OSGOODE HALL LAW SCHOOL

Comparative Research in Law & Political Economy

RESEARCH PAPER SERIES

Research Paper No. 54/2013

10 Years 'Equator Principles': A Critical Economic-Ethical Analysis

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Electronic copy available at: http://ssrn.com/abstract=2359573

10 Years 'Equator Principles': A Critical Economic-Ethical Analysis

Manuel Wörsdörfer[1]

Abstract:
June 4th, 2013 marks the formal launch of the third generation of the Equator Principles (EP III) and the tenth anniversary of the EPs – enough reasons for evaluating the EPs initiative from an economic ethics and business ethics perspectives. In particular, this essay deals with the following questions: What are the EPs and where are they going? What has been achieved so far by the EPs? What are the strengths and weaknesses of the EPs? Which necessary reform steps need to be adopted in order to further strengthen the EPs framework? Can the EPs be regarded as a role-model in the field of sustainable finance and CSR? The paper is structured as follows: The first chapter defines the term EPs and introduces the keywords related to the EPs framework. The second chapter gives a brief overview of the history of the EPs. The third chapter discusses the Equator Principles Association, the governing, administering, and managing institution behind the EPs. The fourth chapter summarizes the main features and characteristics of the newly released third generation of the EPs. The fifth chapter critically evaluates the EP III from an economic ethics and business ethics perspectives. The paper concludes with a summary of the main findings.

Keywords: Equator Principles, Equator Principles Association, project finance, reputational risk, corporate social responsibility, sustainable finance, multinational companies/business and human rights.

A. Introductory Remarks

On June 4th 2013, the Equator Principles Association celebrated the formal launch of the third generation of the Equator Principles (EP III) and at the same time the tenth anniversary of the Equator Principles – enough reasons for evaluating the Equator Principles initiative from an economic ethics and business ethics perspectives.

In particular, this essay deals with the following questions: What are the Equator Principles and where are they going? What has been achieved so far by the Equator Principles (Association)? What are the strengths and weaknesses of the Equator Principles? Which necessary reform steps need to be adopted in order to further strengthen the Equator Principles framework? Can the Principles be regarded as a role-model in the field of sustainable finance and CSR?

The remainder of the paper is structured as follows: The first chapter defines the term Equator Principles and introduces the keywords related to the Equator Principles framework. The second chapter gives a brief overview of the history of the Equator Principles. The third chapter discusses the Equator Principles Association, the governing, administering, and managing institution behind the Equator Principles. The fourth chapter summarizes the main features and characteristics of the newly released third generation of the Equator Principles. The fifth chapter critically evaluates the EP III from an economic ethics and business ethics perspectives. The paper concludes with a summary of my main findings.

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B. General Overview

The Equator Principles[2] aim at environmental protection (i.e., the protection of project-affected ecosystems) as well as the promotion of environmental and social stewardship, and corporate environmental and social responsibility (CESR) – including human rights. An illustrative list of potential environmental and social issues tackled by the Equator Principles include the protection and conservation of biodiversity (i.e., endangered species, sensitive ecosystems/critical habitats); sustainable resource management and use of renewable natural resources; management and use of dangerous substances/chemical waste management; efficient production, delivery and use of energy; pollution prevention and waste minimization; respect (protection and realization) of human rights (i.e., prevent, mitigate and manage adverse human rights impacts); labor issues and occupational health and safety; participation and consultation of project-affected stakeholders in the design, review and implementation of the project; socio-economic impacts; impacts on project-affected communities, and disadvantaged or vulnerable groups; gender impacts; land acquisition and involuntary resettlement; impacts on indigenous peoples, and their unique cultural systems and values; protection of cultural property and heritage.[3]

The Equator Principles are officially described as a voluntary and self-regulatory finance industry benchmark in project finance. In particular, they are a finance industry standard for environmental and social risk management or as it is often referred to a "credit risk management framework for determining, assessing, and managing environmental and social risk in Project Finance transactions"[4] (Equator Principles Website). The Equator Principles Association refers to the Principles as the "gold standard"[5] and good practice in environmental and social risk management for project finance.

They impose obligations on both lenders (Equator Principles Financial Institutions (EPFI)) and borrowers (clients) with regard to environmental and social impact assessment, public participation and stakeholder engagement, risk management, compliance, enforcement, and monitoring. E.g., lenders are held accountable to implement responsible and sustainable

[2] Cp. for a general overview: Silvina S. Gonzales Napolitano, Equator Principles, in Max Planck Encyclopedia of Public International Law (2011), available at: www.mpepil.com/subscriber_article?script=yes&id=/epil/entries/law-9780199231690-e1038&recno=48&letter=E (accessed 11 July 2013).

[3] Cp. Equator Principles Association, The Equator Principles (EP III), 20 (2013), available at: http://equator-principles.com/index.php/ep3/ep3 (accessed 11 November 2013).

[4] Cp. Equator Principles Association, Equator Principles Website (2013), available at: www.equator-principles.com/ (accessed 31 October 2013).

[5] Suellen Lazarus & Alan Feldbaum, Equator Principles Strategic Review. Final Report, i (2011), available at: www.equator-principles.com/resources/exec-summary_appendix_strategic_review_report.pdf (accessed 11 July 2013).

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lending practices. They are held liable for negative social and environmental externalities of their clients. While the participating EPFIs have adopted the Equator Principles and help enforcing and monitoring them, it is in fact the client or borrower that is expected to fulfill and adhere to the requirements laid down by the Equator Principles. These obligations are imposed by the lender upon the borrower and they get formalized as covenants which are part of the loan documentation or investment agreement between the financial institution and the project developer (cp. Principle 8 of the Equator Principles on Covenants).

The term 'Equator' represents the balance between 'developed' countries, 'developing countries' and emerging markets, a balance between the southern and the northern hemisphere, between East and West. Furthermore, the Equator Principles apply *globally* on both sides of the Equator. The third generation of the Equator Principles (EP III) applies to four financial products, namely project finance, advisory services related to project finance, project-related corporate loans, and bridge loans. They apply where total project capital costs exceed US$ 10 million. They are adopted by so called EPFIs, financial institutions which are active in project-finance or project-related advisory services.

The Equator Principles are based on the Performance Standards on Social and Environmental Sustainability[6] of the International Finance Corporation[7] (i.e., the private sector lending arm of the World Bank Group) as well as on the World Bank Group Environmental, Health, and Safety Guidelines (EHS Guidelines[8]). Typically, a revision of the IFC Performance Standards

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[6] The *IFC Performance Standards* include the following guidelines: Assessment and Management of Environmental and Social Risks and Impacts; Labor and Working Conditions; Resource Efficiency and Pollution Prevention; Community Health, Safety and Security; Land Acquisition and Involuntary Resettlement; Biodiversity Conservation and Sustainable Management of Living Natural Resources; Indigenous Peoples; and Cultural Heritage (cp. International Finance Corporation, Performance Standards on Environmental and Social Sustainability (2012), available at: www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+Sustainability/Sustainability+Framework/Sustainability+Framework+-+2012/Performance+Standards+and+Guidance+Notes+2012/ (accessed 11 July 2013); see also Michael Torrance (ed.), IFC Performance Standards on Environmental and Social Sustainability. A Guidebook (2012).

[7] The *IFC*, established in 1956, is a public financial institution affiliated with the World Bank Group. It is a separate legal entity with its own operational mandate, professional staff and financial resources. Its main aim is to encourage private sector growth and investment in developing countries and emerging markets. In fact, the IFC is one of the largest providers of multilateral finance in these countries. Its activities supplement the work of the World Bank Group that exclusively lends to member state governments. It has a commercial orientation and its loan syndications program includes private multinational banks. The IFC functions as a meeting facilitator and technical advisor. In this respect, the IFC is well-known for its expertise in environmental and social risk management. It has formed partnerships with the UN Global Compact and the United Nations Environment Program Finance Initiative (UNEP-FI). As such, the IFC is often regarded as a de facto standard-setter in the finance industry sector. E.g., the Equator Principles use the IFC's environmental and social safeguard policy framework as a blueprint (cp. Christopher Wright, Setting Standards for Responsible Banking: Examining the Role of the International Finance Corporation in the Emergence of the Equator Principles, in International Organizations and Global Environmental Governance, 51, 52 (F. Biermann, B. Siebenhuener, A. Schreyrogg eds., 2009); cp. Torrance (note 6).

[8] The *EHS Guidelines* are technical reference documents containing examples of good international industry practices. Two sets of guidelines are important: the *General Environmental, Health and Safety Guidelines*

precedes a revision of the Equator Principles. The EPFIs commit themselves to not providing loans and credits to projects where the borrower is not or is unable to comply with the respective social and environmental standards and guidelines.

