3(5) *Journal of International Financial Markets: Law and Regulation* 159.

<sup>12</sup> B.J. Richardson, "Implications of Recent Changes to the EMAS and Eco-label Regulations for the Financial Services Sector" [2002] 14(2) *Environmental Law and Management* 131.

<sup>13</sup> A. von Ahnen, C. Lange and M. Pianowski, "Corporate Environmental Reporting: Survey and Empirical Evidence" [2004] 3(1) *International Journal of Environment and Sustainable Development* 5; KPMG Environmental Consulting, *International Survey of Environmental Reporting* (1999).

<sup>14</sup> L.J.R. Scholtens, *Greenlining: Economic and Environmental Effects of Government Facilitated Lending to Sustainable Economic Activities in the Netherlands* (2001).

<sup>15</sup> UK Social Investment Forum, "UK Social Investment Forum tells MPs of need to include environment in framework for financial services regulator" (Press Release, 19 April 1999).

<sup>16</sup> S. Labatt and V.W. Maclaren, "Voluntary Corporate Environmental Initiatives: A Typology and Preliminary Investigation" [1998] 16(2) *Environment and Planning C-Government and Policy* 191. Parts of the following discussion in this section draw upon S Wood, "Voluntary Environmental Codes and Sustainability" in B.J. Richardson and S. Wood (eds), *Environmental Law for Sustainability* (2006): *forthcoming*; see also, by way of introduction, A. Mol, V. Lauber and D. Liefferink (eds), *The Voluntary Approach to Environmental Policy* (2000); N. Gunningham and J. Rees, "Industry Self-Regulation: An Institutional Perspective" [1997] 19(4) *Law and Policy* 363.

<sup>17</sup> Wood, *supra*, p. 15

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is thriving in many countries.<sup>18</sup> Among the many CSR standards and codes of conduct drafted by industry groups, governments, and non-governmental organisations (NGOs) in recent decades are the: Responsible Care, Sigma Guidelines, OECD Guidelines for Multi-national Enterprises, the Global Reporting Initiative, ISO 14000 standard, among many others.<sup>19</sup> Complementing these initiatives is a burgeoning literature on corporate citizenship and business ethics, which challenges the dominant economic conception of companies.<sup>20</sup>

Although it is a worldwide phenomenon, Western European companies have tended to lead the world in the depth and breadth of voluntary environmental commitments.<sup>21</sup> The European Commission has started to pay attention to the role of voluntary environmental measures for CSR. It has cautiously welcomed the trend. The Commission in 2002 published a Communication on Corporate Social Responsibility, which explained:

Codes of conduct are innovative and important instruments for the promotion of fundamental human, labour and environmental rights, and anti-corruption practices – especially in countries where public authorities fail to enforce minimum standards. However, it should be underlined that they are complementary to national, EU and international legislation and collective bargaining, and not a substitute to them.<sup>22</sup>

In its current Sixth Environment Action Programme, the Commission promised to “consider a voluntary initiative with the financial sector which could cover, for example, exchange of best practice, agreement to meet harmonised standards for reporting by companies in the financial sector, for issuing loans, for green investment funds etc”.<sup>23</sup>

Already, several voluntary initiatives specifically for the financial sector have arisen. In Britain, the Department for Environment and the Corporation of London in August 2002 issued the so-called “London Principles of Sustainable Finance”, which advocate measures to improve financiers’ engagement with the environment in making loans and investments.<sup>24</sup> In the United States, an Environmental Bankers Association was formed in 1994 to assemble bankers and other financial institutions involved in environmental risk management to share relevant technical, risk management and legislative information.<sup>25</sup> Also established in 1994, is Germany’s *Verein für Umweltmanagement in Banken, Sparkassen und Versicherungen* (Association for Environmental Management in Banks, Savings Banks and Insurance Companies). It serves to facilitate the exchange of information and promote dialogue among financial entities that are environmentally committed.<sup>26</sup> A focus of the Association’s work has been to develop environmental accounting and reporting methodologies for providers of financial services.<sup>27</sup> Endorsing an essentially voluntary approach, the Association has proclaimed:

The core issue is whether, and if so how, [financial

institutions] should of their own accord insist on environmental protection standards going beyond the national standards applicable in the recipient States, and how those requirements can be implemented, especially in view of tough international competition in the [financial] sector.<sup>28</sup>

Internationally, a catalyst for bringing environmental issues to the attention of global financial markets is the United Nations Environment Programme’s (UNEP) Financial Institutions Initiative. It began in 1992 with the release of the “Statement by Banks on Environment and Sustainable Development”, to provide a

<sup>18</sup> The “social” in CSR is commonly understood to incorporate environmental responsibility: see A.J. Hoffman, *From Heresy to Dogma: An Institutional History of Corporate Environmentalism* (2001).

<sup>19</sup> K. McCague and W. Cragg (eds), *Compendium of Ethics Codes and Instruments of Corporate Responsibility* (2005) p. 9. See further B. Paton, “Voluntary Environmental Initiatives and Sustainable Industry” in P. ten Brink (ed.), *Voluntary Environmental Agreements: Process, Practice and Future Use* (2002) p. 37; T.P. Lyon and J.W. Maxwell “‘Voluntary’ Approaches to Environmental Regulation” in M. Franzini and A. Nicita (eds), *Economic Institutions and Environmental Policy* (2002) 75; J. Moffet and F. Bregha “Non-Regulatory Environmental Measures” in R.B. Gibson (ed.), *Voluntary Initiatives* (1999) p. 15.

<sup>20</sup> See e.g. J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (1995) p. 22; J. Moon, “The Firm as Citizen? Social Responsibility of Business in Australia” [1995] 30(1) *Australian Journal of Political Science* 1. Much of this literature is directed to the financial sector, e.g. C. Holliday, S. Schmidheiny and P. Watts, *Walking the Talk: the Business Case for Sustainable Development* (2002); R. Sparkes, *The Ethical Investor* (1995).

