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COMPARATIVE ANALYSIS OF METHODOLOGIES FOR ENVIRONMENTAL AND SOCIAL RISK MANAGEMENT IN LENDING APPLIED BY INTERNATIONAL FINANCIAL INSTITUTIONS

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Abstract

More and more banking institutions face the need to do environmental risk management in their lending portfolios. Since this is comparatively new practice for them, they need to draw from the experience of international financial institutions. Currently there are some methodologies applied for the purpose - among which the one has been developed by the European Bank for Reconstruction and Development, the other - by the International Financial Corporation, and a few others exist. The current paper aims at comparing the methodologies applied the most and drawing conclusions regarding their differences and applicability. This is considered important for the smoother applicability of the methodologies by the financial institutions – once they can differentiate between the specificities of the methodologies, they would be in a position to select the most appropriate one for them.

Key words*: environmental risk, financial institutions, lending*

BACKGROUND

Climate change and environmental challenges are shaping the environment in which business operates. Financial institutions, being intermediaries on the market facilitating the needs of the firms and households need to undertake the challenges by adapting to the new specificities of the environment. Only in this way they will be in a position to meet the needs of society.

Environmental risk management in the lending portfolio is a prerequisite for the financial institutions to receive funds and guarantees from certain international financial institutions such as the European Bank for Reconstruction and Development (EBRD) and the World Bank, more specifically – the International Financial Corporation (IFC). Both institutions have adopted designated policies explaining the need to be aware and to follow environmental and social risk management procedures. This is a requirement for the part of the loan portfolio originating from the funds received from these institutions. However, both institutions explicitly state that they encourage banks to adopt environmental and social risk management over their entire portfolios.

Environmental and social risk management methodologies offered by the EBRD and the IMF are extremely useful for any bank which strives to deploy environmental risk management over its core banking activities. They facilitate banks especially because this type of activity is new to them and they need guidance to start implementation. Since these ready methodologies have been developed in order to assist banks with their own development of methods, they need to be reviewed and adapted prior to application in a particular bank in order to ensure appropriate and smooth application.

1. EBRD METHODOLOGY FOR MANAGING ENVIRONMENTAL AND SOCIAL RISKS

The EBRD adopted Environmental and Social Policy for the first time in 2003. This policy was subsequently amended and that is how the version of 2008 appeared. Currently (2013Q1) it is undergoing another review. All the reviews are aiming at streamlining the policy and adapting it further to the needs of the institutions (primarily banks) for which it is meant.

Within its Policy, the EBRD has adopted a set of 10 specific Performance Requirements (PRs) that its clients are expected to meet, covering key areas of environmental and social impacts. PRs reflect the EBRD’s commitment to promote European Union (EU) environmental standards as well as the European Principles for the Environment. EBRD expects its clients to assess and manage the environmental and social issues associated with their projects so that projects meet the PRs. Performance Requirements should be read in conjunction with EBRD’s Environmental and Social Policy and Procedures (Environmental and Social Policy, 2009). Regarding environmental risk management in particular, the most relevant PRs are PR 1: Environmental and Social Appraisal and Management and PR 3: Pollution Prevention and Abatement.

The Environmental and Social Policy is the core document which outlines the EBRD's commitments toward contributing to the addressing of the existing environmental and social problems in the world, and represents the background on which all the other important documents related to environmental risk management for banks, combined in the so called EBRD Environmental and Social Risk Management Manual, have been developed.

The Policy consists of two larger sections:

1. The first one is devoted to the general framework of the commitments the bank has undertaken and sets out its readiness to stand behind their implementation. Apart from this, the importance of integrating environmental and social considerations into the project cycle is stressed and specific guidelines on how this needs to be done are presented
2. The second section outlines the ten PRs.

As set out in the Policy, the appraisal done by the EBRD over specific projects incorporates three key elements:

1. the environmental and social impacts and issues associated with the proposed project;
2. the capacity and commitment of the client to address these impacts and issues in accordance with this Policy; and
3. the role of third parties in achieving compliance with this Policy (Environmental and Social Policy, 2009).