Currently, 78 financial institutions from 35 countries and six continents (as of November 2013) adopted the Equator Principles. According to official data provided by the Equator Principles Association, the Equator Principles cover over 70% of international project finance debt in emerging markets.[9]

I. The Special Role of Project Finance[10]

As mentioned before, the Equator Principles apply globally to four financial products, namely project finance, advisory services related to project finance, project-related corporate loans, and bridge loans. The project finance (PF) sector itself funds the design, construction and operation of large industrial and infrastructure projects especially in emerging markets and developing countries. Examples include power plants, chemical processing plants, manufacturing plants, (gold, silver, copper, etc.) mines, oil and gas projects as well as transportation and telecommunication infrastructures (e.g., bridges, dams and pipelines). These large infrastructures and industrial projects can have a substantially large ecological and social footprint (i.e., impact on natural/ecological resources and local communities). They are technically complex, capital-intensive and involve significant financial and non-financial risks. They are usually conducted by short-term joint ventures most often in the form of special purpose vehicles (SPV). Moreover, these kinds of projects are typically financed jointly by syndicates that involve several financial institutions. The reason is that significant financial and non-financial risks are involved, i.e., the failure of a project may result in a near-complete loss of investments. Sources of risk include the following: *market* and/or *financial risks* (i.e., interest rate risk, credit risk, off-balance-sheet risk, foreign exchange risk/risk of

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(which contain information and data on cross-cutting environmental, health, and safety issues applicable to all industry sectors; they are divided into sections entitled: Environmental; Occupational Health and Safety; Community Health and Safety; Construction; and Decommissioning) and the *Industry Sector Guidelines*, containing sector-specific recommendations (cp. International Finance Corporation/World Bank Group, Environmental, Health and Safety Guidelines (2007), available at: www.ifc.org/wps/wcm/connect/554e8d80488658e4b76af76a6515bb18/Final%2B-%2BGeneral%2BEHS%2BGuidelines.pdf?MOD=AJPERES (accessed 11 July 2013)).

[9] Cp. Equator Principles Association (note 3).

[10] Cp. Christopher Wright & Alexis Rwabizambuga, Institutional Pressure, Corporate Reputation, and Voluntary Codes of Conduct: An Examination of the Equator Principles, 111 Business and Society Review, 89, 96 (2006); Stefanie Kleimeier & Roald Versteeg, Project Finance as a driver of economic growth in low-income countries, 19 Review of Financial Economics, 49 (2010); Patrick Haack, Dennis Schoeneborn & Christopher Wickert, Exploring the Constitutive Conditions for a Self-Energizing Effect of CSR Standards: The Case of the "Equator Principles", 115 Working Paper Series Institute of Organization and Administrative Science University of Zurich, 17 (2010); Marissa Marco, Accountability in International Project Finance: The Equator Principles and the Creation of Third-Party-Beneficiary Status for Project-Affected Communities, 34 Fordham International Law Journal, 452, 456 (2011).

currency devaluation, liquidity risk, insolvency risk, operational risk), *political risks* (i.e., risk of political interference and confiscation, expropriation risks, risk of governmental nationalization, political turmoil, civil unrest/civil war), *environmental and social risks* (i.e., financial institution's direct liability for environmental and social damage caused by its borrowing clients), and last not least, *reputational risk* (i.e., risks to the bank's reputation and negative publicity from environmental, social and corporate governance issues[11]).[12]

Typically, the lender's loan is secured by the different project assets and repaid mainly from the cash flows of the project and the value of the facilities themselves. What makes the project finance sector so attractive is the fact that it is a (potentially) high margin business with large revenue streams (given that the project runs successfully).[13]

The market itself is shaped by a few market players. The major lenders in project finance are the World Bank Group (and in particular the IFC), export credit agencies, development banks and large private commercial banks. Noteworthy is also the fact that project finance is only a small segment of major financial institutions. It commonly accounts for up to 5% of the overall turnover of financial institutions. As such, the Equator Principles apply only to a small fraction of multinational bank's total activities.[14]

Project finance is often regarded as a substitute for a lack of local or regional financial and institutional development. Project finance as a complement for foreign direct investments can compensate for a lack of managerial capabilities and poor political and corporate governance. The public sector in developing countries is most often not capable to design, construct and operate such complex projects due to its inefficiencies and lack of management know-how. Project finance, thus, transfers the development, construction and management to the private sector and its superior expertise. In addition, project finance stimulates economic growth: Newly acquired telecommunication and transportation infrastructures can lead to improved economic growth in developing countries and emerging markets – so called "finance-growth

[11] Non-CSR behavior can backfire in the sense that it might cause media-driven scandalization which directly affects the reputational capital and stock market value of a company. If the project developer (client) performs in a socially and environmentally irresponsible manner, it may cause legal and other financial costs and reduce revenues due to NGO pressure and reputational damage. Reputational capital has direct impacts on financial institutions' ability to generate future revenue. Adopting and implementing CESR guidelines and 'voluntary' codes of conduct (being part of the (reputation) risk management), therefore, provides defense against potential customer boycott and NGO criticism. CESR is also beneficial since it enhances the bank's reputation (cp. Richard Macve & Xiaoli Chen, The "equator principles": a success for voluntary codes?, 23 Accounting, Auditing & Accountability Journal, 890, 894 (2010).

[12] Cp. Marcel Jeucken, Sustainable Finance and Banking: The Financial Sector and the Future of the Planet, 118 (2001/2002); Bede O.N. Nwete, The Equator Principles: How far will it affect Project Financing?, 2 International Business Law Journal, 173 (2005); Andrian Lozinski, The Equator Principles: Evaluating the Exposure of Commercial Lenders to Socio-Environmental Risk, 13 German Law Journal, 1487 (2012).

[13] Especially, projects that circumvent environmental and social standards cause the most adverse environmental and social impacts; yet, they also happen to generate the most (corporate) revenue – at least in the short run.

[14] Cp. Haack et al. (note 10), 17.

nexus".[15] With its growth-enhancing properties, project finance might be regarded as a main driver of economic growth in low-income countries and emerging markets.[16]

C. A Brief History of the Equator Principles

In October 2002, the first meeting of the later 'Equator banks' was convened in London together with the IFC to discuss environmental and social risk topics in the project finance sector. This meeting was triggered by the growing reputational pressure[17] [18] from NGOs such as BankTrack[19], Bankwatch, Friends of the Earth, Greenpeace, Human Rights Watch, International Rivers Network, Rainforest Action Network, and World Wide Fund for Nature.

In fact, NGO criticism and activism have played huge (catalyzing) roles in developing and adopting the Equator Principles.[20] NGOs, civil society organizations, and other stakeholder

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[15] Cp. Kleimeier & Versteeg (note 10).

[16] Project finance is often undertaken as part of a national growth strategy. "It remains particularly popular in emerging markets: in the aftermath of the financial crisis, India developed a $475 billion infrastructure stimulus plan and Brazil has plans to build 24 dams in the Amazon this decade at a cost of roughly $100 billion (the nation already gets 80% of its power from dams but wants to boost its capacity by 60% by 2019 to keep-up with its economy)" (Ariel Meyerstein, Global Private Regulation in Development Finance: The Equator Principles and the Transnationalization of Public Contracting, in The Internationalization of Public Contracts, 9 (Mathias Audit & Stephan Schill eds., forthcoming in 2013). The need for project finance and in particular infrastructure projects stems also from the fact that developing countries have to meet population growth needs and, thus, increasing energy and food supply needs.

[17] Given the persistent NGO pressure, it seems at odds to describe the Equator Principles as a 'voluntary' code of conduct. They are mostly adopted due to external pressure (i.e., demands from local communities, customers, socially responsible investment groups, etc.). What makes them 'voluntary' is the fact that the adoption is not formally obliged by the regulatory authorities; a threat of mandatory legal regulation is lacking.

[18] Especially Western European and North-American multinational financial institutions face strong reputational pressure to become 'green' and behave socially responsible. Scholtens/Dam found out that institutions that adopt the Equator Principles are significantly larger than those that do not. The reason is that reputation appears to be more important for large institutions since they experience more pressure from NGOs. CSR issues are, thus, essential for large, multinational banks in the spotlight (cp. Bert Scholtens & Lammertjan Dam, Banking on the Equator. Are Banks that Adopted the Equator Principles Different from Non-Adopters, 35 World Development, 1307 (2007); see also Parashar Kulkarni, Pushing Lenders to Over-Comply with Environmental Regulations: A Developing Country Perspective, 22 Journal of International Development, 470, 475 (2010).

[19] BankTrack is a worldwide operating network and consortium of various NGOs and civil society organizations. It functions as a watchdog of the activities of global financial institutions and their impact on people and the planet. It has played an important role in reviewing and updating the Equator Principles as well as in channeling civil society pressure on the EPFIs.