<sup>21</sup> E. Rehbinder, “Self-regulation by Industry” in G. Winter (ed.), *European Environmental Law: A Comparative Perspective* (1996).

<sup>22</sup> European Commission, Communication from the Commission concerning Corporate Social Responsibility: A Business Contribution to Sustainable Development 2 July 2002, COM(2002) 347 final, at p. 11.

<sup>23</sup> European Commission, *supra* p. 20.

<sup>24</sup> Corporation of London and Department of Environment, Food and Rural Affairs (Defra), *Financing the Future. The London Principles: The Role of UK Financial Services in Sustainable Development* (2002) p. 7.

<sup>25</sup> Environmental Bankers Association, at <www.enviro-bank.org>.

<sup>26</sup> Association for Environmental Management in Banks, Savings Banks and Insurance Companies, at <www.vfu.de/english\_index.html>.

<sup>27</sup> See Umweltberichterstattung von Finanzdienstleistern, Ein Leitfaden zu Inhalten, Aufbau und Kennzahlen von Umweltberichtern für Banken und Sparkassen, *Environmental Reporting of Financial Service Providers – A Guide to Content, Structure and Performance Ratios of Environmental Reports for Banks and Savings Banks* (1996).

<sup>28</sup> Association for Environmental Management in Banks, Savings Banks and Insurance Companies, *Time to Act: Environmental Management in Financial Institutions* (1998) p. 3.

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normative framework for banks to manage environmental risks.<sup>29</sup> In 1995 UNEP sponsored a similar statement for the insurance company sector.<sup>30</sup> In May 1997 a more general "Statement by Financial Institutions Initiative on the Environment and Sustainable Development" was drafted by UNEP, enjoining signatories to develop environmentally sound management practises.<sup>31</sup> These Statements epitomise a growing partnership between UNEP and the international financial community to advance dialogue regarding the relationship between environment, trade and development, and to foster greater accord to environmental considerations in credit, investment, and other business decisions.<sup>32</sup> The UNEP's Financial Institutions Initiative also promotes education, research and information programmes, sharing of best practices and development of effective management tools.<sup>33</sup> There are now over 200 signatories to the Initiative, including commercial banks, venture capitalists, asset managers and MDBs.<sup>34</sup>

Significantly, the UNEP is also finalising a set of Principles of Responsible Investment (PRI), which will eventually establish best-practice standards for institutional investors to promote sustainable development.<sup>34a</sup> Climate friendly economic investment is likely to be a major focus of the PRI.

Also recently, a new environmental code known as the 'Equator Principles' has emerged for the project finance sector.<sup>35</sup> Drafted in 2003 under the auspices of the World Bank's International Finance Corporation, the Equator Principles provide a framework that commit interested banks to develop individual policies, procedures and practices to ensure that projects are assessed and carried out according to specific social and environmental considerations.

Not wishing to be sidelined from the agenda, a coalition of environmental NGOs in 2003 also drafted their own code of environmental conduct for financial institutions, known as the Collevocchio Declaration.<sup>36</sup>

While the use of voluntary codes and standards in environmental management has unquestionably grown, they have not necessarily displaced other regulatory tools.<sup>37</sup> Moreover, one should recognise that environmental regulation in many jurisdictions has often been a result of negotiation with subject organisations and thus contains a voluntary, consensual dimension.<sup>38</sup> The model of unilaterally imposed command regulation is a rarity. Environmental regulation, from general legislative norms to industry-specific licence conditions, typically arise through negotiations between governments and polluters and resource users, even if the outcome are laws that do not fully satisfy subject organisations.

### Voluntary codes – structures, functions and values

Before looking at the Equator Principles in detail, it is worthwhile to comment generally on the type of voluntary approach it utilises. Among the various voluntary environmental mechanisms, the Principles can be categorised as a third party voluntary code,

developed by third parties to which subject organisations are invited to implement. Third parties are actors at arm's length from both the individual businesses who implement the codes and from public authorities. They may be environmental NGOs, industry associations, international technical standardisation bodies, or an intergovernmental entity such as the International Finance Corporation in the case of the Equator Principles.

The contents and aims of voluntary codes vary greatly. We can distinguish between those that are performance-based and process-oriented, though most combine both approaches.<sup>39</sup> Performance-based codes dictate substantive goals for the improvement of participants' environmental performance, such as reduction of waste or other indicators of sustainable development.<sup>40</sup> Process-oriented codes concern the procedures by which businesses manage their interaction with the environment, without setting specific targets for environmental performance.<sup>41</sup> They may include, for example, expectations for participants to publicly report on their environmental activities.

Codes also differ in their regulatory function and policy scope. Some perform several regulatory functions such as rule making (e.g. target setting), administration (e.g. reporting and monitoring), and enforcement.<sup>42</sup> In terms of policy scope, some codes target

<sup>29</sup> UNEP, Advisory Committee on Banking and the Environment, *Statement by Banks on Environment and Sustainable Development* (1992).

<sup>30</sup> Contained in C. Joly, "UNEP Insurance Industry Initiative on the Environment: Developments in 1996" [1997] 2 *International Journal of Insurance Law* 171.

<sup>31</sup> See UNEP Financial Institutions Initiative on the Environment, at < [www.unep.ch/etu/fi/finserv/mission.htm](http://www.unep.ch/etu/fi/finserv/mission.htm) >.

<sup>32</sup> In relation to the activities and achievements of the Initiative, see UNEP, *2nd Annual General Meeting of the UNEP Financial Institutions Initiative*, Sept 1998, Chicago (1998); *Managing Environmental Risks in Project Finance, UNEP Financial Institutions Initiative – Fact Sheet No.1* (1999).

<sup>33</sup> R. Cooper, "UNEP's Financial Institutions Initiative" [1999] (Jan/Mar) *UNEP Industry and Environment* 13.

<sup>34</sup> For the list of signatories, see < [www.unepfi.org/signatories/index.html?&no\\_cache=1](http://www.unepfi.org/signatories/index.html?&no_cache=1) >.

