ENVIRONMENTAL ASSESSMENT IN MULTILATERAL DEVELOPMENT BANK INTERMEDIARY LENDING

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Abstract

A substantial portion of private sector investments in emerging market economies internationally is routed through the use of Financial Intermediaries (FIs). FIs act as important gateways for channeling the resources from large Multilateral Development Banks (MDBs), to micro, small and medium-sized (SME) projects and enterprises whose comparatively limited business portfolios would otherwise make them ineligible for funding. During a MDB's scoping, FI clients are classified into a unique Category FI, whereby the onus for Environmental Assessment (EA) is transferred from the MDB to the FI. Although EA guidelines exist, FI institutions often fail to adequately incorporate them in their sub-project review. This increases the potential for environmentally and socially harmful development decisions being made by the FI with financial resources originating from MDBs. This paper identifies the factors limiting the successful incorporation of EA in FI subproject financing, in an attempt to develop tools to assist MDB's and their FIs attain compliance with local, national and international EA laws and regulations.

Keywords: International development; Impact assessment; Social responsibility; Policy

Introduction

Private sector development is one of the keys to promoting economic growth and job creation in the developing world. A healthy private sector allows governments to generate the revenue needed to expand health, education and infrastructure services and, in effect, increase their productivity. Strong economies are essential if developing nations are to meet the Millennium Development Goals (MDG) and halve the number of people living in poverty by 2015. Although global capital flow to emerging market economies has been increasing at a constant rate since the mid-nineties, the proportion of private sector investments has been generally rising at a steeper rate (Das, 2000; Institute of International Finance, 2008). A substantial portion of private sector investments to emerging market economies internationally is routed through Financial Intermediaries (FIs) (see Aggarwal, 2001). FIs are important gateways through which funding from large Multilateral Development Banks (MDBs) can be channeled to micro, small and medium-sized (SME) projects and enterprises whose comparatively limited business portfolios would otherwise make them ineligible for funding from these organisations (European Bank for Reconstruction and Development (EBRD), 2004). Internationally, investments in FIs from large development banks, private equity and trust funds have undergone considerable growth (Kiviat, 2008). If this trend continues, the future in development banking and development aid will likely involve an even greater use of FIs in lending (International Finance Corporation (IFC), 1999).

As large international organizations, it is part of the MDBs mandates and responsibilities to secure and improve the livelihood and wellbeing of both society and the environment. Environmental Assessment (EA) is therefore a central concept in the environmental and social (E&S) policies of most major MDBs. EA procedures are incorporated into all MDB lending operations, initiated at the scoping phase where potential projects are categorized based on the scale of impact (African Development Bank (AfDB), 2004). When projects are funded through FIs, they are automatically assigned by the MDB to a separate Category, FI, whereby the onus for EA is on the FI and not on the Bank (IFC, 1999; AfDB, 2001; Asian Development Bank (ADB), 2003; European Investment Bank (EIB), 2007; Netherlands Development Finance Company (FMO), 2007a). However, FI institutions often struggle to adequately incorporate EA into their review of the smaller projects they fund, as EA procedures do not have much elasticity and often cannot be “compressed” to smaller proportions and multiplied to numerous projects. This “EA operational loophole” opens the door to the potential for on-lending MDB finance to sub-projects with major cumulative adverse environmental and/or social impacts in a given location or sector. Since FIs are under the scrutiny of regulators and investors for whom corporate governance and accountability is of increasing investment concern, there is a need to improve the current EA protocols of both FI lending and FI sub-project financing.

Worldwide, financial institutions have begun to reform the way that they appraise projects for environmental and social risk through the application of best practice benchmarks such as the Equator Principles II, which govern 80 percent of projects in the emerging market economies (Oxford Analytica, 2008). These principles set standards that require E&S assessment be included in project financing. Whereas in the past only large multilateral organisations felt pressured to incorporate E&S issues into their lending operations, the pace at which organizations have voluntarily become Equator Principle Financial Institutions is an indication that the Equator Principles are raising the bar for financial institutions of all sizes (Scholtens and Dam, 2007). It is internationally recognized that FIs can play a potential role in promoting environmental protection and the sustainable use of resources and social

safeguard policies internationally, by incorporating EA into their banking operations (FMO, 2007b).

This paper evaluates the role of the FIs in international development aid and critiques their application of EA. It examines the EA procedures set by the major MDBs in regard to their FI loans (FILs); specifically, the FIL EA procedures of the AsDB, AfDB, Deutsche Investitions- und Entwicklungsgesellschaft (DEG), European Bank for Reconstruction and Development (EBRD), FMO, Inter-American Development Bank (IDB), International Finance Corporation (IFC) and Promotion et Participation pour la Coopération économique (PROPARCO). While other MDBs also have FI EA procedures in place, details on these were not available at the time of our research. The aim here is to identify the factors limiting the successful incorporation of EA in FI subproject financing to ensure compliance with local, national and international laws and regulations.