[20] Almost all of the founding members of the Equator Principles have been targeted in one way or the other by NGO activism/criticism and civil society organizations' advocacy campaigns (especially ABN AMRO, Barclays, Citigroup and WestLB). Prominent examples causing public outcry include the *Three Gorges Dam project* on the Yangtze Rivers in the Peoples Republic of China, the *Baku-Tbilisi-Ceyhan oil pipeline project*, the *Sakhalin II oil and gas project* in Russia, the *Orion Paper-Pulp Mill case* in Uruguay, and the *Belo Monte Dam* in the Brazilian Amazon. Current controversies include e.g., fracking and tar/oil sands mining in Canada (which has potential negative impacts on the Canadian ecosystem and on climate change), the *Bristol Bay controversy* in Alaska (salmon fisheries and indigenous peoples vs. copper and gold mining companies), the *Keystone oil pipeline* from Alberta/Canada to the Gulf of Mexico, the *Marlin mining project* in Guatemala (involving the Canadian mining company Glamis Gold/Goldcorp), the *Fenix mining project* in Guatemala (involving the Canadian mining company Skye Resources/HudBay Minerals), and the *Pascua Lama mining project* in Argentina and Chile (involving the Toronto-based mining company Barrick Gold; it is noteworthy that two Equator Banks, Ex-Im Bank and Export Development Canada (EDC), decided to not finance the project due to clear violations of the Equator Principles (including serious human rights violations committed on the Diaguita Indigenous community) (cp. Andrew Hardenbrook, The Equator Principles: The Private Financial Sector's Attempt at Environmental Responsibility, 40 Vanderbilt Journal of Transnational Law, 197, 215 (2007); Shin

groups function as watchdogs and "counter accountants".[21] They monitor the ethical, social and environmental commitments and business activities of financial institutions and challenge the moral legitimacy of their practices.[22] They hold financial institutions "accountable for perceived deficiencies in recognizing and reporting credibly on their social and environmental responsibilities".[23] In case of apparent non-compliance (i.e., adverse environmental, social and human rights impacts/violations and other forms of corporate governance scandals), NGOs might start public 'naming and shaming' campaigns, customer boycotts and civil disobedience protest movements. These protests often catch media attention and as a consequence might cause negative publicity and negative reputational effects for the involved EPFIs and their clients: "Public scrutiny of bank activity can be extremely detrimental to a bank's reputation, leading to a devaluation of a bank's brand and potentially a decrease in the stock price[24]. To avoid the negative publicity, private banks began to incorporate into their financial agreements environmental standards that go above and beyond the standards of the country where the project is being constructed".[25]

In January 2003, the *Collevecchio Declaration on Financial Institutions and Sustainability*[26] was launched at the World Economic Forum in Davos/Switzerland. Its aim was to coordinate NGO finance sector campaigning. The declaration laid the foundation of the NGO BankTrack and was endorsed by more than 100 civil society organizations. In the centre of the declaration are the following six principles:

- *Commitment to Sustainability* ("FIs must expand their missions from ones that prioritize profit maximization to a vision of social and environmental sustainability. […] integrate the consideration of ecological limits, social equity and economic justice into corporate strategies

Imai, Ladan Mehranvar & Jennifer Sander, Breaching Indigenous Law: Canadian Mining in Guatemala, 6 Indigenous Law Journal, 101 (2007); Shin Imai, Bernadette Maheandiran & Valerie Crystal, Accountability Across Borders: Mining in Guatemala and the Canadian Justice System, 26 Osgoode CLPE Research Paper (2012), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2143679 (accessed 31 July 2013); Vivian Lee, Enforcing the Equator Principles: An NGO's Principled Effort to Stop the Financing of a Paper Pulp Mill in Uruguay, 6 Northwestern Journal of International Human Rights, 354 (2008); Christopher Wright, Global Banks, the Environment, and Human Rights: The Impact of the Equator Principles on Lending Policies and Practices, 12 Global Environmental Politics, 56, 65 (2012); Meyerstein (note 16).

[21] Niamh O'Sullivan & Brendan O'Dwyer, Stakeholder perspectives on a financial sector legitimation process. The case of NGOs and the Equator Principles, 22 Accounting, Auditing & Accountability Journal, 553 (2009).

[22] Due to the great visibility of most of the financed projects within project finance, environmental and ethical malpractices are highly exposed to external stakeholder pressure which might cause reputational damage for the companies involved (cp. Wright/Rwabizambuga (note 10), 109).

[23] O'Sullivan & O'Dwyer (note 21), 558.

[24] Empirical research has shown that environmental, social and corporate governance issues positively affect long-term shareholder value pointing towards a link between environmental, social and financial performance (cp. Kulkarni (note 18), 474).

[25] Hardenbrook (note 20), 206.

[26] Cp. Andreas Missbach, The Equator Principles: Drawing the line for socially responsible banks? An interim review from an NGO perspective, 47 Development, 78, 81 (2004); Benjamin Richardson, The Equator Principles: The Voluntary Approach to Environmentally Sustainable Finance, 11 European Environmental Law Review, 280, 288 (2005); Wright (note 7), 8; O'Sullivan & O'Dwyer (note 21), 563.

and core business areas […], to put sustainability objectives on an equal footing to shareholder maximization…"),

- *Commitment to 'Do not harm'* ("FIs should commit to do no harm by preventing and minimizing the environmentally and/or socially detrimental impacts of their portfolios and their operations. FIs should create policies, procedures and standards based on the Precautionary Principle to minimize environmental and social harm"),
- *Commitment to Responsibility* ("FIs should bear full responsibility for the environmental and social impacts of their transactions" including the "social and environmental costs that are borne by communities"),
- *Commitment to Accountability* (FIs must be accountable to their stakeholders, particularly those that are affected by the companies and activities they finance"),
- *Commitment to Transparency* ("FIs must be transparent to stakeholders, not only through robust, regular and standardized disclosure, but also by being responsive to stakeholder needs for specialized information on FIs' policies, procedures and transactions. Commercial confidentiality should not be used as an excuse to deny stakeholders information"), and
- *Commitment to Sustainable Markets and Governance* ("FIs should ensure that markets are more capable of fostering sustainability by actively supporting public policy, regulatory and/or market mechanisms…").[27]

The Collevecchio Declaration had a tremendous impact on the Equator Principles and accelerated the dynamic interaction process between EPFIs, NGOs, civil society organizations and other stakeholder groups.

On June 4th 2003, the first generation of the Equator Principles (EP I) was launched and adopted by the first ten financial institutions.[28] Among the founding members were ABN AMRO, Barclays, Citigroup, Credit Lyonnais, Credit Suisse, HVB, Rabobank, Royal Bank of Scotland, WestLB, and Westpac. Beginning of 2006, the first strategic review and update process took place. Several NGOs, civil society organizations, export credit agencies, industry associations, etc. participated in this first engagement and review process. The aim was to revise the Equator Principles and to incorporate the various changes in the IFC Performance Standards which came into effect in April 2006. A couple of months later, on July 6th 2006, the second generation of Equator Principles (EP II) was launched. Key changes (EP I vs. EP II) include the lowering of the financial threshold from US$ 50 million to US$ 10 million, the

[27] Collevecchio Declaration, The role and responsibility of financial institutions (2003), available at: www.banktrack.org/download/collevechio_declaration/030401_collevecchio_declaration_with_signatories.pdf (accessed 11 July 2013).

[28] In the last ten years, the Equator Principles have seen a rapid and widespread adoption rate, both in terms of quantity and diversification. Almost all important banks that are currently engaged in project finance have adopted the Equator Principles, including Barclays, BNP Paribas, Citigroup, Credit Suisse, Royal Bank of Scotland, ING, among others (cp. for more information about the Equator Principles 'diffusion process': Haack et al. (note 10)).

extension of scope (i.e., inclusion of project-related advisory services: the Equator Principles are now applied at an earlier stage, namely the advisory stage of project planning), the inclusion of stronger environmental and social standards as outlined in the IFC Performance Standards (i.e., environmental plus(!) social assessment; enhanced consultation (i.e., prior informed consultation, yet not consent!) and covenanting requirements; labor standards; project-level grievance mechanism), increased transparency by requiring each EPFI to report publicly on its Equator Principles implementation on an annual basis (cp. the newly added Principle 10).

In April 2008, the Equator Principles Secretariat got established followed by the formal establishment of the Equator Principles Association and the launch of the Governance Rules in July 2010.[29] Both steps contributed immensely to the (enhanced) formalization and institutionalization of the Equator Principles and its public visibility. From October 2010 until May 2011, the Equator Principles Association launched a Strategic Review Process followed by an official Update Process starting in July 2011. This update and review process reflected ongoing learning, implementation experience and emerging good practices. Moreover, the process reflected the changing financial landscape as well as the changing public perception of the role of financial institutions. The financial crisis of 2007/2008 had contributed to a legitimacy crisis and a loss of public trust in finance industry institutions. Key thematic areas during the second update and review process were the extension of scope of the Equator Principles, as well as reporting, transparency, and governance issues including stakeholder engagement, climate change/global warming, and human rights. In the first phase, an internal consultation process yielded a first draft of EP III. The second phase, the stakeholder consultation and public comment period, gave stakeholder groups the chance to comment on the initial draft and make suggestions for further improvement (although not all recommendations were taken into account by the Equator Principles Association and included in the final draft). In the third phase, the third generation of the Equator Principles was finalized and launched taking into considerations the newly revised IFC Performance Standards which came into effect on January 1st 2012. June 4th 2013 marks the formal Launch of EP III as well as the tenth anniversary of the Equator Principles. Until the end of 2013, a transition period applies to give EPFIs as well as clients the chance to implement EP III for all products in the newly extended scope. From January 1st 2014, EP III will be applied to all new transactions.