<sup>34a</sup> See UNEP, Principles for Responsible Investment at < [www.unepfi.org/work\\_programme/investment/principles](http://www.unepfi.org/work_programme/investment/principles) >.

<sup>35</sup> The text of the Principles is available at ([www.equator-principles.com](http://www.equator-principles.com)) >

<sup>36</sup> The Declaration is available at < [www.foe.org/camps/intl/declaration.html](http://www.foe.org/camps/intl/declaration.html) >

<sup>37</sup> Wood, *supra*.

<sup>38</sup> D. Fiorino, "Regulatory Negotiation as a Policy Process" [1998] 48 *Public Administration Review* 764 (discussing practices in the United States).

<sup>39</sup> E. Meidinger, "Environmental Certification Programs and U.S. Environmental Law: Closer Than You May Think" [2001] 31 *Environmental Law Reporter* 10162 at p. 10163.

<sup>40</sup> *Ibid.*

<sup>41</sup> *Ibid.*

<sup>42</sup> M. Priest, "Five Models of Self-Regulation" [1997–98] 29 *Ottawa Law Review* 233 at p. 239.

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specific environmental problems such as pollution control, while others more comprehensively address the environment in the context of CSR or sustainability.<sup>43</sup> But many codes tend not to be self-executing and therefore need to be translated into precise operational requirements to take effect.

In practice, it should be recognised that voluntary codes are seldom if ever “voluntary” initiatives made autonomously and freely. Most are adopted because the relevant actors have been pressured to act.<sup>44</sup> However, voluntary codes can be considered “voluntary” to the extent their adoption is not formally obliged by authorities. Pressure on businesses to undertake voluntary codes may arise from a threat of mandatory regulation, the prospect of adverse publicity, the need to distinguish themselves in a competitive market, demands from a local community, customers or investors, and industry association membership rules.<sup>45</sup> Further, while the adoption of voluntary codes is not obliged by official regulation, they can have legal consequences once adopted.<sup>46</sup> An industry code or standard may be binding because of subsequent contracts among participating firms (e.g. a loan covenant between a lender and borrower) or through an industry-government negotiated agreement, and it may even become the standard for “reasonable care” in negligence actions.

Some commentators see voluntary approaches as offering a valuable alternative to the much maligned command styles of environmental regulation.<sup>47</sup> Voluntary approaches may embody a “reflexive” style of regulation. In contrast to the heavy hand of command regulation, which seeks to control behaviour directly, a system based on reflexive law “attempts to create incentives and procedures that induce entities to act in certain ways and to engage in internal reflection about what form that behaviour should take . . . the state sets goals, but shares more of the responsibility for achieving them with regulated entities”.<sup>48</sup> Policy instruments such as codes of conduct, corporate environmental management systems and economic incentives are representative of reflexive law. Voluntary codes for example may promote reflection and learning within subject organisations, and thereby a positive cultural change in the management of their business.<sup>49</sup>

For governments, the appeal of voluntary measures is the prospect of a reduced regulatory load as implementation and monitoring costs become more internalised in the participating businesses.<sup>50</sup> The self-regulated enterprises may also have greater knowledge of management practices and innovative possibilities within their area than public authorities.<sup>51</sup> Other advantages to the state may be cost savings from the emphasis on negotiation rather than litigation to achieve environmental objectives. This approach may also lead to higher levels of compliance because industry feels some sense of “ownership” for the rules and norms made.<sup>52</sup>

From the perspective of industry, voluntary com-

mitments can offer a wide range of benefits, including access to technical assistance, financial aid and professional certification and public kudos. Thus, the value of voluntarism has often been framed in terms of the opportunity for lower costs and the competitive advantages for business through an improved environmental profile.<sup>53</sup> Participation in voluntary codes can help reduce company exposure to costly environmental liabilities and lead to improved relations with stakeholders. Apart from production cost advantages, market advantages may also accrue from the improved profile of companies among consumers, financial sponsors and other stakeholders.<sup>54</sup>

But many other scholars and policy-makers are sceptical about whether voluntary codes and standards

<sup>43</sup> E.g. ICC Business Charter; ISO 26000; UN Global Compact.

<sup>44</sup> J. Morrison *et al.*, *Managing a Better Environment: Opportunities and Obstacles for ISO 14001 in Public Policy and Commerce* (2000) pp. 8–10.

<sup>45</sup> E. Bergman and A. Jacobson, “Environmental Performance Review: Self-Regulation in Environmental Law” in G. Teubner, I. Farner and D. Murphy (eds), *Environmental Law and Ecological Responsibility: The Concept and Practice of Ecological Self-Organization* (1994) p. 208.

<sup>46</sup> OECD, *Voluntary Approaches for Environmental Policy in OECD Countries* (1999) pp. 19–20; A. Baranzini and P. Thalmann (eds), *Voluntary Agreements in Climate Policy* (2004) p. 4.

<sup>47</sup> See G. Teubner, I. Farner and D. Murphy (eds), *Environmental Law and Ecological Responsibility: The Concept and Practice of Ecological Self-Organization* (1994); E.W. Orts, “Reflexive Environmental Law” [1995] 89(4) *Northwestern University Law Review* 1227.

<sup>48</sup> D.J. Fiorino “Rethinking Environmental Regulation: Perspectives on Law and Governance” [1999] 23 *Harvard Environmental Law Review* 441, p. 448.

<sup>49</sup> J. Nash and J. Ehrenfeld, “Codes of Environmental Management Practice: Assessing their Potential as a Tool for Change” [1997] 22 *Annual Review of Energy and the Environment* 487 (considering five codes in terms of their generation of new environmental practices and facilitation of cultural change in participating organisations).

<sup>50</sup> On the acclaimed advantages of business self-regulation, see A. Ogus, “Rethinking Self-Regulation” in R. Baldwin, C. Scott and C. Hood (eds), *A Reader on Regulation* (1998) p. 374.