It is important to mention that there are a number of activities which EBRD has identified and for which it is not granting finance. These activities are listed in the so called Exclusion List. Common for all these activities is the high environmental and social risk associated with them. They fall under one of six categories as presented in the list:

1. The production of or trade in any product or activity deemed illegal under host country (that is, national) laws or regulations, or international conventions and agreements, or subject to international phase out or bans
2. Production or use of or trade in unbonded asbestos fibers or asbestos-containing products
3. Activities prohibited by host country legislation or international conventions relating to the protection of biodiversity resources or cultural heritage
4. Driftnet fishing in the marine environment using nets in excess of 2.5 kilometers in length
5. Shipment of oil or other hazardous substances in tankers which do not comply with International Maritime Organization (IMO) requirements
4. Trade in goods without required export or import licenses or other evidence of authorization of transit from the relevant countries of export, import and, if applicable, transit (Environmental and Social Policy, 2009).

Examples are the production of, or trade, in ozone depleting substances subject to international phase- out, shipment of oil or other hazardous substances in tankers which do not comply with International Maritime Organization (IMO) requirements.

1. Apart from the Exclusion List there are the so called projects category A. They are generally projects which imply high environmental and social risk and require additional special care to ensure that this risk is controlled. These projects are not rejected from financing. They need to be kept under strict review and subsequent controls in order not to allow for unwanted consequences. These projects fall within 28 categories and as defined by the EBRD are "greenfield" or major extension or transformation-conversion projects in the categories listed below. The list is indicative and the types of projects it contains are examples. The categorization of each project will depend on the nature and extent of any actual or potential adverse environmental or social impacts, as determined by the specifics of its design, operation, and location" (Environmental and Social Policy, 2009).

Examples are:

- number 1 in the list, "Crude oil refineries (excluding undertakings manufacturing only lubricants from crude oil) and installations for the gasification and liquefaction of 500 tonnes or more of coal or bituminous shale per day, also,

- number 8: Pipelines, terminals and associated facilities for the large-scale transport of gas, oil and chemicals",
- number 10: "Waste-processing and disposal installations for the incineration, chemical treatment or landfill of hazardous, toxic or dangerous wastes", etc.

This categorization is very useful for banks as they can directly apply it rather than looking for answers to inquires how to differentiate the projects in terms of their hazard to nature and society – activity not inherent to them and very costly if assigned to external consultancy. That is why the information captured in the Policy is very useful for banks; they can directly draw from it.

Apart form he Exclusion List the so called Referral List has been designed listing hazardous industries whose financing is allowed but only upon EBRD's consent for this.

As stated above, the Manual has been developed based on the Policy. The Manual comprises a set of documents presenting the practical side of the implementation of the Policy. It has been created as a kind of tutorial for bank employees who can both use it to learn the basics of environmental and social risk management, and as a source of consultation on various issues arising in the process.

The Manual is divided in three parts – one is related to lending, the other to investment and the third one – to other transactions.

The section devoted to lending is divided in three parts as well – one for corporate lending, one for micro and small business loans (below the threshold of USD 100 000) and the last one – to retail banking. Separate methodologies have been developed for environmental and social risk management in these three aspects of the core banking activities.

1.1. Corporate lending

As regards corporate lending, the process is as outlined in Fig. 1 below. More specifically the methodology applied is mostly visible from the initial environmental and social risk rating process. This process is captured in a designated form which outlines four steps to be taken to produce the rating (EBRD Environmental and social risk management procedures: Corporate lending, www.ebrd.org)