International Development Aid

Brief history of international development aid

The initial concept of the World Bank was conceived at the 1944 United Nations (UN) Monetary and Financial Conference and formally established with the 1945 ratification of the Bretton Woods agreement in New Hampshire (Driscoll, 1996; IFC, 2008c). Its original mandate was to facilitate post World War II reconstruction and development by lending capital to its member governments. In 1947, France was the first recipient of World Bank funding when it received a loan of US$250 million. In response to developing needs internationally, over time the World Bank adjusted focus to poverty reduction and debt alleviation, although reconstruction and development still occupy a large part of its portfolio (World Bank, 2008).

The World Bank provides financing to the governments of low to middle income countries in order to promote economic growth and with the ultimate goal of poverty eradication. Financing from the World Bank is limited, however, in that it is reserved for public sector (government) lending. In the 1950's and 60's, international corporations and commercial financing institutions had little or no interest in investing in the emerging market economies of Africa, Asia, Latin America or the Middle East; economies where the benefits of private sector development were most desperately needed. With few prospects for foreign investment in the developing world and just minor opportunities to draw upon domestic capital, there was a realization by many of the need for a catalyst to stimulate private investment (IFC, 2008c).

The International Finance Corporation (IFC) was created in 1956 as a new private sector arm of the World Bank Group, owned by governments and acting as a corporation. As the World Bank was doing for public sector projects, the IFC was responsible for lending money, taking equity and providing technical support in appraising private investment proposals in developing countries. By working as a partner alongside public investors and assuming an equal commercial risk, the IFC was able to remove some of the major obstacles impeding private investment to developing countries. Indirectly, the IFC also played a dual role acting as a mechanism to mobilize finances, technology and expertise from the developed world to the underdeveloped (IFC, 2008c). Although focused on the private sector, the IFC differs from traditional commercial banks in that it is mandated to play a catalytic role in the developing economy by investing in projects that cannot attain sufficient private capital on reasonable terms (IFC, 2008c).

The World Bank paved the way for public sector financing to developing nations, as did the IFC for the private sector, and together these institutions set precedence for the regional MDBs that followed. The Inter-American Development Bank (IDB) founded in 1960, The African Development Bank (AfDB) founded in 1963, the Asian Development Bank (AsDB) founded in 1966, and several more leading to the most recent, The European Bank for Reconstruction and Development (EBRD) founded in 1991 (Tussie, 1995; Rist, 2004; English & Mule, 2005; Kappagoda, 2005; Ben-Artzi, 2006). These MDBs reserve their financing for regional development and therefore are also often referred to as Regional Development Banks (RDBs). Unlike the World Bank and IFC, which specialize only in the public and private sector respectively, most Regional Development Banks are involved in both public and private sector lending.

The role of the private sector in international development aid

Financial institutions and private investors are the major benefactors of the private sector (i.e. non-government development and entrepreneurs) in emerging market economies. Much like government initiatives, the private sector contributes many key components to development such as mobilizing new capital flow, job creation, acquisition of new labor skills, increasing management capacity and technological advancements; all of which help alleviate poverty (Beck et al., 1999; OECD, 2006; IFC, 2008c). The private sector is argued to be better suited for sustaining rapid economic growth in the developing world than government. The more prosperous the private sector, the more taxes may be collected and used to expand basic social services, such as healthcare, education and infrastructure, all of which directly result in increased productivity of the citizens (Beck et al., 1999). In addition, competitive private enterprise is a proactive way to improve human wellbeing, in that it comes from the initiative of the individual and the people themselves (Garner, 1956; AsDB, 2008; IFC, 2008b).

Today, private sector investment into emerging market economies is on the rise. Although global capital flow to developing countries has been increasing at a constant rate since the mid 1990’s, the proportion of net private sector investment has undergone a much sharper increase, particularly since 2002. By 2005, the amount of private capital flow exceeded official capital flow in emerging economy development (Culpeper, 2005). This surge in private sector growth has provoked the claim that the future of development in low-income countries, lies not in foreign aid, but in private sector investment (Harford et al., 2005; Klein, 2005).

With the private sectors of developing nations taking on larger roles in international markets, public institutions are looking at new ways to incorporate these private sources in the process of development (Ben-Artzi, 2006). Since the early 1990s there has been an increase in collaboration between public institutions and the private sector in financing development projects in developing countries. Whereas the majority of MDBs traditionally provided loans with government guarantees, they have become increasingly interested in engaging private sector actors in development projects and in co-financing loans with private institutions (Ben-Artzi, 2006).

Micro-lending as a developing tool in the private sector

Micro-lending is a term used to describe the disbursement of diminutive sized loans to the private sector, most often to SMEs. In many regions of the world, SMEs are the principal engines of economic growth and employment creation. Since SMEs have been recognized as an efficient means to stabilize developing economies, MDBs have been pushing to invest in micro-lending. MDBs face challenges, however, because the finance requirements of SMEs

fall below their minimum disbursement limits. In order to overcome this obstacle, MDBs use FIs (IFC, 2008a).

An FI is an establishment which acts as the ‘middleman’ between the MDBs and the final SME recipients of the resources they disburse. Loans are made to a FI which, in turn, finances smaller loans and investments. MDBs may use public and privately owned institutions, central banks, sectoral credit agencies, commercial banks, development finance corporations, rural credit cooperatives and non-governmental organizations (NGOs) as FIs (IFC, 1999; World Bank, 2002). The FIs then on-lend MDB capital principally to SMEs, but also to smaller commercial banks, other FIs, cooperatives, NGO’s and private ventures, in the form of lines of credit, equity investments, leasing, reinsurance, funds and so forth (IFC, 1999).