[29] Cp. Equator Principles Association, Governance Rules (2010), available at: www.equator-principles.com/index.php/about/governance-and-management (accessed 11 November 2013).

With the introduction of EP III the scope of the Equator Principles will be extended to cover not only project finance and project-related advisory services, but also project-related corporate loans and bridge loans; i.e., more projects will be assessed under a strengthened and broadened environmental and social risk management framework. EP III also aims at a greater consistency in the implementation of the Equator Principles and an enhanced transparency through extended reporting requirements.

Even more important fact is that the EP III framework takes into account climate change/global warming, human rights and stakeholder engagement issues (although major deficiencies still exist, of which more later). With regards to climate change and global warming, EP III requires an Alternative Analysis for high CO_2 emitting projects.[30] Projects emitting more than 100,000 tons CO_2 equivalent should consider alternative technologies and procedures requiring less carbon intensive fuel or energy sources. These resource-saving technologies have to be technically and financially feasible and cost-effective. The overall aim of the Equator Principles is to reduce project-related greenhouse gas (GHG) emissions during the design, construction and operation phases of the particular projects. The Alternative Analysis should include a comparison to other viable and feasible technologies and procedures used in the same country, region, or industry sector. High carbon intensity sectors include thermal power, cement and lime manufacturing, steel mills, metal smelting and refining, and foundries. Moreover, borrowers have to report publicly on GHG emissions.[31] With regard to stakeholder engagement and human rights issues, EP III introduces the term human rights in the Equator Principles framework for the first time. EP III also acknowledges John Ruggie's 'Protect, Respect, and Remedy' Framework, the United Nations' Guiding Principles on Business and Human Rights, the UN Declaration on the Rights of Indigenous Peoples, and the importance of human rights in the due diligence process. Finally, the current Consultation and Disclosure procedure is extended by the Stakeholder Engagement process requiring 'informed consultation and participation' (ICP) as

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[30] EP III focuses (solely) on carbon dioxide (CO_2) emissions, while other greenhouse gases such as methane (CH_4), nitrous oxide (N_2O), ozone (O_3) and chlorofluorocarbon (CFC) are mainly neglected. In addition, EP III concentrates on fossil fuel burning, while other sources of the greenhouse effect such as deforestation only play a minor role.
New technologies such as fracking, oil/tar sands or deepwater drilling raise complex environmental issues such as groundwater contamination, depletion of water reserves, methane leakage, contamination from spills, and related health effects. The question that comes up in light of these new technologies is whether EP III is readily equipped to deal with these new technological challenges (which at least partially threaten the overall goal to fight climate change/global warming due to their partial increase in GHG emissions). EP III as well as the IFC Performance Standards and EHS Guidelines provide only limited guidance related to these new technologies. Furthermore, even in Western Europe, the United States and Canada, inadequate environmental regulation exists in terms of these new technologies (cp. Suellen Lazarus, The Equator Principles at Ten Years, Transnational Legal Theory (forthcoming in 2014)).

[31] Cp. Equator Principles Association (note 5), 12.

well as ‘free, prior and informed consent’ (FPIC) – given that indigenous peoples are involved.[32]

D. The Equator Principles Association – Governance and Management

The Equator Principles Association is the unincorporated association of EPFIs. Its objective is the management, administration and further development of the Equator Principles. The association got established on July 1st 2010. It is governed by a set of Governance Rules which are accessible on the website of the Equator Principles Association. Two governance levels have to be distinguished: the administration and the management levels. The management level consists of the Steering Committee which is responsible for the coordination of the administration, management and further advancement of the Equator Principles on behalf of EPFIs. The Steering Committee can set up permanent or temporary working groups fostering the inclusion of stakeholder groups. One of the main tasks of these working groups is to discuss governance and implementation issues and provide guidance to EPFIs with regards to further advancement of the Equator Principles. Currently, 10 working groups exist, e.g., on stakeholder engagement (NGOs and civil society organizations), biodiversity, climate change, social risks, sustainability issues, etc.

As of November 2013, 14 members are part of the Steering Committee which makes consensus-building an increasingly difficult task. EPFIs become members of the Steering Committee on the basis of a rotation principle for a maximum of three years. Among the members of the Steering Committee, one EPFI is elected as Chair of the Steering Committee who functions as the speaker and provides coordination across the Steering Committee, the other member of the institutions, and the working groups. Members of the Steering Committee hold the chair for a term of approximately one year (with the maximum of two consecutive terms) on the basis of a rotation principle as well. Currently, Leonie Schreve, Director and Head of Sustainable Lending at ING, holds the Chair of the Equator Principles Association.

The second level of the Equator Principles Association is the administration level consisting of the Equator Principles Secretariat. The Secretariat manages the every-day running of the Equator Principles Association. In particular, the Secretariat is responsible for the Equator

[32] “’Consultation’ in this context should be ‘free’ (free of external manipulation, interference or coercion, and intimidation), ‘prior’ (timely disclosure of information), and ‘informed’ (relevant, understandable and accessible information), and apply to the entire project process and not to the early stages of the project alone. Additionally, the borrower will tailor its consultation process to the language preferences of the affected communities, their decision-making processes, and the needs of disadvantaged or vulnerable groups” (David M. Ong, From ‘International’ to ‘Transnational’ Environmental Law? A Legal Assessment of the Contribution of the ‘Equator Principles’ to International Environmental Law, 79 Nordic Journal of International Law, 35, 64 (2010)).

Principles website, internal and external communications, public relations, advice and assistance with regards to adopting and implementing the Equator Principles, and the management of financial affairs.

Decision-making within the Equator Principles Association aims at consensus-seeking which gets increasingly difficult the more EPFIs coming from heterogeneous backgrounds and having conflicting interests adopt the Equator Principles. Proposals are typically adopted when at least 50% of EPFIs (each EPFI has one vote) cast votes – so called quorum of half – and when 2/3 of them vote in favor of a particular proposal (i.e., basic rule of decision-making).

The annual fee for the financial year 1 July 2013-30 June 2014 is GBP £ 3,290. The fee covers all of the costs incurred in the administration, management, and further advancement of the Equator Principles.

E. Equator Principles: The Third Generation

The updated third generation of Equator Principles (EP III) consists of ten principles.[33] The first principle (*Review and Categorisation*) requires the EPFIs to categorize each proposed project "based on the magnitude of its potential environmental and social risks and impacts."[34] The screening process is based on the environmental and social categorization process of the IFC.[35] Category A projects are "Projects with potential significant adverse environmental and social risks and/or impacts that are diverse, [cumulative] irreversible or unprecedented". Category B projects are "Projects with potential limited adverse environmental and social risks and/or impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures." Category C contains "Projects with minimal or no adverse environmental and social risks and/or impacts." The categorization process is crucial due to the decision on which environmental and social standards and procedures are subsequently applied. The following Equator Principles apply to Category A and B projects only. Category C projects do not fall into the Equator Principles framework since they are socially and environmentally inoffensive; they can be classified as safe from an environmental, social and human rights perspective.

Principle 2 (*Environmental and Social Assessment*) requires the client to conduct for all Category A and B projects an environmental and social assessment process to address all relevant environmental and social risks and impacts of the proposed project. The Environmental and Social Assessment Documentation should include "measures to minimize, mitigate, and offset adverse impacts." It should also include an Environmental and Social Impact

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[33] Cp. Equator Principles Association (note 5).

[34] The following quotes refer to the third generation of the Equator Principles (EP III): cp. Id.

[35] Cp. International Finance Corporation (note 6).

Assessment (ESIA) and an Alternative Analysis for projects emitting more than 100,000 tons of CO_2 equivalents annually.[36] For these projects, an alternatives analysis has to be conducted to evaluate less GHG-intensive technologies and procedures.

Which environmental and social standards are applicable depends on the location of the particular project. In 'designated countries' – i.e., mainly industrial and (high-income) OECD countries – compliance with host country laws, regulations and permits pertaining to environmental and social issues is required. In 'non-designated countries', however, compliance is also required with the IFC Performance Standards and the World Bank's EHS Guidelines (Principle 3: *Applicable Environmental and Social Standards*).

Principle 4 – *Environmental and Social Management System and Equator Principles Action Plan* – demands that the client develops and maintains an Environmental and Social Management System[37] (ESMS) as well as an Environmental and Social Management Plan (ESMP). The overall aim is to comply with the applicable environmental and social standards. In case that the applicable standards are not met, the client and the EPFI will develop a joint Equator Principles Action Plan (AP).