<sup>51</sup> J. Verschuuren, “EC Environmental Law and Self-Regulation in the Member States: In Search of a Legislative Framework” in H. Somsen *et al.* (eds), *Yearbook of European Environmental Law*, volume 1 (2000) p. 103 at p. 108.

<sup>52</sup> *Ibid.*

<sup>53</sup> See K. Lester, “Protecting the Environment: A New Managerial Responsibility” in D. Owen (ed.), *Green Reporting: Accountancy and the Challenge of the Nineties* (1992) p. 39.

<sup>54</sup> See S. Arora and S. Gangopadhyay, “Toward a Theoretical Model of Voluntary Overcompliance” [1995] 28(3) *Journal of Economic Behavior and Organization* 289.

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can provide a viable means of environmental protection and doubt that they are legitimate instruments of environmental regulation.<sup>55</sup> One major concern is that voluntary measures may lack transparency and accountability in the way they are developed and the means by which interested persons can judge compliance.<sup>56</sup> In relation to CSR codes for ethical investment, the European Commission in its 2002 Communication on Corporate Social Responsibility commented on the importance of transparency:

For Socially Responsible Investment (SRI) to contribute to the promotion of CSR, the development by rating organisations – independent consultants or SRI departments of investment banks – of criteria and indicators which identify the factors of competitive advantage and business success of socially responsible enterprises is essential.<sup>57</sup>

Not all codes provide a means of external verification, usually an essential means of achieving transparent, accountable decision-making.<sup>58</sup> Verification of conformity may be achieved in several ways. Self-verification is where a business self-assesses and self-determines its own compliance. By contrast, second-party verification involves compliance being verified by another party with a commercial interest in the subject business (e.g. a bank verifying a borrower). And third-party verification is where an independent, impartial third party assesses compliance.<sup>59</sup>

Apart from compliance problems, voluntary measures may serve to pre-empt regulation and thereby forestall meaningful change – in other words, they become a means to disguise business as usual.<sup>60</sup> Voluntary regimes have implications for power relations, as their development, content or implementation may disadvantage particular actors such as developing countries, public interest NGOs, governments or the general public.<sup>61</sup> We must therefore ask which actors and interests are dominant and which are excluded or marginalised from the environmental decision-making? Greater involvement of environmental and community NGOs in the design of voluntary environmental measures may therefore assist in making these instruments more publicly acceptable. Arguably, self-regulation is not an optimal form of control of activities that are particularly hazardous, pose risks to third parties or for those which information is uncertain or controversial.<sup>62</sup> Finally, it should be noted that the negotiation and development of voluntary measures is also accompanied by transaction costs, and there is the perennial danger of free riding, whereby some non-participating businesses take advantage of the benefits of a voluntary environmental regime without contributing to their costs.<sup>63</sup>

The remainder of this article considers in detail the example of the Equator Principles. The aim is to explain what it demands of financial institutions, to assess its implementation and to make some observations about the adequacy of this voluntary measure for the promotion of environmentally sustainable finance.

## III. The Equator Principles

### Main provisions

The Equator Principles (EPs) are an international voluntary code of environmental conduct for banks.<sup>64</sup> The EPs were drawn up under the auspices of the World Bank group, and are directed primarily to private, commercial lending in developing countries and emerging economies where borrowers rely more heavily on external project finance than is the case for businesses and governments in OECD countries. The principles arose in the context of pressure from institutional investors like the Calvert Group of funds in the United States and Insight Investment in the United Kingdom, as well as pressure from environmental NGOs such as the Worldwide Fund for Nature and Friends of the Earth.<sup>65</sup>

In 2002, the World Bank's International Finance Corporation (IFC), the private-sector lending arm of the World Bank Group, convened a meeting of some of the world's major commercial banks to address environmental and social issues encountered in project finance. The parties agreed to develop voluntary guidelines regarding these risks. The result, issued in June 2003, was the "Equator Principles", to which interested banks were invited to implement.<sup>66</sup> The EPs are not a self-contained set of principles, but incorporate other sets of standards, particularly the IFC's Safeguard Policies which address: environmental assessment, natural habitat, pest management, forestry, safety of dams, indigenous peoples, child labour, international waterways, etcetera.

<sup>55</sup> See A. Neale, "Organising Environmental Self-Regulation: Liberal Governmentality and the Pursuit of Ecological Modernisation in Europe" [1997] 6 *Environmental Politics* 1; I. Maitland, "The Limits of Business Self-Regulation" [1995] 27(3) *California Management Review* 132.

<sup>56</sup> R.B. Gibson, "Questions About a Gift Horse" in R.B. Gibson (ed.), *Voluntary Initiatives* (1999) pp. 3, 6–7.

<sup>57</sup> European Commission, *supra* p. 16.

<sup>58</sup> Wood, *supra*.

<sup>59</sup> *Ibid.*

<sup>60</sup> OECD, *supra* pp. 31–38.

<sup>61</sup> See R. Krut and H. Gleckman, *ISO 14001: A Missed Opportunity for Sustainable Global Industrial Development* (1998); N. Roht-Arriaza, "Shifting the Point of Regulation: The International Organization for Standardization and Global Lawmaking on Trade and the Environment" [1995] 22(3) *Ecology Law Quarterly* 479; R. Hillary, *Environmental Management Systems and Cleaner Production* (1997).

<sup>62</sup> Ogus, *supra* p. 379.

<sup>63</sup> OECD, *supra* pp. 40–42, 99.

<sup>64</sup> T. O'Riordan, "Converting the Equator Principles to Equator Stewardship" [May 2005] 47(4) *Environment* 1.

<sup>65</sup> Freshfields Bruckhaus Deringer, *Banking on Responsibility* (July 2005) p. 7.

<sup>66</sup> The EPs can be found in their entirety at < [www.equator-principles.com](http://www.equator-principles.com) > .