FIs act as important gateways for channeling MDB capital to SMEs that would otherwise not be possible to fund (World Bank, 2002; EBRD, 2004). FIs are essential to SME financing, because managing each individual loan to a SMEs would carry too high a transaction cost for a MDB.

MDB Environmental and Social Responsibility

Unlike traditional commercial banks that have profit generation as their primary objective, an MDB is mandated to invest in high risk or low-income countries that have difficulty attracting financing through traditional sources. In addition to enabling a healthy investment environment, MDBs are mandated to invest in projects that will result in bringing a “positive development impact” to the people (AfDB, 2008b). In other words, the projects financed by MDBs must contribute to the social and environmental wellbeing of a country and thereby assist in decreasing poverty and improving livelihood. As large, international organizations, it is part of the MDB’s responsibility to secure and improve the income and welfare of those with whom they do business (Clarke, 2000).

Evolution of MDB Environmental and Social Policies and Procedures

The 1992 United Nations ‘Earth Summit’ in Rio de Janeiro was the event that catapulted environmental issues into the international center stage and triggered the series of United Nations conventions, national regulations and international standards that then followed suit. The social and environmental movements that followed had an immense influence of the activities of MDB’s internationally, most notably the World Bank. During this time, civil society was extremely vocal in accusing Banks of not adhering to their environmental policies, blaming them for deteriorating the economic and environmental state of countries instead of assisting them to combat poverty. In addition, increased public awareness made irresponsible or rushed Bank investments costly as projects were subsequently stopped by NGOs, institutions underwent public scrutiny and stakeholders filed lawsuits. Public pressure, international environmental regulation and cost were therefore the three main drivers forcing MDBs to reform the way they did business in the 1990’s and early 21st century (World Bank, 2008).

MDB reform transpired in the form of Environment and Social (E&S) policies. Between 1989 and 1991 all of the predominant MDB players internationally developed E&S policies, most notably the World Bank Safeguard Policies and the IFC’s Performance Standards, based on similar basic principles and including a framework for EA (Kennedy, 1999). EA was incorporated into MDB procedures as a tool to aid them improve project selection, design and implementation in order to minimize adverse environmental impacts (Kennedy, 1999). Although the specifics of each MDB’s E&S policies vary somewhat depending on the needs

and objectives of the particular MDB and the region it supports, all incorporate similar EA benchmark standards to be incorporated into their lending operations (Table 1) (AsDB (Asian Development Bank), 2002; AfDB, 2004; IFC, 2006b; FMO, 2007a; EBRD, 2008).<Table 1>

EA Procedures of the major MDBs

In order to help them effectively meet the EA requirements outlined in their E&S policies, MDB have developed EA procedures. These procedures require EA to be incorporated as early as possible into MDB operations, initiated at project identification by an initial screening phase. During project screening, potential projects are classified according to the scale of their potential impacts. Classifying development projects serves as an indicator to project officers, borrowers and stakeholders (donor governments, co-financers, NGOs) of the degree, scale and significance of environmental impacts associated with the project and therefore the corresponding level of EA review required (Kennedy, 1999). The majority of MDBs use a three-tiered classification system (Table 2), each category possessing its own set of EA instructions that outline the studies and documentation required by the MDB and the project sponsor (Table 2).

<Table 2>

Both the MDB and the project sponsor are responsible for different phases of the EA process, sharing EA responsibilities (Figure 1). Through project screening and categorization, it is the MDB that determines the scale of assessment required by the project sponsor. It is then the responsibility of the proponent to carrying out the required studies and compile necessary documentation (e.g., the environmental impact statement (EIS), environmental management plan (EMP), etc.) and public consultation. The MDB is then responsible for the final review and public disclosure of the environmental impact assessment (EIA) documentation, to ensure the sponsor has met the set standards and there is no unaddressed public opposition. It is from this review, in conjunction with the required national environmental authorization, that the MDB's Board of Directors will decide whether to go ahead with project financing. After the first loan disbursement it is the responsibility of the proponent to undertake the project follow-up and monitoring and, in the case of Category 1 projects, to adhere to its EMP. During this time, it is the responsibility of the MDB to undertake regular supervision, auditing and reporting (Kennedy, 1999).

Some MDBs, and in particular the World Bank, are presently examining ways to alternatively use the "country system" of Environmental and Social Assessment and Regulation as a basic requirement and tool for their own Environmental and Social Risk Management, if they can find equivalency in the degree of E&S safeguarding and in order to avoid duplicating efforts. This tendency may as well be carried to requirements from the parts of FIs in the future.

EA Procedures for MDB FILs

The EA procedures of the major MDB undergo continuous updating and review and are therefore considered to be relatively successful environmental safeguards for traditional project financing. Having been developed before FILs constituted a significant portion of MDB portfolios, these EA procedures were designed with traditional project financing in mind and therefore designed the EA steps to run parallel with the stages of project development (see Figure 1).