Principle 5 asks for an encompassing and constant *stakeholder engagement* process. Project-affected communities and other stakeholder groups must have rights to information, consultation and influence. Of particular importance is the 'informed consultation and participation' (ICP) process, a process which ideally takes place in a "culturally appropriate manner". Information has to be made readily and publicly available to the affected communities in their local languages. The disclosure of information (e.g., assessment documentation) should occur as early as possible in the assessment process – ideally within the planning stage and before construction commences – and on an ongoing basis. Moreover, project affected communities have to have the right to participate in decision-making (i.e., notion of *Teilhabe* and inclusion). Their voices have to be heard, and the interests and needs of disadvantaged and vulnerable groups shall be taken into consideration. The whole stakeholder engagement process should be free from external manipulation, interference, coercion and intimidation. Projects with adverse impacts on indigenous or aboriginal peoples

[36] This includes Scope 1 and Scope 2 emissions: Scope 1 emissions are direct GHG emissions from the facilities themselves while Scope 2 emissions refer to the indirect GHG emissions associated with the off-site production of energy used by the infrastructure or industry project (cp. Equator Principles Association (note 5), 19).

[37] Cp. for more information on E(S)MS: Stepan Wood, Environmental Management Systems and Public Authorities in Canada: Rethinking Environmental Governance, 10 Buffalo Environmental Law Journal, 129 (2003); Stepan Wood, Green Revolution or Greenwash? Voluntary Environmental Standards, Public Law, and Private Authority in Canada, 123, 123 (Law Commission of Canada ed., 2003); Stepan Wood & Lynn Johannson, Six Principles for Integrating Non-Governmental Environmental Standards into Smart Regulation, 46 Osgoode Hall Law Journal, 345 (2008).

even require 'Free, Prior and Informed Consent' (FPIC). This consent, however, does not entail any veto rights nor does it require unanimity – a majority decision suffices. The practical challenge of course is how to implement FPIC in practice (cp. the paragraph on third-party beneficiary rights later on in this paper).

The client is, furthermore, required by Principle 6 to establish a (project-level and worker) *grievance mechanism* (as part of the ESMS), which is "designed to receive and facilitate resolution of concerns and grievances about the Project's environmental and social performance. […] It will seek to resolve concerns promptly, using an understandable and transparent consultative process that is culturally appropriate, readily accessible, at no cost, and without retribution to the party that originated the issue or concern."

In order to assess compliance with the principles, independent monitoring, reporting, and reviewing is required. Principles 7 and 9 deal with these topics. Principle 7 requires that an *independent review* of the Assessment Documentation (including ESMP, ESMS and stakeholder engagement process) is conducted by an independent environmental and social expert or consultant who is not directly linked with the client. Moreover, the consultant can propose a suitable action plan for the projects that are not in compliance with the Equator Principles. The projects which cause potential adverse impacts on indigenous peoples, critical habitat impacts, significant cultural heritage impacts, and large-scale resettlement are the most important projects.

Principle 9 is devoted to *independent monitoring and reporting*. Here, an independent consultant or a "qualified and experienced external expert" is required in order to assess project compliance with the Equator Principles. The consultant or expert is responsible to verify monitoring and reporting information after financial close and over the life of the loan.

The *Covenants*-Principle 8 also deals with compliance: It requires the client to "covenant in the financing documentation to comply with all relevant host country environmental and social laws, regulations and permits." Furthermore, the client has to covenant to comply with the ESMP and Equator Principles action plan, to report publicly in an appropriate format (i.e., provide public reports), and to decommission facilities where applicable. Finally, "[w]here a client is not in compliance with its environmental and social covenants, the EPFI will work with the client on remedial actions to bring the Project back into compliance to the extent feasible. If the client fails to re-establish compliance within an agreed grace period, the EPFI reserves the right to exercise remedies, as considered appropriate."[38]

The final principle 10 deals with accountability in the form of *reporting and transparency* requirements both for clients and EPFIs. The client ensures that a summary of the ESIA is

[38] "…EP 8 requires that the obligations imposed by the project lenders upon the project developers get formalized as covenants in the loan documentation between the bank syndicate and the project developer. By making these requirements covenants, the bank lenders can condition project financing upon their adequate fulfillment and can use their non-fulfillment as conditions of material default, that is, a basis for calling for repayment of the loan …" (Meyerstein (note 16), 26).

publicly available and readily accessible (i.e., online disclosure/publication). Principle 10 also requires the client to publicly report on GHG emission levels for projects emitting more than 100,000 tons of CO_2 equivalents annually.[39] The EPFI is required to report publicly on an at least annual basis on "transactions that have reached Financial Close and on its Equator Principles implementation processes and experience, taking into account appropriate confidentiality considerations." The EPFI is further requested to provide additional information on the total number of deals financed under the Equator Principles, the number of Category A, B and C projects, the sector, region, and country of financed projects as well as information with regards to Equator Principles implementation (i.e., credit and risk management policies), independent review, role of senior management, internal preparation and (ongoing) staff-training, etc. Project names will be conveyed to the Equator Principles Association. Given the client's approval, this information might be made public on the Equator Principles website in the near future.

The Governance Rules as well as the legal *Disclaimer* state that "the Equator Principles do not create any rights in, or liability to, any person, public or private." EPFIs adopt and implement the Equator Principles on a voluntary, legally non-binding basis. The Equator Principles framework is, therefore, voluntary in use relying purely on self-enforcement and the goodwill of EPFIs; no mandatory obligations or direct punitive actions can arise from the principles themselves (i.e., exclusion of liability).[40]

F. A Critical Economic-Ethical Evaluation

The following paragraphs critically examine and evaluate the Equator Principles from an economic ethics and business ethics perspective. It weighs the pros and cons and investigates what has been achieved so far and which necessary reform steps should be adopted in the future. The main aim is to provide a baseline for a revision of EP III and pave the way towards EP IV.

I. Limited Scope of the Equator Principles

One major flaw of the Equator Principles is that they apply 'only' to project finance; the Equator Principles are restricted to the narrow definition of project finance. As it has been pointed out already, the project finance sector is a small segment for multinational financial

[39] Interestingly, the new IFC Performance Standards require annual reports for projects emitting over 25,000(!) (and not 100,000) tonnes of CO_2 equivalent annually. The Equator Principles threshold is much higher than the one of the IFC Performance Standards. Thus, the Equator Principles fall behind the commitments made by the IFC Performance Standards. "EP III does not contain any commitments on issues that are beyond[!] what is included in the IFC Performance Standards. In some cases the commitment in EP III is even below what is required in IFC PS (such as reporting requirements on CO_2 emissions)" (cp. BankTrack, Tiny steps forward on the Outside Job. Comments on the Equator Principles III Official First Draft, 8 (2012), available at: www.banktrack.org/show/pages/equator_principles#tab_pages_documents (accessed 11 July 2013). The Equator Principles should ideally go above and beyond the IFC Performance Standards and not fall behind.

[40] Cp. Jane Andrew, Responsible Finance?: The Equator Principles and Bank Disclosures, 14 Journal of American Academy Business, 302, 306 (2009).

institutions. The sector commonly accounts for up to 5% of the overall turnover of major banks. Therefore, project finance portfolios are rather small and what is even worse is that the portion is declining.[41] When taking a closer look at general financial market trends in recent years, it becomes clear that multinational banks have shifted their banking activities more towards the highly profitable investment banking sector. As a consequence, the Equator Principles apply only to a small fraction of major bank's total activities.[42] What is required from an economic ethics perspective is a deeper engagement: The application of the Equator Principles should be extended to other business segments and departments within a firm. The "Spirit of the Equator Principles"[43] should ideally be embedded throughout the whole company and across product categories; it should be internalized in the sense that it is part of the core activities of multinational banks and insurance companies. Required are, thus, an outreach to neighboring fields and a spillover to other finance areas. As a minimum requirement, the Equator Principles should be extended to cover not only project finance, but any transactions with a potential significant adverse impact on the socio-ecological environment, local communities and in particular aboriginal peoples. Here, the third generation with its inclusion of project-related corporate loans and bridge loans is a major step forward to 'Go Beyond Project Finance'[44], although, it remains to examine whether this extension of scope has any practical meaning.[45] Thus, a future reform of the Equator Principles (EP IV) should include (all forms of) export finance and other forms of corporate lending and financing. To put it differently: The scope of the Equator Principles should at minimum be "extended from 'project finance' to 'financing projects.'"[46]

II. Special Case: The BRIC Countries

So far, a high number of BRIC countries' banks are not members of the Equator Principles Association.[47] Especially, the new economic powerhouses, China and India, are

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[41] Yet, the privatization of state-owned enterprises and the deregulation of state monopolies and key industry sectors (e.g., electricity and telecommunication sectors) in developing countries and emerging markets in combination with the overall trend towards globalization boost the project finance sector (cp. Scholtens & Dam (note 18)).

[42] Cp. Lazarus & Feldbaum (note 4), iii.

[43] John M. Conley & Cynthia A. Williams, Global Banks as Global Sustainability Regulators? The Equator Principles, 33 Law and Policy, 542, 547 (2011).

[44] Lazarus & Feldbaum (note 4), iii/8. EP I was solely restricted to project finance. EP II included advisory services related to project finance. EP III goes one step further and incorporates project-related corporate loans and bridge loans. EP IV ideally extends the scope and goes beyond project finance including all forms of corporate financing, export financing, etc.

[45] Cp. BankTrack (note 39), 8.