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The EPs address project finance, which involves lending for specific, new projects such as highways, dams, factories and other major economic investments. Though the Principles are “adopted” by interested banks, the bank’s borrowers, whether government or nongovernment, are expected to adhere to them so long as the lender has put in place appropriate policies and procedures. The EPs expect that each adopting lender’s policies and processes will, for all projects with a total capital cost of US\$50 million or more, provide for the following:

- 1 The lender must categorise the risk to the environment posed by a project as either Category A, B or C, according to standardised guidelines. Category A includes projects “likely to have significant adverse environmental impacts that are sensitive, diverse or unprecedented”. Category B projects pose impacts that are “less adverse” than those of Category A projects. Category C projects are “likely to have minimal or no adverse environmental impacts”;
- 2 The borrower must complete an environmental impact assessment (EIA) for all Category A and Category B projects, which evaluate specified issues, and prepare an environmental management plan based on the findings of the project’s EIA;<sup>67</sup>
- 3 The borrower or a third party expert, for all Category A projects and appropriate Category B projects, must consult “in a structured and culturally appropriate way, with project affected groups, including indigenous peoples and local NGOs”. This requires that (a) the assessment or a summary thereof be made publicly available in a local language and (b) the assessment and management plan take account of the required consultations with project affected groups. For all Category A projects, the assessment and management plan must be “subject to independent expert review”;
- 4 The borrower must covenant with the lender to: (a) comply with the environmental management plan in the construction and operation of the project, (b) provide regular reports on compliance with the plan, and (c) where applicable, decommission facilities in accordance with an agreed plan; and
- 5 If necessary, the lender must appoint an independent environmental expert to provide additional monitoring and reporting.

Where an EIA is required, the issues that it must address, as applicable, include: assessment of baseline environmental and social conditions; requirements under host country laws and international agreements; use of renewable natural resources; protection of human health, cultural properties, and biodiversity; impacts on indigenous peoples and local communities; the cumulative impacts of existing projects, the proposed project, and anticipated future projects; and consideration of feasible environmentally and socially preferable alternatives.

The EPs have been generally well received by the banking community. A recent study by British law

firm Freshfields Bruckhaus Deringer concluded that the EPs “impact on the financial market generally and their success in redefining banking considerations has been far greater than anyone could have predicted”.<sup>68</sup> The online magazine *Environmental Finance* in 2005 described the Equator Principles as “a shining beacon for responsible banking”.<sup>69</sup> To date, 33 banks and other financial institutions including mutual fund providers and life insurance businesses have pledged themselves to the Principles, accounting for about 80 percent of the global project financing market.<sup>70</sup> But Japanese<sup>71</sup> and French banks are notably absent from the project-finance banking community that has endorsed the EPs.<sup>72</sup> The participating organisations have had various motives for signing up to the Principles, including: the standards expected represent business as usual, stake-holder and NGO activism, protection of market share, the desire for a level business playing field, the voluntary nature of the standards, and to minimise financial risk taking.<sup>73</sup> For some lenders, subscription to the EPs offer public relations benefits in the face of increasing NGO scrutiny of their environmental activities. For instance, in 2000, the Rainforest Action Group (RAN) began campaigning against the Citigroup’s funding of old-growth logging projects and an oil pipeline through an Ecuadorian nature reserve.<sup>74</sup> Thereafter, Citigroup

<sup>67</sup> The environmental management plan need not be prepared for Category B projects if it is not “considered appropriate”.

<sup>68</sup> Freshfields, *supra* p. 1.

<sup>69</sup> Environmental Finance: <www.environmental-finance.com/2005/0506jun/equator.htm>.

<sup>70</sup> Listed at <www.equator-principles.com> (as of September 2005). The adopting institutions are: ABN Amro Bank NV, Banco Bradesco, Banco do Brasil, Banci Itau, Bank of America, Barclays, BBVA, BES Group, Calyon, CIBC, Citigroup, Credit Suisse Group, Dexia Group, Dresdner Bank, EKF, HSBC Group, HVB Group, ING Group, JP Morgan, KBC, Manulife, MCC, Mizuho Corporate Bank, Rabobank Group, Royal Bank of Canada, Scotia Bank, Standard Chartered Bank, Royal Bank of Scotland, Unibano, WestLB AG, and Westpac Banking Corporation.

<sup>71</sup> One reason for fewer Japanese banks participating is because the Japan Bank for International Co-operation has its own Guidelines for Coordination of Environmental and Social Considerations (April 2002). Some Japanese banks may feel that those guidelines are adequate: Freshfields, *supra* p. 66.

<sup>72</sup> *Ibid.* p. 47.

<sup>73</sup> *Ibid.* p. 50. The Freshfields study (p. 65) identified various reasons why some banks want to stay out of the EPs: scepticism, necessary internal systems not in place, similar procedures already in place, and fear of contagion (ie principles may latter spread like a virus to other arms of the bank’s business, such as export credit finance or general lending).

<sup>74</sup> M Yeomans, “Banks Go for Green” [30 May 2005] *Time* A13.



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began to consult with RAN and in 2004 announced that it would apply the EPs to its future business including no further financing of firms that logged primary rainforests.

The EPs should apply to projects involving more than US\$50 million of financing. To put this figure in perspective, this threshold excludes only about three percent of private sector project financing around the world.<sup>75</sup> In any event, some Equator banks have lowered (e.g. JPMorgan Chase) or abandoned (e.g. Citigroup, ABN Amro Bank) the \$50 million threshold where feasible. JP Morgan Chase and Citigroup have also extended the Equator-like categorisation to equity and underwriting transactions (outside of project finance) even though the use of proceeds may be unknown.<sup>76</sup> The HSBC perhaps goes furthest in this respect, applying the EPs “to project advisory roles, corporate lending where the end use of proceeds is for a project, and to other forms of financial assistance such as bonding and guarantees directly linked to projects”.<sup>77</sup>

While some financial institutions outside of the project-financing sector have embraced the EPs, and some Equator banks have extended the Principles to their non-project finance activities, the EPs do not provide a general framework for promoting environmentally sound financing across the whole financial services sector. The Principles are structured around decision-making in project finance. They are not intended for, and cannot easily be adapted to, investments made by pension funds or mutual funds, for instance.