<Figure 1>

Contrary to a project sponsor, when an FI approaches a MDB for financing, it is not proposing a specific development project or activity per se. Instead, the FI will use its MBD loan, most often in the form of a line of credit, to finance its own sub-borrowing. At the time of MDB loan application, an FI's subprojects are usually unknown and run the risk of being geographically dispersed, in unknown sectors, with unknown investors (World Bank, 2002). It is, therefore, difficult to assess the environmental risk associated with a FIL compared to that of project financing. Screening and categorization therefore becomes a challenge and traditional EA cannot be undertaken by the MDB. For this reason, the MDB's traditional EA procedures are not relevant for FI lending.

In order to adapt EA to FI lending, MDBs have developed modified EA guidelines for FILs. The nature of FILs requires both the MDB and the sponsor to take on different roles and responsibilities than they would in traditional project financing (AsDB, n.d.; World Bank, 2002). Under the adapted EA guidelines for FILs, upon project identification, the MDB is responsible for project screening and classification. FILs are not "screened" in the classical sense of the word, but instead are automatically categorized into a distinct Category FI, or Category 4, without any consideration of the size of the loan or the FI's portfolio of activities (AfDB, 2001, n.d.-a; EIB, 2007; IFC, 1999). Category 4/FI has unique EA requirements and procedures that differ from those for all categories of project financing.

In the EA procedures for FILs, in the place of project scoping it is the MDB's responsibility to perform an FI Due Diligence and/or FI E&S Appraisal (see Figure 2). Due diligence is usually undertaken by the investment officers (IO), or project managers (PM), and involves a review of the FI's business portfolio, in order to determine their potential subproject financing and the associated E&S risk. Since the FI is not approaching the MDB for specific project funding, but merely the route taken by MDB capital to finance SMEs, it is not subject to EA. The FI however, is required to undertake business in a manner that is compliant with the MDB's E&S policies, including its policy on EA. Since the FI will become a subproject financer, by virtue of subsidiarity, it has the responsibility to integrate EA in its sub-project lending. Consequently, for FILs, the onus for EA is on the FI and not the MDB.

In this situation, the role of the FI in subproject financing becomes one mirroring that of a MDB in project financing (World Bank, 2002). More specifically, the FI is responsible for subproject screening, monitoring, follow-up and reporting. The FI's are also responsible for ensuring their clients meet the local and national EA requirements and regulations and comply with the MDB's E&S policies (IFC, 1999; AfDB, 2001; AsDB, 2003; EIB, 2007; FMO, 2007a). It is the responsibility of the ultimate subproject sponsor to carry out the necessary EIA studies, however, it is the FI that is responsible for final appraisal of the subproject's EIS, and EMP if necessary, and the decision to accept or reject the financing of the subproject (World Bank, 2002).

<Figure 2>

In addition to FI Due Diligence, the IO/PM also performs an FI Appraisal, which assesses the FI's ability to employ EA in subproject financing and conduct business in accordance with the E&S policies of the MDB. Additionally, the MDB will verify that the national EA requirements pertinent to the FI are equivalent to the MDB's own EA requirements. This will allow the MDB to assume that if an FI subproject obtains EA clearance from the national environmental authority, that their EA standards have been met. This saves time, work and replication on behalf of both the FI and the MDB (World Bank, 2002). In some instances, EA

procedures for FIL give the MDB the right to review the EIS of any subproject classified as Category 1 or Category 2 by the FI, if they so choose (World Bank, 2002).

Limitations of Successful Incorporation of EA in FI operations

Although MDBs have designed specific guidelines and procedures for FILs, they have not been entirely effective in acting as the E&S safeguard they were designed for and FIs are often neither compliant with local, national nor international EA laws and regulations nor the EA procedures of the MDB's that finance them. Until recently, FI non-compliance was not considered problematic for two reasons: firstly, because FILs only represented a small fraction of MDB business, and secondly because traditionally FI portfolios tended to be small and the risk associated was considered insignificant. Today however, FI's make up a significant part of the MDB private sector portfolio and are increasingly financing much larger-scale infrastructure projects such as power facilities and roads (World Bank, 2002). In addition, experts are realizing that there is currently no consideration of the cumulative effects of micro-financing in a given region or sector. FIs are finding themselves under the scrutiny of regulators and investors for whom corporate governance is of mounting importance (UNEP-FI, 2008). In an environment where E&S issues are of ever increasing public concern, MDB's have become aware that inadequate E&S risk in their FIL is risky business. As a result, there is a need to improve the current EA protocols of both FI lending and FI sub-project financing.

The EA accountability loophole and the lack of FI in-house capacity

In their EA guidelines for FILs, the MDBs have created both operational obstacles and an "accountability loophole" whereby EA liability is the onus of the FI and not the MDB. The difficulty is that FIs do not have the capacity of a MDB to adequately manage the E&S risk associated with the subprojects they finance and therefore often fail to include E&S aspects into their review of their sub-lending to a larger number of projects of generally smaller size. This "EA accountability loophole" opens the door to the potential of on-lending MDB finances to sub-projects with major, adverse E&S impacts. Unless all subprojects would be classified as 3 or C (Table 2), the result is that some projects that would otherwise be considered Category 1 or 2 by the MDB escape the stringent safeguard rules established by them.