[46] BankTrack, The Outside Job. Turning the Equator Principles towards people and planet, 11 (2011), available at: www.banktrack.org/show/pages/equator_principles (accessed 11 July 2013).

[47] One noteworthy exception is Brazil. Here, 5 financial institutions joined the Equator Principles Association. Another exception, although, the country is not part of the BRIC countries, is South Africa. Here, 3 financial institutions have adopted the Equator Principles.

underrepresented when it comes to the adoption of the Equator Principles. As of November 2013, only one Chinese (Industrial Bank Co.), one Indian (IDFC Limited), and one Russian bank (Otkritie) have joined the Equator Principles Association. In particular, the major Asian players are still missing, e.g., Agricultural Bank of China, Bank of China, China Construction Bank, ICICI Bank, Industrial and Commercial Bank of China (ICBC), Sberbank, State Bank of India, etc.[48] Especially, China is of major importance since China is a major cross-border lender that is even larger than the World Bank Group.[49]

In total, only five Asian banks – one Chinese, one Russian and three Japanese banks – are members of the Equator Principles Association. Asian banks now represent a tiny fraction of all EPFIs (6.4%); Equator banks from emerging markets represent around 25-35% of EPFIs (depending on the definition of emerging markets), while there is still a high concentration of Western-European, North-American and Australian EPFIs accounting for up to 65% of all EPFIs.[50] 51 out of 78 EPFIs are from industrialized countries – a fact which contrasts heavily with the regional distribution of project finance markets and the tremendous growth of project finance transactions in Asia.

The most recent financial market crisis as well as the European sovereign debt crisis – the so called Eurozone crisis – have caused fundamental shifts and changes in the global project finance markets. While the share of North-American and European banks in project finance markets has dropped dramatically – due to limited liquidity, constrained risk appetite, mergers and acquisitions (by governments) and as a consequence reduced or closed project finance business activities –, the share of project finance activities in emerging markets has rocketed – accounting now for up to 45% of the market in 2012 (up from 22% in 2008). Recent years have witnessed not only a tremendous growth of project finance activity in emerging markets, but also an increasing Asian, or to be precise: Chinese dominance in (project) finance markets: By 2012, the top 5 project finance banks were all Asian.

[48] Other global players which have not yet joined the Equator Principles club are the Deutsche Bank, Morgan Stanley, and the Swiss UBS.

[49] "As much as the EPs have grown to become an industry standard, they have, thus, far not successfully penetrated key emerging markets where a tremendous amount of project finance – and some of the largest individual deals – have been done in recent years, namely, India, China and Russia. In the first quarter of 2011, the top 25 lending banks were split almost evenly between the EPs and Indian and Chinese institutions: Indian and Chinese banks covered 38.6 percent of the market and EPFIs covered 33.9 percent. Moreover, the very largest individual projects sponsored in the first quarter of 2011 were nearly all in either India, China or Russia …" (Meyerstein (note 16), 20).

[50] Most of the member institutions are from high-income OECD countries such as Australia (4 EPFIs), Canada (7), France (4), Germany (4), Spain (5), the Netherlands (6), UK (5), and the United States (5). One reason is that Western-European and North-American financial institutions face strong reputational pressure to become 'green' and to behave in a socially responsible manner.

Two of the top ten project finance banks were not EPFIs, namely the State Bank of India and the Korea Development Bank.[51] Moreover, most of the Chinese financial institutions which display huge growth rates in all financial market segments are not (yet) Equator banks – a fact which brings us to our next point of criticism that various non-Equator Principles deals are carried out in BRIC countries with serious and detrimental consequences for the environment and the people affected by project finance transactions.

One of the biggest problems in developing or emerging countries is that environmental and social governmental regulations are often inadequate and rather poor. The Equator Principles could help establishing worldwide minimum environmental and social standards – at least for the project finance sector. In addition, these countries face the problem of "environmental shopping"[52]: Borrowers and clients that are unconcerned with the environmental and social impacts of their projects can easily reduce their transaction costs by shopping the project around until they find a lender with the lowest environmental and social standards and requirements.[53] If bank A – an EPFI – refuses to finance a particular project, non-Equator banks B, C or D might do so, and the Equator bank A might lose a lucrative business (bank A, thus, faces a dilemma situation). As a direct consequence of 'environmental shopping', environmental and social standards are circumvented and undermined.[54]

This is all the more important given the geographical limitations and the missing global coverage of the Equator Principles which threaten the de facto impact of the Equator Principles in the global project finance market. With some major project finance lenders not being part of the Equator Principles Association, the playing field is not completely leveled.[55] Chinese, Indian and Russian banks have the potential to undermine the whole project by financing 'dirty projects'. Therefore, it is crucial to win over the major financial institutions in these countries. The status quo needs to be overcome in order to prevent disadvantages for member banks, to minimize the problem of environmental shopping and to secure global socio-environmental standards. A broader geographic diversification and an outreach to BRIC countries are required. The regional scope of the Equator Principles has to be extended in

[51] Cp. Thomson Reuters, Project Finance Review Full Year 2012; available at: http://dmi.thomsonreuters.com/Content/Files/Q42012_Project_Finance_Review.pdf (accessed: 11 November 2013); Lazarus (note 30).

[52] Nwete (note 12), 178.

[53] Cp. Hardenbrook (note 20), 212.

[54] The Equator Principles as an industry-wide standard theoretically help to prevent 'environmental shopping' by creating a level playing field. The greater uniformity and commonality among project financiers make it harder for corporations to pit one financial institution against the other and to negotiate or water down environmental and social standards (cp. Id., 211). Yet, the missing global coverage and outreach to BRIC countries impedes the (entire) abolition of 'environmental shopping'.

[55] Cp. Lazarus (note 30).

order to assure the worldwide compliance with UN and IFC environmental, social and human rights standards. It is one major task of the Equator Principles Association in the upcoming years to promote the Equator Principles in other geographical areas.[56]

One follow-up problem of expanding Equator Principles membership in emerging markets and developing countries might be the rising tension between broadening and deepening the membership[57]: When more and more financial institutions from different regional areas, different cultural backgrounds and heterogeneous financial interests become member of the Equator Principles Association, consensus-seeking becomes increasingly difficult. The increasing diversity, heterogeneity and complexity might lead to conflicting interests across geographies. The danger comes up that only the lowest common denominator is found (which seems to be already the case).[58] One way out of this dilemma between deepening and broadening might be a tiered membership structure reflecting different aspirations. We will come back to this reform proposal by Lazarus/Feldbaum in paragraph 11).

III. Lack of Transparency

One major problem concerning the Equator Principles is the lack of publicly disclosed information (i.e., problem of limited or no disclosure). Public consultation and public disclosure of information are often prevented by confidentiality duties towards clients.[59] In some cases, banks "hide behind excessive interpretations of 'client confidentiality' to withhold information to stakeholders and the public".[60] However, it is in the bank's own interest to not hide behind confidentiality issues (i.e., overcoming of disclosure concerns) and to be more open-minded towards stakeholder dialogue and engagement. Inclusion rather than secrecy as well as a spirit of openness and transparency might help to restore the public trust lost in the banking sector – especially in the aftermath of the latest financial market crisis.

A further problem related to the lack of transparency is the lack of (consistent) reporting standards and a lack of agreed standards for audits.[61] So far, reporting most often is limited

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[56] Cp. Lazarus & Feldbaum (note 4), 6; Conley & Williams (note 43), 557/566.

[57] Cp. Lazarus & Feldbaum (note 4), iii.

[58] BankTrack ((note 39), 4) criticizes the EP III (draft) for being a "watered down compromise between parties with a widely divergent view on matters, with those Equator banks aiming for a more ambitious new 'gold standard' clearly loosing the debate from those who are fine with a little tinkering on the edges".

[59] On the one hand, breaches of client confidentiality "can entail civil or criminal sanctions and damage relationship between a lender and its client" (Richardson (note 26), 287). On the other hand, "NGOs have complained that this caveat ['appropriate confidentiality considerations'] is a hindrance to disclosure and transparency. They have found that banks are characterizing many relevant issues as "commercially sensitive" and, as such exempt from disclosure for reasons of confidentiality" (Kirsten Mikadze, Public Participation in Global Environmental Governance and the Equator Principles: Potential and Pitfalls, 13 German Law Journal, 1386, 1406 (2012)).

[60] BankTrack (note 46), 5; Wright (note 20), 64.