1. The industry type is defined. Depending on the industry type decision is taken whether the loan application can be considered or not. In case the type of industry falls in the Exclusion List, financing is denied. The next step is to check if the type of industry is mentioned in the Referral List and if so, then the consent of the EBRD is needed prior to proceeding with further evaluation. If the industry is not on the Referral List, then the loan officer needs to check its environmental and social risk according to the EBRD Environmental and Social Categorization List. This list encompasses almost all types of industries and states the levels of environmental and of social risk (low, medium or high) that the specific industry has. In the Environmental and Social Risk Rating Guide (the Guide), the weight recommended for the industry type is 40%.
2. The size of the loan needs to be taken into account. The Guide recommends the split of the loans into three sizes – up to USD 200 000 are considered low risk loans, between EUSD 200 000 and USD 1 000 000 – medium risk ones, and all the loan above USD 1 000 000 – high risk ones. This rule draws from one of the main principles in risk management – the bigger the exposure, the bigger the risk. Although these are the recommended levels for each of the three categories by the EBRD, each bank should review its portfolio and adjust the thresholds depending on its specificities.
3. Defining the risk related to the term of the loan. It is essential to define the appropriate levels for each financial institution. The EBRD recommends in its manual the following division among the various terms: when the loan expires in less than 6 months, it should be considered implying low environmental and social risk, when it expires between 6 months and 2 years the risk should be considered as medium, and when it is longer than 2 years – high. It could be claimed that, and the practice of financial institutions in Bulgaria show, that these thresholds are rather too strict in view of the specificities of the corporate portfolios. Practice shows that there is a small number of corporate loans which term is less than 6 months, so it is recommended by the author the lower threshold to be lifted to at least 1 year, in view of the fact, too, that normally this is the term at which loans are reviewed. The second category – between 6 months and 2 years is too narrow in the view of the author, since it practically captures only very short term exposures. The recommendation is to widen this category of medium risk to be between 1 and 5 years and any loan above 5 years to be considered implying high environmental and social risk following the basic rule that the longer the term, the higher the risk.