There are numerous reasons why FIs often do not incorporate environmental and social guidelines into their institution's operations. Sometimes, these institutions fear that hefty E&S regulations will weaken their competitive position, reduce transaction efficiency and increase cost. There are also few incentives for incorporating E&S assessment in developing nations where there is little in terms of environmental and social legislation. The majority of non-compliance however, is primarily due to a lack of resources, knowledge and institutional capacity on the part of the FI, to incorporate E&S aspects into their business activities. The large majority of the FIs do not have a system in place to systematically assess the E&S risk associated with its lending operations. It then becomes a challenge for them to attempt to comply with MDB E&S policies.

For those FIs with adequate capacity, the challenge then becomes finding subproject sponsors capable of, and willing to take on, the EA responsibility. In these circumstances, it is not in the best interest of the FI to reject or lose investment opportunities by enforcing the E&S requirements of large MDBs, when their development risk is minimal in comparison.

MDB EA procedures for FILs

MDB Due Diligence and FI appraisal

One of the challenges to the current EA process for FILs occurs at FI Due Diligence. Upon FI identification, the MDB often knows little about the subprojects other than perhaps their sector of development and thus the IO/TM may be forced to appraise the FI only on the assumption of the types of subprojects that they might finance (IFC, 1999). Assessing the E&S risk associated with an FI is, therefore, a challenging task.

Another challenge lies in the MDB's capacity for FI Appraisal. Although the larger MDBs, such as the IFC, have the adequate human resources necessary to assign an environmental specialist to each FIL, the majority of the MDBs allocate this responsibility to the IO/PM (Kremer, 2008). However, E&S regulations and standards are continuously evolving making this task a difficult one to manage for staff who are not E&S specialists.

When undertaking EA for their subproject financing, FIs are required to adhere to the EA standards of the MDB from which they receive financing. However, the EA standards and guidelines of MDBs are designed for large-scale, multifaceted, development project financing. When applied to subproject financing, these same EA requirements often become too demanding, exceed the scope of FI lending and create unnecessarily difficult obstacles impeding SME development. Similarly, EA guidelines have had the tendency to be written in both a language and form which is difficult for non-EA specialists to comprehend. This makes it difficult both for the FI that must incorporate EA requirements into their lending, and the IO/PMs who must assess FIs for EA compliance. In many ways, the current EA standards imposed on FI lending can be seen as discouraging the uptake of EA by FIs.

MDB mandate vs. MBD EA requirements

The regions most in need of financial support from MDBs are the same regions where national and corporate E&S regulation is the least developed or enforced. This paradox makes it difficult for MDBs to select FI clients, as they are mandated to invest in projects that will result in the most significant positive development impacts, all the while required by their Board of Directors to ensure that FIs have the ability to manage their own E&S risk. MDB's therefore have to make the decision to either finance FIs that have an adequate EA management capacity in place and may not be as desperate for MDB assistance, or FIs that are in need, but therefore pose an E&S risk to the MDB. Based on the mandate of MDBs, they should be looking to finance the latter, however, to do so would require a system to provide FIs with capacity training.

FIL covenants

In order to provide aid to those regions most in need, MDBs will often accept FILs even if it is found during appraisal that the FI does not have the 'in-house' capacity to manage E&S risk (Elteren, 2008). In these circumstances, in order to receive the Board of Directors approval, covenants are added into FIL documentation. These covenants bind FIs to meeting the EA standards of the MDB within a delineated time period. The challenge however, lies in the fact that the quantity of time awarded for FI capacity training often exceeds the time it takes the MDB to arrange disbursement of the FIL. FILs are most often in the form of lines of credit and are generally entirely distributed in one or two disbursements. Once the FIL has been disbursed in its entirety, there is little incentive for the FI to comply with the loan covenants, and little power on the side of the MDB to force compliance (Cronin, 2008). In

addition, loan covenants create a situation where very little regulation is invested upfront and more emphasis is put into policing during FIL follow-up and auditing.

MDB FIL follow-up and auditing

Follow-up and auditing is often the greatest challenge faced by all institutions that apply EA (Hanna, 2005). Without sound follow-up and auditing, there is no sure way of verifying whether FIs meet the conditions of their loan covenants or continue to comply with MDB policies. Weakness in follow-up is not limited to FILs and MDB staff generally considers the E&S risk associated with traditional development projects as being greater than that of FILs. Therefore, follow-up and auditing for project financing is often given priority over FILs. Additionally, following the first disbursement, a project's portfolio is passed from the IO/PM's team to the Portfolio Officer's (PO) team (AfDB, 2001). This inconsistency in who holds responsibility for the FIL limits the efficacy with which the FIL is monitored. Because the FI's sub-financing is often unknown at the time of FI identification, many of the E&S risks associated with an FIL have not been identified in the loan documentation. Unless communication between IO/PM and POs is efficient, the PO may not be familiar with the EA shortcomings and E&S risk associated with a given FI.