[61] Cp. Equator Principles Association, Guidance Note on Equator Principles Implementation Reporting (2011), available at: http://equator-principles.com/index.php/reporting-requirements (accessed 11 November 2013).

and inconsistent. Enhanced and consistent reporting standards are required to promote transparency. It remains to be seen whether the new reporting requirements of EP III (cp. Principle 10) will help to overcome the lack of transparency and accountability. As it looks, the EP III reporting requirements with their (more) detailed information on the Equator Principles portfolio (i.e., detailed composition, regional and sectoral breakdown) are a step in the right direction. However, what is still missing is a mandatory(!) revelation and online disclosure (on the website of the Equator Principles Association) of all project names and project sponsors that are financed 'under' the Equator Principles. Detailed information on the Equator Principles implementation and compliance should be made public: Which projects got approved, which transactions got declined, and for what reasons? Which projects are in compliance with the Equator Principles and which ones are not, and for what reasons? In the case of non-compliance, which corrective measures have been adopted in order to bring the project back to compliance?[62]

In order to enhance transparency at the project level, an encompassing stakeholder dialogue and engagement process is crucial. Locally affected communities and especially indigenous peoples have to have full rights to information, consultation/participation and influence, and full access to all relevant information.[63] This is tackled by the updated Principle 5 and its 'Informed Consultation and Participation' and 'Free, Prior, and Informed Consent' paradigms. The practical challenge of course is how to implement it in reality – this remains to be seen. Different interpretations of what FPIC entails might prevent its full realization. E.g., who is affected? Who gives consent? What constitutes consent? For which projects should FPIC be sought – for projects impacting indigenous peoples or universal application of FPIC to all projects? Who counts as indigenous peoples? Are they adequately represented – in terms of gender, age and societal structure? Who is responsible for seeking FPIC – the state or the company? Does FPIC require a binding consultation or is an informative consultation sufficient? Does FPIC grant any veto rights? Does it require unanimity? If a majority is sufficient, which majority rule should be followed? Does 51-per-cent approval constitute consent? Is two-thirds' majority approval of a project sufficient for consent? And what happens in cases when consent cannot be reached and third-party mediation fails?

Stakeholder engagement has also to be enhanced within the Equator Principles Association: A structural reform in the form of a creation of an EP Advisory Group with representatives from

[62] Cp. BankTrack (note 46); BankTrack (note 39).

[63] Cp. the 1989 ILO's Convention No. 169 on Indigenous and Tribal Peoples, the 1992 Rio Declaration on the Environment and Development, the 1998 Aarhus Convention on Access to Information, Public Participation in Decision-making and Access to Justice in Environmental Matters as well as the 2007 UN Declaration on the Rights of Indigenous Peoples.

stakeholder and civil society groups and an EP Forum for engagement on finance industry sustainability issues seems promising.[64] The inclusion of stakeholder groups and especially NGOs in decision-making processes of the Equator Principles Association could raise the legitimacy of the Equator Principles and help to further strengthen it. The feedback EPFIs will receive from the various civil society organizations will be of great help to overcome practical challenges.

IV. Lack of External Accountability and Liability

The Disclaimer of the Equator Principles states that the Principles do not create any rights or liabilities. As such, it ensures that there are no mandatory obligations or direct punitive actions that can arise from the Principles. The Equator Principles framework is a voluntary, legally non-binding governance system that relies on self-enforcement. Minimum entry requirements and absolute performance standards are lacking. Furthermore, clear, verifiable metrics that are transparently and independently monitored are absent as well.[65] In sum, no formal mechanism exists to ensure accountability and liability.[66] When it comes to accountability, liability (and transparency), the current Equator Principles framework is not an appropriate governance system; especially in this regard, the EP framework requires a further improvement and strengthening of its governance regime.

This lack of accountability at an institutional (macro level), organizational (meso level) and individual project level (micro level)[67] has negative effects on the EPFIs as well as project-affected communities and local stakeholder groups: Irresponsible business activities negatively affect the organizational legitimacy of financial institutions. They might open or widen the legitimacy gap between organizational and social values respectively between current business practices and societal expectations and perceptions. In the end, they might threaten the reputational capital of a company.[68] Even worse, a lack of accountability and responsibility often leads to adverse environmental, social and human rights impacts with serious consequences especially for indigenous peoples and other vulnerable groups. EPFIs' accountability to the public, to project-affected communities, stakeholders and shareholders is therefore indispensable.

[64] Cp. Lazarus & Feldbaum (note 4), 10; BankTrack (note 46), 10; BankTrack (note 39).

[65] Donald H. Schepers, The Equator Principles: a promise in progress?, 11 Corporate Governance, 90, 101 (2011).

[66] Although, it is true that financial institutions can escape legal liability for violating the Equator Principles, they cannot avoid being accountable in the 'court of public opinion'. In case that an EPFI fails to meet public expectations, public criticism will occur and the company's brand reputation will suffer. Moreover, socially responsible investment (SRI) groups might reduce or withdraw their investments (cp. Hardenbrook (note 20), 231).

[67] Cp. O'Sullivan & O'Dwyer (note 21), 556.

[68] Cp. Haack et al. (note 10), 23; O'Sullivan & O'Dwyer (note 21).

Some commentators even go as far as to claim *third-party beneficiary rights for project-affected communities*[69] in order to enhance accountability and liability. These rights would allow non-signatories to a contract (i.e., project-affected communities) to enforce their rights against the contracting parties (i.e., lender and borrower). A third-party beneficiary status would provide a right to a promised performance enforceable by a non-signatory to a contract. This approach proposed by Marco[70] would hold both borrowers and lenders accountable for failing to adhere to the Equator Principles. It, thus, contains a right to proper Equator Principles implementation. Borrowers and lenders as promisors owe duties of performance to project-affected communities as local stakeholders, that, if breached are enforceable by the respective communities. EPFIs and clients that violate the Equator Principles could be sued[71]: Project-affected communities would be able to assert their third-party beneficiary rights through breach of contract actions in US[72], Canadian[73] or (Western) European courts. The overall aim is to curb negative environmental and social impacts on local communities and to ensure that project-affected communities and indigenous peoples maintain their livelihoods.[74]

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[69] The *Alien Tort Claims Act* in the United States allows US-American companies to be sued by foreigners from the host country in US courts for torts committed abroad. Domestic courts become increasingly aware of human rights abuses committed on foreign soil and the need to grant legal standing for the victims. More and more litigations are brought before domestic courts for distant human rights violations, perpetrated by governments or private actors such as multinational companies (cp. Imai et al. (note 20), 137; Imai et al. (note 20); Peer, Zumbansen, Globalization and the Law: Deciphering the Message of Transnational Human Rights Litigation, 5 German Law Journal, 1499 (2004); Peer Zumbansen, Beyond Territoriality: The Case of Transnational Human Rights Litigation, 4 Constitutionalism Web-Papers (2005), available at: www.wiso.uni-hamburg.de/fileadmin/sowi/politik/governance/ConWeb_Papers/conweb4-2005.pdf (accessed 31 July 2013); Peer Zumbansen, Transnational Law, in Encyclopedia of Comparative Law, 738 (Jan Smits ed., 2006).

[70] Cp. Marco (note 10).

[71] If a lawsuit could be brought against an EPFI for violating the Equator Principles, this would have significant consequences: EPFIs would have an increased incentive to strictly screen and monitor financed projects in order to avoid lawsuits (and the fines for violating environmental and social laws, the court fees for defending against these lawsuits, and the damage to the brand reputation). Yet, this possibility would also create a large disincentive for other banks to join the Equator Principles Association, and already members of the Equator Principles could leave the Association to avoid being sued (cp. Hardenbrook (note 20), 218). Nevertheless, accountability, liability and transparency are indispensable aspects of an effective governance regime: Global environmental, social and human rights standards can only be established and effectively monitored when the relevant actors can be held accountable for their practices. Moreover, third-party beneficiary rights and the possibility of lawsuits could also help to separate free-riders that are merely interested in gaining reputational benefits from those EPFIs that are truly committed to the 'Spirit of the Equator Principles'.

[72] Cp. the 1789 US-Alien Tort Statue/Alien Tort Claims Act: "The district courts shall have original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States" (28 U.S.C. § 1350).

[73] Cp. Supreme Court of Canada, Judgments of the Supreme Court of Canada: Ezokola v. Canada (2013), available at: http://scc.lexum.org/decisia-scc-csc/scc-csc/scc-csc/en/item/13184/index.do (accessed 25 July 2013).

[74] Cp. Marco (note 10); Hardenbrook (note 20), 218.

V. Inadequate Monitoring

So far, Equator Principles compliance relies mainly on passive or interactive monitoring.[75] NGOs, civil society organizations, and other stakeholder groups function as watchdogs.[76] In case of apparent non-compliance – i.e., corporate governance scandals and serious violations of environmental, social and human rights standards – NGOs might start public 'naming and shaming' campaigns. These protests often catch media attention and as a consequence might cause public outcry and negative reputational effects for the involved EPFIs and their clients. In fact, most of the founding members of the Equator Principles have been targeted by NGO criticism and civil society organizations' advocacy campaigns. Therefore, it is in the EPFIs own best interest to take preventative measures and to boost their credibility and reputation relative to critics.

In order to avoid reputational threats, an active and 'internal' form of monitoring is required. A mandatory, independent and transparent third-party assessment of compliance – e.g., in the form of an independent Equator Principles ombudsman[77] – is needed (Principles 7 and 9 deal with these requirements in particular. It remains to be seen whether they are able to establish a properly working independent review and monitoring system). This impartial verification of conformity should be based on absolute performance standards as well as clear, verifiable metrics that are transparently monitored – both aspects are still missing in the third generation of the Equator Principles. Finally, official and joint project-level grievance mechanisms as well as third-party complaint (and dispute settlement) mechanisms[78] at the corporate or industry-level are needed to address inadequate implementation and non-compliance. These compliance mechanisms should conform to the principles of legitimacy, accessibility, predictability, equitability, rights-compatibility, and transparency. It is important to examine whether Principle 6 of the third generation of Equator Principles might be able to establish effective and efficient project-level grievance and complaint mechanisms.