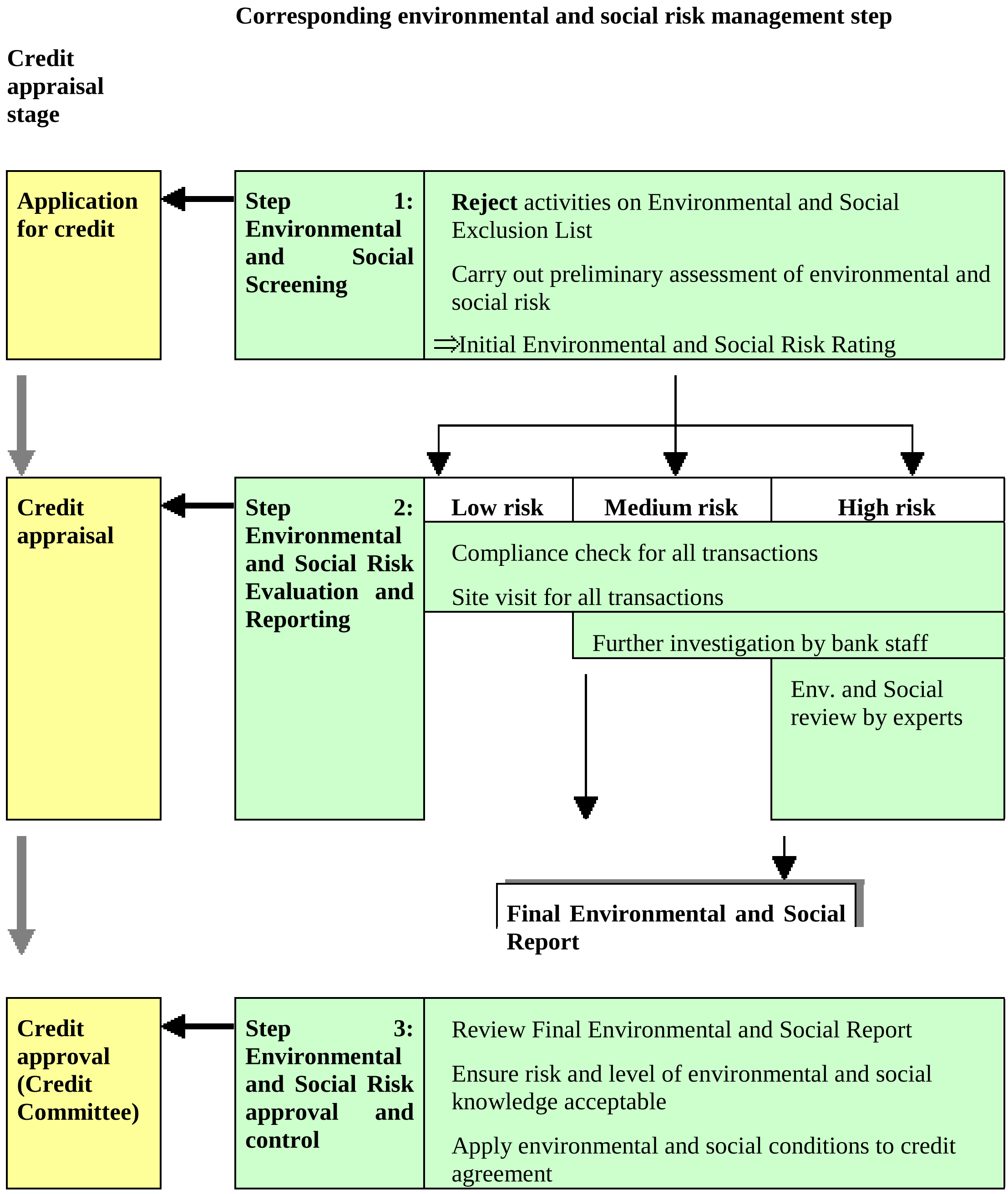

Fig. 1. Environmental and social risk management in the credit approval process (EBRD Manual. Environmental and social risk management procedures: Corporate lending)

4. Clarifying the collateral type and its relation to environmental and social risk. Here again the EBRD is recommending that all collateral types are split in three categories assigned low, medium or high environmental risk each of them. Thus low risk are considered cash and in general any liquid investments such as cash, guarantees. Medium risk are considered land with no industrial history or adjacent industry, fixed assets, non-liquid current assets such as stock, and high - land with industrial history, contamination or adjacent. Practice reveals that this simple split among collateral types is not similarly easy in practice due to the large number of collaterals banks accept. Another difficulty met in practice is the correct identification of the risk level when there is a combination of several collateral types.

This brief review shows that the methodology put forward by the EBRD is very practical but it requires each bank to review it and to adapt it to its particular specificities so that relevance of efforts is ensured. For example, if no adaptation is done regarding the risks assigned depending on the term of the loan, this might lead to, apart from spread of unneeded efforts to deal with short term exposures, also to the skewing of the risk profile to the directing on having too many high and medium environmental and social risk loans.

1.2.Small loans and micro lending

As regards small loans and micro lending the EBRD recommends only the check in the Exclusion and Referral Lists to be done and this to serve as a qualitative judgment. In case the industry falls in the Exclusion List, it should be rejected, if it falls within the Referral List – consent on the part of the EBRD needs to be sought. The following caveat is provided: when the loan is for more than USD 50 000, in a medium or high risk sector and for a term longer than 6 months, it needs to undergo further investigation, i.e. "credit officers should always seek documentary proof that borrowers comply with all applicable regulatory requirements. Also, the Loan Agreement should include a requirement that borrowers comply with applicable health, safety, labour and environmental regulations and standards during the term of the loan."(EBRD Environmental and Social Management Procedures for Small & Micro Loans, www.ebrd.org)

1.3. Retail lending

Most retail banking activities present little environmental and social risk [4]. The only more obvious area in which such risks could be sought is mortgage lending. The risks can materialize in the decrease of the price of the property in case of environmental and social issues associated with it.

The EBRD relevant procedure presents the following examples of such environmental and social risks include:

- Soil and groundwater contamination of the land on which houses are situated, which may not only affect the value of the property but could also present a health and safety risk to the owners;
- Use/presence of hazardous materials in construction, e.g. friable asbestos or radon;
- Houses at risk of flooding, coastal erosion or seismic activity;

Restrictions imposed by local or national legislation to conserve historic buildings/neighbourhoods or protect cultural heritage (EBRD Retail Banking Procedures, www.ebrd.org).

The recommendation from the EBRD is to ensure compliance checks on site prior to granting the loans, obtaining experts opinions on particular cases and the incorporation of legal clauses binding the beneficiary of the loan to abide by the local environmental and social legislation.

As evident from the above analysis, the EBRD places most stress on evaluation of environmental and social risk and its management in corporate lending. This is understandable since volumes in this segment are the highest in the portfolios of commercial banks. The risk evaluation process is less detailed for small and micro lending and for retail transactions.

The investigation of EBRD recommendations as regards investment activities and other transactions fall outside of the scope of the current paper and need to be reviewed separately.

2. IFC METHODOLOGY FOR ENVIRONMENTAL AND SOCIAL RISK MANAGEMENT

The International Financial Corporation has similar officially accepted documents which ensure the application of its intentions as regards environmental and social risk management. These documents form the IFC sustainability framework (Fig. 2).