Recommendations for the incorporation of EA in FI Lending

Inadequate capacity on the part of the FI is the major limiting factor to successful EA integration into FI sub-lending. However, as the initial lenders, it should be the duty of the MDBs to find ways to resolve the current issues in FI lending. By assisting FI institutions to obtain the resources and expertise necessary to incorporate E&S aspects into their operations, and by careful review of their own EA procedures for FILs, MDB's can play an active role in disseminating good environmental and social practices and standards worldwide while aiding in reducing poverty (Netherlands Development Finance Company (FMO), 2007). There are four areas whereby MDB could alleviate part of the operational and accountability loophole. These four areas are: 1) Strategic Environmental Assessment; 2) Environmental and Social Management Systems; 3) Financial Assistance and 4) Capacity strengthening.

Strategic Environmental Assessment (SEA)

In many ways, the decision on the part of MDBs with regard to FIL is analogous to the process of Strategic Environmental Assessment, imposing some E&S risk appraisal on undefined multiple projects assembled into a program or a plan. In addition to Due Diligence, or as part of it, MDBs should incorporate some level of Strategic Environmental Assessment in their appraisal of FI loans.

SEA's upstream the processes of E&S risk assessment to the level of decision-making, at a time when the projects are not yet defined. This seems to be the exact situation that arises when MDBs attribute lines of credit to FIs. While the sector, or the region, or the generic types of projects may be known at the time of the decision to provide credits, projects and proponents are not yet selected. Generic, Sectoral or Regional Environmental Assessment, all various forms of Strategic Environmental Assessment, could be conducted at that time, jointly by the FI and the MDB, that would allow them to foresee some generic impacts, provide for cumulative impact assessments, and streamline project-level EA's that could eventually be required at the project level.

If the FI is to operate within a single country, or within a limited number of countries in a given region, part of the SEA could include an appraisal of the country's EA regulation and system to assess the level of E&S risk management that they will provide for the various

projects, and to assess the level of capacity building that would need to be included in the general credit supply.

Environmental and Social Management Systems

In accepting the conditions that come with an MDB loan, an FI is pledging to adhere to the E&S standards of the given MDB. The majority of MDB's have developed their private sector E&S policies and guidelines inspired by the IFC's eight Performance Standards (Table 3). The IFC's PF defines the client's responsibilities and requirements for receiving and maintaining IFC finances. Performance Standard 1 requires that EA be integrated into all project financing, including a component of community participation and disclosure. The 2006 IFC Performance Standard updates have added the further requirement for the use of an Environmental and Social Management System (ESMS) for proper managing of E&S performance throughout the life of a project (IFC, 2006a).

<Table 3>

An ESMS is part of an institution's overall management system framework that sets an organizational structure, allocates responsibilities, produces guidelines, develops procedures and creates resources to ensure the integration and maintenance of E&S management and risk evaluation into all the FI's business activities. It involves the creation of an institution's in-house E&S policy and taking into consideration regional, national and international requirements. A successful ESMS should integrate E&S aspects into everyday business operations so that the environmental and social stewardship becomes part of daily responsibilities of all employed not just the environment department (AfDB, n.d.-b). Traditionally, such an ESMS was required for an institution to obtain ISO 14001 certification. Importantly, ESMS schemes based on ISO 14001 do not include an EA review component, although an institution may choose to include such a system as part of good E&S risk management practices (ISO, 2008). In contrast, the ESMS requirements outlined in the IFC's Performance Standards must incorporate: EA, a management program, organizational capacity, training, community engagement, monitoring and reporting. By incorporating EA, an ESMS, should include procedures for screening, review, monitoring, follow-up and reporting in addition to identifying the staff responsible for E&S issues and the plans for environmental training (IFC, 2006a). The adoption of ESMS based on the IFC's definition is not yet commonplace. However, by promoting or requiring these ESMS to be adopted by their FI clients, MDBs can facilitate FI Appraisal and Due Diligence duties.

Incentives for establishing an ESMS

Streamlining E&S aspects into business operations through the adoption of an ESMS adds value to an institution by promoting a positive corporate image while creating new financing opportunities and financial stability (UNEP-FI, 2008). It is also internationally recognized that FIs can play a role in promoting environmental protection, the sustainable use of resources and social safeguard policies internationally, by incorporating these issues into their banking operations (FMO, 2007b). In countries where adequate E&S regulation is lacking, promoting FI's to adopt ESMS can help build the country's capacity in EA (World Bank, 2002). In adopting an ESMS, FIs can look to benefit in more ways than simply ensuring compliance with MDB requirements. Evidence suggests that it is in the best interest of the FI to consider the environment, because E&S risk is financial risk (World Bank, 2002; Prakash-Mani et al., 2008;). Incorporating E&S aspects into lending operations can save an institution money by reducing the risk of environmental mishap, project stoppages or delays, legal

disputes, environmental cleanup, lawsuits, fines, weakening collateral, decreased business opportunities, corporate reputation, or lowered liquidity of assets (Gancberg & Klassen, 2006; AfDB, 2008a, 2008b). In contrast, by dedicating themselves to subprojects that are socially and ecologically sound, an institution can increase financing opportunities, financial stability, positive publicity, raise staff morale, create a good corporate image and allow it to meet international requirements (AfDB, 2008a; Prakash-Mani et al., 2008). In the end, it is less about avoiding public scrutiny as learning how to turn it into an opportunity for growth (UNEP-FI, 2008).