### Implementation of the Equator Principles

Ultimately, the value of the EPs depends on how they are implemented. The quality of implementation hinges heavily on public accountability, transparency and enforceability.

On accountability, decisions by a lender regarding the categorisation of a project or the scope of a related EIA or management plan cannot readily be challenged. The categorisation of a project is crucial, for it influences the types of environmental standards and procedures that would subsequently be applied. Normally, environmental legislation would allow interested persons to review and challenge such a threshold decision. While affected groups may comment publicly on an EIA or a proposed management plan, as a voluntary code the EPs do not provide them with any legal rights to challenge an assessment or a management plan that is deficient. The value of a series of principles is questionable if one cannot verify that they are being applied on a project-by-project basis.

The EPs however allow for an independent environmental expert to monitor a project where “necessary” in the view of the Equator bank, but do not mandate it. Further, although the principles require the EIA report to be made public, there is no similar requirement for the management plan or for

continued public disclosures regarding compliance once a project has commenced. For some banks, an open transparent implementation of the EPs may sit uncomfortably with the protocols of client confidentiality, breach of which can entail civil or criminal sanctions, and damage the relationship between a lender and its clients.

A study by BankTrack, an umbrella organisation of various NGOs, was critical of the Equator banks’ efforts to promote accountability and transparency. Its 2005 review of the Principles concluded that the majority of them provided only limited reporting of their implementation of the EPs.<sup>78</sup> BankTrack suggested there has also been some hesitancy among Equator banks to disclose the details (e.g. names, locations, facilities) of projects that have been financed or declined.<sup>79</sup> On the other hand, a report by Freshfields more optimistically suggested that the Principles have led some Equator banks “into more structured dialogue with stakeholders and NGOs about social and environmental aspects of their lending”.<sup>80</sup>

On enforceability, the EPs expressly declare that they “do not create any rights in, or liability to, any person, public or private”. Thus, while borrowers must adhere to environmental covenants that lenders include in the loan agreement, lenders themselves are not contractually bound to comply with the principles or to enforce them against their borrowers. Of course, shareholders of a publicly-listed Equator bank might contend that they have relied on their bank’s public statements that they are abiding by the EPs. In some jurisdictions this would enable shareholder suits where the bank’s reputation (and therefore the business and shareholder value) suffered because of a failure to implement the principles.<sup>81</sup>

The effectiveness of the EPs is being tested early on by several major, international infrastructure projects. One is the Baku-Tbilisi-Ceyhan (BTC) pipeline, which will traverse Azerbaijan, Georgia and Turkey to bring Caspian Sea oil to the West.<sup>82</sup> According to

<sup>75</sup> Freshfields, *supra* p. 11. But there is a risk that sponsors could “salami-slice” a project so that each part falls below the \$50 million cut-off. But such a financing arrangement would be impractical for most banks in project financing.

<sup>76</sup> *Ibid.* p. 73.

<sup>77</sup> M. Chan-Fishel, *Unproven Principles: The Equator Principles at Year Two. An Anniversary Assessment*, commissioned for Friends of the Earth and BankTrack (June 2005) p. 8.

<sup>78</sup> *Ibid.* p. 5.

<sup>79</sup> *Ibid.* p. 6.

<sup>80</sup> Freshfields, *supra* p. 10.

<sup>81</sup> See R. Kraakman *et al.*, “When are Shareholder Suits in Shareholder Interests?” [1994] 82 *Georgetown Law Journal* 1733.

<sup>82</sup> BankTrack, “Principles, Profit or Just PR?” (BankTrack, 2004); see also “BTC Project is the First Major Test of the Equator Principles”, available at <www.equator-principles.com/btc.shtml>.

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BankTrack, this project, funded by a consortium of financiers including several Equator banks, violates the EPs in several key areas. These include protection of indigenous peoples and risk of oil pollution of some ecologically sensitive terrain. However, the pipeline development consortium has in many respects applied the EPs in an open manner. To comply with EPs' public disclosure requirement, the consortium created a publicly accessible website,<sup>83</sup> where the public could consult the environmental assessments and related documents, many published in English, Azerbaijani, Georgian and Turkish. The IFC also devoted a portion of its website to the BTC project and made numerous project documents available to the public.<sup>84</sup> The BTC case shows that an Equator bank may be fully in conformity with the decision-making procedures laid down by the Principles yet still ultimately fund a development that many regard as fundamentally incompatible with sustainable development.

Another controversial project is the Sakhalin II oil and gas project, in Sakhalin Island, a far eastern Russian territory. The British Petroleum constructed project is financed by an international finance consortium including Shell, and Credit Suisse First Boston (itself an Equator bank). The first stage was financed with assistance from the European Bank for Reconstruction and Development (EBRD) and Japanese and US export credit agencies. Environmentalists fear the pipelines risk oil spills that could destroy rich salmon fisheries and endanger the rare western gray whale.<sup>85</sup> In June 2005 eight international NGOs placed a full-page advertisement in the *Financial Times* urging Credit Suisse First Boston to abide by its EP sustainability commitments and to sever its relationship as financial advisor to the Sakhalin II project.<sup>86</sup>

Both of these projects highlight, among various problems, the challenges of upholding the EPs for projects financed by an international consortium. Not all of the participating banks may have endorsed the Principles and how should those that have fulfil their environmental responsibilities? A few banks explicitly describe their application of the Principles when participating in loan syndications with non-EP banks. For example, the Australian bank Westpac notes that "in terms of lending to projects alongside non-equator banks, we require compliance with the Principles irrespective of the position of non-signatory banks".<sup>87</sup>

The Freshfields study cautioned against unrealistic expectations given the structure of project financing arrangements. It suggested that the potential leverage of lenders over borrowers' environmental performance can be limited because banks often do not get involved in a project financing deal until late in the game when basic project choices and design decisions have already been made.<sup>88</sup> Further, determined would-be borrowers who wish to carry out environmentally problematic projects have various means at their disposal to circumvent an Equator bank's demands – such as by self-financing a project using shareholder funds, re-

financing using limited recourse debt once the project is completed or in operation, or a project bond or similar capital markets product.<sup>89</sup> The latter problem points to the need for more comprehensive solutions that address the entire financial markets rather than merely project finance.