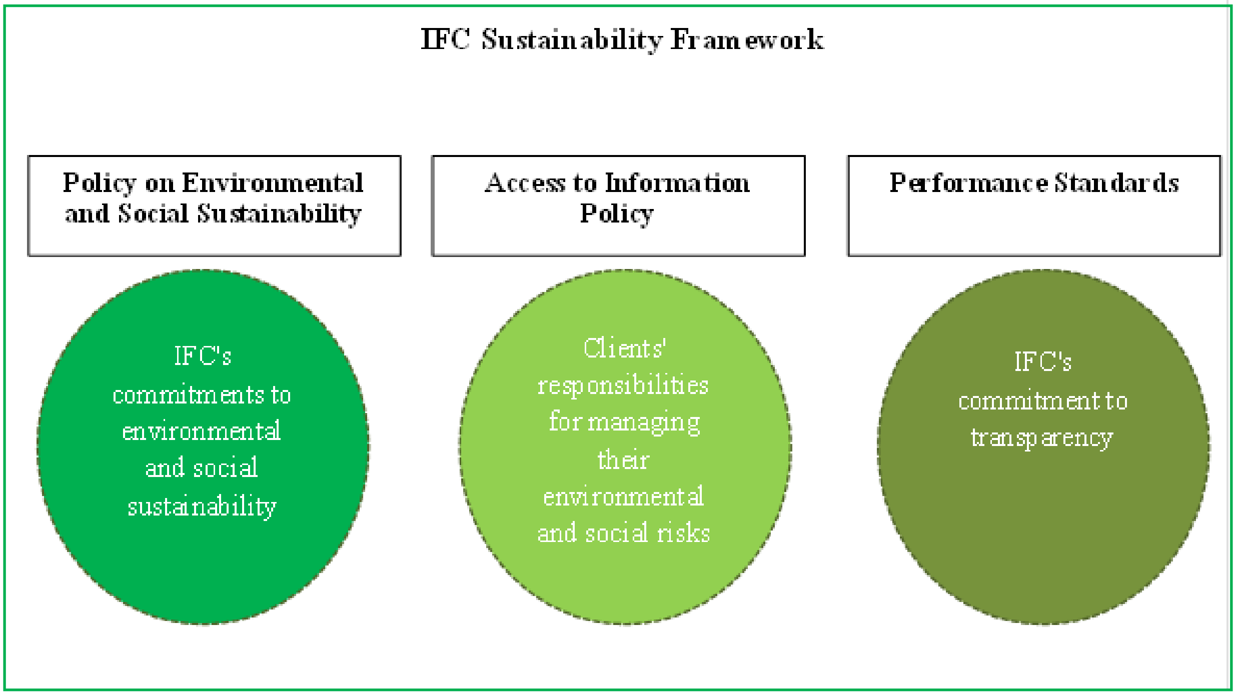

Fig. 2. IFC Sustainability Framework (Environmental and Social Review Procedures Manual, www.ifc.org)

Apart from them, similarly to the EBRD, the IFC has developed its own Risk Management System Manual which comprehensively deals with various issues related to the practicalities of the application of risk management procedures in financial operations. The ESRP Manual applies to the full range of IFC's investment activities, such as direct lending to private enterprises including corporate and project finance; lending to financial intermediaries (FIs); equity/shareholding in companies, financial institutions, and other entities; structured finance products such as guarantees and securitizations; municipal finance; and E&S due diligence of Advisory Services (AS) projects. The ESRP Manual also describes the methodology to implement IFC's institutional disclosure requirements in accordance with the AIP (IFC Environmental and Social Review Procedures Manual, www.ifc.org).

Similarly to the EBRD, the IFC has adopted eight performance standards which define in detail what the financial institutions should do with respect the environmental and social risks they face.

What is typical for the methodology of IFC is the split of the projects to be financed in three categories depending on their environmental and social risks:

- Category A: Projects with potential significant adverse social or environmental impacts that
  are diverse, irreversible, or unprecedented
- Category B: Projects with potential limited adverse social or environmental impacts that
  are few in number, site-specific, largely reversible, and readily addressed through mitigation measures
- Category C: Projects with minimal or no adverse social or environmental impacts.