The Equator Principles as an example for corporate responsibility

Worldwide, smaller financial institutions have begun to reform the way they appraise projects for environmental and social risk through the application of best practices benchmarks such as the Equator Principles, which govern 80 percent of projects in the emerging market economies (Oxford Analytica, 2008). Based on the IFC's Performance Standards, the Equator Principles refer to a set of voluntary guidelines intended to provide a common baseline for private financial institutions and commercial banks to assess and manage the social and environmental risks associated with their investment. Founded in 2003, the EP's were later updated and revised in 2006 to make way for the Equator Principles II which are presently used by over sixty financial institutions internationally. Whereas previously there was pressure only on large-scale multilateral organisations to incorporate E&S issues into their lending operations, the Equator Principle Financial Institutions are raising the bar for financial institutions of all sizes (Watchman et al., 2007). The Equator Principles II are a prime example of the concise and clear EA guidelines needed to encourage FIs to incorporate E&S aspects into their everyday business. Considering their success in promoting EA adoption at the commercial bank level, the Equator Principles should be used as a template for the EA requirements that MDBs require of FIs.

FI financial assistance

As previously discussed, MDBs find themselves in the difficult position of having to select FILs that will result in the most significant positive development impacts, while ensuring that these same FIs have the ability to meet the E&S standards of the MBD. The current system of adjoining covenants to the FILs has not been particularly successful in ensuring FI capacity building and this is deemed a poor effort on the part of the MDB. In its place, MDB should streamline a system for FI financial assistance into their FILs. Many national development agencies such as FMO and DEG, who also provide FILS have special FI funds in place from which financial assistance can be mobilized when the need for FI capacity strengthening is identified on a client to client basis. Alternately, FIL could systematically include a financial assistance component reserved specifically for FI capacity strengthening. Financial assistance can assist the FI to cover the cost of meeting the MDB's EA requirements, (e.g., the costs of consultancy), and provide an incentive for the FI to become MDB compliant.

Ideally, the financial assistance provided to FIs subsidize only a portion of the costs for compliance, as there needs to be a level of commitment on the side of the FI for the E&S aspects to be properly adopted. Additionally, financial assistance should also be disbursed in installments. An initial financial assistance component could be put towards the cost of ESMS set up and consultancy and a later financial assistance component dedicated to covering the cost of consultant follow-up. This later component will help ensure that the FI is successful in implementing its ESMS. In a review of the FI procedures of many of the major MDBs, it has been found that many already have a system in place to provide technical assistance, in the form of human and/or financial resources, to their FI clients.

FI capacity strengthening

In some regions of the world, particularly those where national and corporate E&S regulations are the least developed, even if FIs are provided with the financial resources to assist them in meeting EA regulations, they do not have access to the technical skills, knowledge and resources required to put these systems in place. Specifically, many countries lack the knowledgeable personnel, consultants and EA experts that are needed to work alongside the FI. Since the current trends suggest that MDBs investments to FIs are likely to increase in the future, it would be advantageous for the MDBs to establish E&S performance training systems for FIs. These training tools can be as simple as making available online resources and training courses, or more comprehensive, such as holding interactive workshops. In reviewing the technical assistance procedures of many of the major MDBs and national development agencies for FILs, it has been found that many already have tools available to their FI clients (FMO, 2007b; UNEP-FI, 2008).

RDB collaboration

Although the IFC works on a one-to-one basis with their FI clients to assist them in achieving E&S compliance (Kremer, 2008), for most MDBs the exponential increase in their private sector operations has prevented them from devoting the equivalent E&S support to their clients. However, multiple MDBs are often lending partners in the same FIL, especially when these loans are in the form of funds. Instead of FIs needing to meet the E&S requirements of multiple donors, these MDBs can collaborate to provide training and assistance to their FI clients. This facilitates both FI training on the part of the MDBs and MDB compliance on the part of the FI. Moreover, many of the MDBs currently offer annual FI workshops and seminars in various regions of the world. By joining forces and sharing their FI resources, MDBs can not only provide more effective FI technical assistance but also meet those stipulations of the Paris Convention.

RDB capacity strengthening

Although all major MDBs vow to adhere to the most relevant and current E&S policies and procedures, this commitment is not always translated in all of its transactions. Even the MDBs lack the in-house capacity, especially when it comes to E&S aspects of business. The most effective way to rectify this setback is to apply more rigorous in-house E&S training and this is especially true for the MDB staff required to conduct EA Due Diligence and Appraisal. Given that the IO/PMs who are not E&S specialists are often assigned this responsibility, especially in the case of low risk FIs, it is necessary for there to be a system in place for routine updating and training of the MDB staff on EA policies and procedures. Similarly, the POs responsible for FI Follow-up should receive similar training to assist them in assessing FI compliance with Bank requirements. Additionally, there is the need to provide MDB officers with effective tools to assist them with FI Due Diligence, Appraisal and Follow-up. Specifically, these tools should be in the form of checklists, designed to guide IOs and POs to perform their tasks. These checklists should be simple and effective and could largely be inspired by the Equator Principles II.