### IV. An Alternative Voluntary Code: The Collevocchio Declaration

Environmental NGOs critical of the EPs have offered financial institutions an alternative code of environmental principles. Their Collevocchio Declaration on Financial Institutions,<sup>90</sup> prepared in January 2003, provides a seemingly more ambitious and stricter set of environmental standards. Because groups outside of the financial sector prepared it, the Collevocchio Declaration presents itself as a more objectively and independently determined voluntary code. On the other hand, this circumstance is also possibly a disadvantage, as the Collevocchio Declaration might be seen as based on a naive or inaccurate understanding of the workings of financial institutions.

The Collevocchio Declaration presents six principles that financiers should embrace, namely commitments to: sustainability, "do no harm", responsibility, accountability, transparency, and sustainable markets and governance. Its accompanying 'Implementation Document' outlines immediate steps financial institutions should take, such as the adoption of internationally-recognised industry standards for credit, investing and underwriting transactions. To date 101 organisations have endorsed the Collevocchio Declaration principles, though very few endorsements have come from financial institutions, perhaps because they probably see the Declaration as too radical and threatening to their status quo.<sup>91</sup>

The Declaration differs from the EPs in many ways. For a start, the "commitment to sustainability"

<sup>83</sup> At <[www.caspiandevlopmentandexport.com/ASP/Home.asp](http://www.caspiandevlopmentandexport.com/ASP/Home.asp)>.

<sup>84</sup> See <[www.ifc.org/ifcext/spiwebsite1.nsf/2bc34f011b50ff6e85256a550073ff1c](http://www.ifc.org/ifcext/spiwebsite1.nsf/2bc34f011b50ff6e85256a550073ff1c)>.

<sup>85</sup> See CEE Bankwatch Network: <[www.bankwatch.org/issues/oilclima/sakhalin2/main.html](http://www.bankwatch.org/issues/oilclima/sakhalin2/main.html)>.

<sup>86</sup> "Oil is Over. Fund the Future" [30 June 2005] *Financial Times*.

<sup>87</sup> Chan-Fishel, *supra* p. 7.

<sup>88</sup> Freshfields, *supra* p. 11.

<sup>89</sup> *Ibid.* p. 12.

<sup>90</sup> Drafted in Collevocchio, Italy, The Declaration is available at <[www.foe.org/camps/intl/declaration.html](http://www.foe.org/camps/intl/declaration.html)>.

<sup>91</sup> Most of the endorsements have come from environmental and civil society NGOs: see further <[www.foe.org/camps/intl/endorsements.html](http://www.foe.org/camps/intl/endorsements.html)>.

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principle projects a more broad based obligation for financial institutions, which:

must expand their missions from ones that prioritize profit maximization to a vision of social and environmental sustainability. A commitment to sustainability would require financial institutions to fully integrate the consideration of ecological limits, social equity and economic justice into corporate strategies and core business areas (including credit, investing, underwriting, advising), to put sustainability objectives on an equal footing to shareholder maximization and client satisfaction, and to actively strive to finance transactions that promote sustainability.

The EPs diverge from the Collevocchio Declaration in several other ways. For example, the Declaration's "do no harm" principle entails an explicit commitment to categorical prohibitions for the most socially and environmentally egregious transactions. Concomitantly, the Declaration emphasises a precautionary-based approach rather than one based on mitigation, as in the EPs. The Collevocchio Declaration also seeks to strengthen financiers' accountability and transparency – notable perceived weaknesses of the EPs. In relation to transparency, for instance, it requests that financial institutions:

be transparent to stakeholders, not only through robust, regular and standardized disclosure, but also through being responsive to stakeholder needs for specialized information on financial institutions' policies, procedures and transactions. Commercial confidentiality should not be used as an excuse to deny stakeholders information.

The Declaration's accompanying Implementation Document usefully elaborates on these principles and gives financiers specific directions on how to promote environmentally sound financing. For example, in relation to the Commitment to Transparency, the Implementation Document provides:

## a) Corporate Sustainability Reporting

Financial institutions should publish annual sustainability reports according to an internationally recognised reporting format supported by civil society. Financial institutions should further include disclosure on the sustainability profile of the financial institution's portfolio, a breakdown of core business activity by sector and region, and the implementation of the financial institution's sustainability policies and objectives.

## b) Information Disclosure

There should be an assumption in favour of disclosure of information. Particularly for compiled transactions, but also for those in the pipeline, financial institutions should publicly provide information on companies and significant transactions in a timely manner, and not hide behind the excuse of business confidentiality.

These and other standards are likely to be too much for banks and other financiers to accept, at least for

now. The reality is that most financial institutions do not see the environment as sufficiently relevant to their business. There are usually only three situations where banks may consider the environment seriously.<sup>92</sup> Firstly, there is the prospect of direct lender liability where a bank becomes responsible for the environmental liabilities of its clients, such as liability to cleanup contaminated land.<sup>93</sup> Secondly, where environmental problems generate indirect credit risks for lenders where a borrower experiences financial hardship, such as by incurring an onerous pollution penalty fine. Thirdly, there is a reputational risk for banks when they associate with environmentally controversial developments or firms. For the moment, banks driven by such concerns will likely find the EPs offer a suitable safe harbour for demonstrating a commitment to the environment without radical change to their lending practices and profit-making opportunities.