These categories basically correspond to the three categories identified by the EBRD – high, medium and low environmental risks. Apart from these categories, the IFC supports an Exclusion List, precluding finance for industries falling within its scope.

3. RECOMMENDATIONS TO BANKS FOR THE APPLICATION OF THE EBRD AND IFC METHODOLOGIES

Since both methodologies presented briefly above are based on similar principles and apply very similar logic, the most immediate question in front of banks when commencing the application is: is any adaptation to the specific needs of the institution necessary or one of these methodologies can be applied directly successfully, saving efforts to review and accommodate it?

The answer is yes, direct implementation is possible even without any adaptation in view of the specificities of the credit process in the particular bank. However, this might lead to unwanted workload in the application process due to the fact that certain parts of the methodology are not designed for the particular bank, or have not taken into consideration the specificities of the local legislation.

The general advise that could be followed in a most practical way is do a review of the methodology chosen for application (whether it be the EBRD’s or the IFC’s) and then design the incorporation of the environmental risk management in the credit process. Considering the specificities of the local legislative environment can be set aside in the initial stage of the implementation of the environmental and social risk management process, since both the EBRD and IFC guidelines regarding categorization of industries are quite well done and comprehensive. It is recommended, though, that review of the legislation and categorization of industries on the background of the local environment is desirable at a later stage, when the bank builds experience.

More specifically, the review of the chosen methodology needs to be focused on the following areas:

1. The risk rating method. Since we suggest industry related risks, i.e. the type of business activity of the applicant to be taken aside in the first steps, here special care should be taken on the three remaining categories under review, namely: the size, the term and the collateral proposed by the potential beneficiary of the loan. In all three categories, review needs to be done of what are the specificities of the size, the term and the collaterals in the credit portfolio of the bank.

For example, if the number of loans below the threshold proposed by the EBRD is large, lowering the threshold can be considered in order to meet the specificities of the bank, or, another approach is to consider all loans below the lower level holding low environmental and social risk and thus to abstain from further investigation regarding this aspect of the risk.

In case the number of loans with term shorter than one year is negligible, then the low risk threshold should be adjusted to be starting from 1 year, and not from 6 months, as it is in the EBRD methodology.

As regards the collaterals, the suggestions is a thorough review of collateral types to be done in the bank in order to see whether they can be captured within the three categories of collaterals used by the EBRD for the purpose of the scoring. It might prove that this is rather complicated and then the bank needs to consider how to accommodate the diverse types of collateral so that the info on them can be used for the purpose of the environmental and social risk soring. Another valid challenge is how to properly score the risk when there is not only one type of collateral, but several (which is often the case in corporate lending) and of several types – liquid funds, non-polluted land and polluted land, for example. The recommendation in such cases is to consider the risk level given for the riskiest of the collaterals – in the case above – to consider the polluted land as collateral so that no environmental and social risks are neglected rather than to try to find an average value for the three types of collaterals and thus artificially lower the total risk score.

In order the above to be done in a proper way and to avoid moral hazard when employees lower risk levels so that credit approval is obtained in an easier way, the adaptation of the methodology needs to be done in a written internal document with instruction to the relevant staff. This will facilitate the workflow and will lower operational risk.

2. Adaptation needs to be considered as well for site visit report forms where relevant questions need to be placed. A good practice is to incorporate a sentence or two which serve as a declaration on the part of the customer that all the information he/she is presenting is correct and reflects reality.

CONCLUSION

The two leading institutions in the world in the area of environmental risk management expertise – the EBRD and the IFC have developed very similar methodologies for in order to guide the financial world in this new area of its work. Both methodologies are intuitive and easy to understand and apply. Of the two, maybe the more suitable to the needs of the banks especially in South-Eastern Europe is the EBRD methodology. This is due to the fact that it was created to serve their needs as they act as beneficiaries for credit facilities from the EBRD. The IFC methodology is more appropriate for large enterprises which strive to comply with the flexible requirements of the changing legislative and financial environment and who want to make use of the World Banks's financial assistance. The above stated reasons explain why many banks choose to directly apply the methodologies in their credit process. Efforts to do the adaptation of these methodologies are not small, indeed, however they will make the process of implementation much easier and much more acceptable for the staff who needs to apply it.

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