Conclusion

Developing the SME sector is among the most effective ways to promote a stable and prosperous economy in the developing world. An FI is an effective tool for channeling MDB finances to SMEs and the proportion of FILs in private sector loans from MDBs is increasing. Although MDBs have specific guidelines and procedures for operations through FIs, they

have not been entirely effective in acting as an environmental safeguard and ensuring FI compliance with local, national and international EA laws and regulations. Upstream from the loan, the MDBs should approach FI lending as they would consider an overall development plan or an investment program, by adding some component of SEA to their 'due diligence' appraisal of the FI. Downstream from the loan, although there are many factors involved, operational difficulties arise primarily due to a lack of resources, knowledge and institutional capacity at the FI level to incorporate E&S aspects into their business activities. By assisting FI institutions to obtain the resources and expertise necessary to incorporate E&S aspects into their operations, MDB's can play an active role in disseminating good environmental and social practices and standards across the developing world, while reducing poverty. MDBs can be most effective in assisting FIs by developing procedures for mobilizing financial assistance, or by including a financial assistance component to FILs. Additionally, MDBs can support FI capacity strengthening through the creation of online resources, training modules and interactive workshops. As multiple MDBs are often lending partners in the same FILs, there should be a collaborative effort amongst the MDBs to provide training and assistance to their FI clients.

In addition, we would encourage a special meeting of development bank staff working on FI and/or E&S policy issues, to discuss what might be best practice approaches to the challenges posed by FI lending and implementation in addition to what the World Bank's Environmental Assessment Sourcebook has proposed in update number 27 (2002).

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Table 1: Common EA Standards of MDBs (Adapted from Kennedy, 1999)

Common EA Standards
(i) Environmental soundness and feasibility
(ii) Changes to the project design
(iii) Mitigative measures to minimize adverse environmental impacts
(iv) Measures that may bring additional environmental benefits to the projects
(v) Environmental management during the projects implementation
(vi) Means of public consulting and disclosure

Table 2: Categorization and Associated EA Review Requirements.

Significance of Impacts	Categorization	EA study required
High Impact	Category A /Category 1	Full environmental appraisal required
Moderate Impact	Category B /Category 2	Limited/partial environmental appraisal required
Low Impact	Category C /Category 3	No environmental appraisal required

Table 3: The IFC Performance Standards for private sector lending (IFC, 2006a)

Introduction to the Performance Standards on Social and Environmental Sustainability
Performance Standard 1: Social and Environmental Assessment and Management Systems
Performance Standard 2: Labor and Working Conditions
Performance Standard 3: Pollution Prevention and Abatement
Performance Standard 4: Community Health, Safety and Security
Performance Standard 5: Land Acquisition and Involuntary Resettlement
Performance Standard 6: Biodiversity Conservation and Sustainable Natural Resource Management
Performance Standard 7: Indigenous Peoples
Performance Standard 8: Cultural Heritage

Figure 1: MDB and project proponent responsibilities for the various stages of EA.

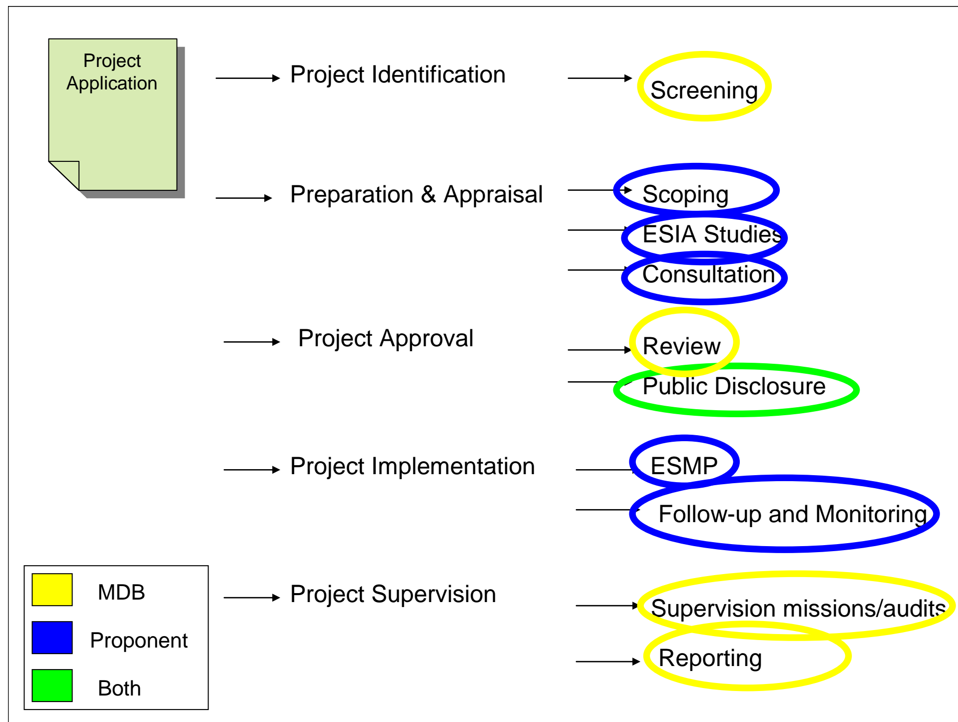

Figure 2: MDB responsibilities for the various stages of EA for FILs