## V. Conclusions

Despite its critics, the EPs are a step in the right direction. But the Principles surely cannot in their current form provide an adequate basis for nurturing a commitment to environmentally sustainable finance. The EPs' core standards are too weak, for they do posit substantive environmental goals or benchmarks for banks to achieve. Rather, the EPs provide a process for incorporating environmental considerations into project financing decision-making. While it is true that the way decisions are made can influence the *outcome* of those decisions (eg requirements to complete an environment assessment of a proposed project), a procedural approach depends on publicly accountable and transparent decision-making to engender meaningful change.<sup>94</sup>

A variety of proposals have been canvassed to strengthen these and other aspects of the EPs. The Freshfields study recommended that the EP banks establish an independent commission or Ombudsman to investigate alleged abuses of human rights and environmental damage relating to financed projects.<sup>95</sup> Freshfields also noted that an independent Environment Bank could be set up to help conduct environmental assessments and to monitor implementation of the

<sup>92</sup> B.J. Richardson, "Environmental Liability and Banks: Recent European Developments" [2000] 17(10) *Journal of International Banking Law* 289 at p. 290.

<sup>93</sup> S. Rose-Ackerman, "Environmental Liability Law" in T.H. Tietenberg (ed.), *Innovation in Environmental Policy* (1992) p. 243; J.J. Norton, R.M. Auerback and J.M. Gaba *Environmental Liability for Banks* (1995).

<sup>94</sup> See B.J. Richardson and J. Razzaque, "Public Participation in Environmental Decision-Making" in B.J. Richardson and S. Wood (eds), *Environmental Law for Sustainability* (2006): *forthcoming*.

<sup>95</sup> Freshfields, *supra* pp. 14–23.

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EPs.<sup>96</sup> In particular, the Equator banks are finding the assessment of social issues and impacts particularly challenging. While there are well-developed EIA methodologies that banks can use, this is not the case for human rights and social issues. Social impacts are very hard to predict, and such impacts can be very site-specific.<sup>97</sup>

BankTrack also sees room for improvement. It argued that the EPs should be adopted not through a simple public announcement but through first making formal changes to lending policies.<sup>98</sup> Equator banks could acquire their status through some kind of assessment and verification process, as used for subscription to certain corporate environmental management systems such as the European Union's Eco-Management and Audit Scheme or the standards and codes of the International Organization for Standardization.

BankTrack also recommended that loan covenants be tailored better to each specific project financed. Loan covenants should include affirmative and negative environmental and social obligations, and provide for the implementation of the environmental management plan (for category A and B projects).<sup>99</sup> BankTrack has demanded that Equator banks develop adequate mechanisms and in-house capabilities to monitor compliance with environmental and social loan covenants on a similar basis as the standard financial loan covenants. Equator Banks should also create a joint "independent accountability mechanism" (IAM) to ensure the implementation and continuous improvement of the EPs and to provide project affected communities a mechanism for recourse.<sup>100</sup> For example, the IAM could collect and review Equator Banks' annual public disclosures regarding their implementation of the Principles. Like the Freshfields study, BankTrack proposed the appointment of an Ombudsman, "to provide people or communities directly impacted by projects financed by EP banks a recourse mechanism that is fair, objective and constructive".<sup>101</sup>

These are not the only problems and challenges facing the EPs. A wide range of technical and practical issues remain unresolved, including the need for greater due diligence by project sponsors and lenders, and for lenders to be consulted and involved much earlier in the project cycle if they are to exert more influence. Equator banks also need to develop sector policies for environmental protection that can provide a more detailed policy framework than that offered by the EPs. Already, for example, ABN Amro Bank has developed industry sector policies for, among others, forestry, mining and tobacco, while the HSBC has prepared a freshwater policy, based in part on the World Commission on Dams' recommendations.<sup>102</sup> A further immediate challenge concerns the IFC's review of its Safeguard Policies, on which the Principles are based. While a substantial number of Equator banks are committed to the EPs however they evolve, some lenders may find the

outcome of the IFC review (to be completed by late 2005) unpalatable. There is a risk of schism between these two groups and some Equator banks may decide to divorce themselves from the Principles.

Beyond project financing, there is the challenge of developing and extending the EPs to other areas of financial markets and institutional investors. Environmental NGOs view the EPs as a springboard; they should be a starting point of a much wider process of reform, extending such principles not only to project finance, but also to all bank activities, and eventually to the financial markets generally.<sup>103</sup> There has been some resistance from Equator banks to such proposals. It seems much easier to incorporate environmental considerations into project finance transactions than other banking activities. The project loan documentation can include covenants such as default and enforcement powers that give the banks much more influence over the business of the borrower than in the case of other types of lending transaction. Other methods of financing such as general corporate lending do not provide the opportunities for assessment, monitoring and enforcement.

UNEP's Financial Institutions Initiative, which involves a wider array of financial entities including insurance companies, already to some extent provides such a broader framework for environmentally responsible financing. But UNEP's seeming lack of success after nearly 15 years suggests that the key issue ultimately may be not the extension of voluntary codes and standards, but to reassess whether voluntary mechanisms *per se* are an appropriate and adequate tool for promoting environmentally sustainable finance.<sup>104</sup> Substantial empirical research is needed to answer that question. We need to know a lot more about the types of regulatory mechanisms that would best induce change in the environmental performance of the financial sector. Voluntary codes are one instrument. Others include economic instruments such as taxation incentives, direct command regulation and informational policy tools like mandatory environmental reporting. Thus, whether the EPs prove to be merely window-dressing or a significant change in the terms of private financing for projects, is not yet clear. But there is already some reason to be concerned that the former rather than latter prognosis will be borne out.

<sup>96</sup> *Ibid.* pp. 96–97.

<sup>97</sup> *Ibid.*

<sup>98</sup> Chan-Fishel, *supra* p. 3.

<sup>99</sup> BankTrack, *No U-Turn Allowed: Recommendations to the Equator Banks* (2004) p. 8.

<sup>100</sup> *Ibid.* p. 9.

<sup>101</sup> *Ibid.*

<sup>102</sup> Chan-Fishel, *supra* p. 8.

<sup>103</sup> *Ibid.* p. 1.

<sup>104</sup> See e.g. criticisms of UNEP signatory banks' involvement in China's controversial Three Gorges Dam: A Aslam, "Chinese Dam Tests 'Green' Banking Club" (13 Sept 1999) *Inter Press Service*.