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[75] Cp. Doug Sarro, Do Lenders Make Effective Regulators? An Assessment of the Equator Principles on Project Finance, 13 German Law Journal, 1522, 1542 (2012).

[76] Cp. O'Sullivan & O'Dwyer (note 21).

[77] The IFC has already established an ombudsman and compliance officer; cp. IFC Compliance Advisor Ombudsman, CAO Annual Report 2013, 1 (2013), available at: http://www.cao-ombudsman.org/publications/documents/CAO_AR13_ENG_high.pdf (accessed: 11 November 2013).

[78] These third-party complaint mechanisms on the associational level could complement client's project-level grievance mechanisms. These mechanisms ideally help to enhance corporate credibility and reputation by fostering lender and client compliance. They also help to overcome the problem of free-riding (due to the fact that the detection of free-riding and cheating is more likely) and help to avoid *collective-action problems* (among EPFIs and within the Equator Principles Association) and *principle-agent problems* (between lenders (EPFIs as principals) and sponsors/clients (as agents). Interestingly, EPFIs play a double role: they function as self-regulators and regulators: the Equator Principles regulate Equator banks (being part of the regulating Equator Principles Association) as well as EPFIs' clients via loan documentation and covenants (i.e., hierarchical relationship) (cp. Anne Flohr, A Complaint Mechanism for the Equator Principles – and Why Equator Members should urgently want it, Transnational Legal Theory (forthcoming in 2014)).

VI. Lack of Implementation and Enforcement

The Equator Principles are a set of voluntary guidelines without appropriate accountability, monitoring and auditing systems. The self-regulatory regime is rather ineffective since a credible deterrent, an 'enforcement pyramid' (including delisting[79] and exclusion of non-compliant EPFIs) and formal sanctions are absent (cp. paragraph 8 on sanctions). Moreover, lots of loopholes, grey areas and a discretionary leeway exist in order to circumvent the Equator Principles in myriad ways (cp. paragraph 9 on exit-door strategies).

A further related problem is the lack of committed resources to the implementation of the Equator Principles by the respective EPFIs. The Equator Principles need to be embedded throughout the whole organization. All levels of the organization should internalize the 'Spirit of the Equator Principles'. Some of the important factors are environmental and social management systems, environmental and social risk management, and monitoring and auditing systems. Environmental and social risk management as well as CSR should ideally be integrated into the company's core businesses. Furthermore, recruitment, outside consultation, staff and front-line training as well as awareness rising and sensitizing are essential. Of eminent importance is the top-level commitment: The CEO and other senior or top-level managers function as role-models. A change in organizational culture also affects the incentive structures and in particular the bonus payment systems that should be long- rather than short-term oriented.

Finally, it is required to enhance funding and staffing of the Equator Principles Association (i.e., reform of the Equator Principles Association). The currently available financial and personal resources are not sufficient to guarantee proper assistance and advice with regards to Equator Principles implementation and to effectively monitor compliance with Equator Principles standards. "The EP Association has reached a point where its ambitions exceed its current capacity to deliver on those ambitions. It simply needs more resources and more structure to address its challenges and more capably fulfill its vision. At this point, the Association is dependent on bare bones fees and the generosity of EPFI members willing to contribute their limited time to the work of the Association. […] run[ing the Equator Principles Association] […] on a minima budget is unsustainable. Of all voluntary organizations reviewed, the EP Association has the lowest annual fees and the smallest secretariat. The EP Association needs additional dedicated professional resources to continue to flourish and sustain momentum. […] The EP Secretariat needs dedicated professional resources to develop training materials, organize the work to establish membership standards and assistance for new members and a transparency framework, develop and

[79] So far, a de-listing is possible according to the Equator Principles Association Governance Rules, if an EPFI fails to report publicly within 18 months or if it does not pay the annual fee. Only in these cases will an EPFI be removed from the list and, thus, be no longer a member of the Equator Principles Association (a re-adoption, however, is still possible). Yet, it is not planned to de-list a company due to non-compliance.

maintain a website, publish an EP Association annual report, establish reporting guidelines, to name just a few."[80]

VII. Lack of Effectiveness and Practical Failure

EPFIs are still financing controversial projects, i.e., projects that are socially and environmentally destructive and unsustainable. This is especially true for developing countries where investors try to maximize profits while shirking contractual responsibilities (covenants) in project-affected communities.[81] The funding of 'dirty projects' continues. Some of the most controversial projects include large scale oil and gas projects (e.g., in the Arctic), massive fossil fuel projects, in particular coal fired power plants which have huge negative impacts on climate change by emitting billions of tons of GHG that are released into the atmosphere.[82]

The aim of EP III is to limit GHG emissions and in general, negative externalities of project finance. The Equator Principles Association should reconsider whether significantly high emitting projects succeeding a certain threshold should be automatically excluded from financing. So far, a categorical exclusion of projects and business activities with a high impact on climate change/global warming does not exist.

A further problem concerns the financing of nuclear power plants which are from an environmental perspective highly destructive and unsustainable (i.e., the problem of finding an adequate permanent repository site for nuclear waste), leaving aside the inherent risks and dangers of nuclear energy (i.e., the nuclear catastrophes in Chernobyl/Ukraine and Fukushima/Japan and other worst case scenarios including terrorist attacks on nuclear power plants).

In summary, non-compliance continues. The Equator Principles are still violated in practice on both sides: Both borrowers and lenders fail to implement the Equator Principles in practice. Reasons for Equator Principles breaches are the failure of an enforcement mechanism, the lack of formal sanctions, the lack of objective and verifiable metrics to measure performance, a lack of transparent monitoring, and last not least, an inconsistent Equator Principles implementation: The latter should be overcome by facilitating knowledge transfer, information sharing, and membership capacity building especially via the Equator Principles Association. The website/intranet of the Equator Principles Association is the ideal place to provide all EPFIs with case studies, training materials, guidelines, implementation

[80] Lazarus & Feldbaum (note 4), iii.
[81] Cp. Marco (note 10), 453.
[82] Cp. BankTrack (note 46), 13; BankTrack (note 39), 10.

tools and resources. Best practice workshops and regional workshops should be organized in order to help EPFIs with Equator Principles implementation.[83]

VIII. Sanctions

Monitoring, enforcement, and sanctions/sanctioning belong together. They form an indissoluble triangle. In all three regards, the Equator Principles lack proper governance mechanisms. With regards to sanctions the question comes up, whether the Equator Principles have enough bite to penalize institutions that fall behind their voluntary commitments? Currently, EPFIs face few sanctions should they not comply with the Equator Principles governance structures. So far, only public naming and shaming campaigns that cause media attention put EPFIs and their clients under pressure.[84] Especially NGOs functioning as watchdogs have a powerful position when it comes to reputational pressure. They help to ensure that non-state actors such as multinational companies abide by their voluntary commitments and guidelines (e.g., corporate human rights responsibility, responsibility for sustainable development and environmental stewardship). Nevertheless, this passive and ex-post way of monitoring is not sufficient to prevent non-compliance. What is needed is the establishment of a credible deterrent and an 'enforcement pyramid'. This pyramid should start with less coercive means like persuasion (i.e., appeal to lender's and client's environmental and social responsibilities), warnings (i.e., highlighting potential consequences of continued violation of the Equator Principles), and setting deadlines for bringing projects back into compliance. Only when less coercive means fail, should more coercive tactics be employed. These tactics include formal sanctions like fines and penalties. The final stage of such an enforcement pyramid should include the delisting of non-compliant institutions and an exclusion of EPFIs that do not meet the standards set by the Equator Principles Association.[85]

IX. Exit-Door Strategies

The Equator Principles are vaguely and sometimes even ambiguously formulated leaving enough discretionary leeway for diverging interpretations. The language used is often more declaratory rather than compulsory and imperative; some principles are conditional in nature, others contain mere recommendations. Words like 'should', 'intend', 'aim', 'encourage'[86], 'make aware of', 'commit' etc. are used, while other legal terminology usually applied such as 'shall', 'must', 'will', 'oblige', etc. is more or less avoided (the Equator Principles are written in 'should' not in 'shall' language which implies no legal obligations).

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[83] Cp. Lazarus & Feldbaum (note 4), 8.
[84] "… exposure of an EPFI to public scrutiny can […] be a powerful and effective tool in holding corporations to their voluntary commitments" (Lee (note 20), 362).
[85] Cp. Sarro (note 75), 1549.
[86] What happens if 'encouraging' and 'awareness rising' do not lead to anything? Which sanctions do exist?

In addition, a number of loopholes and grey areas exist that undercut the Equator Principles' ability to ensure environmental and social stewardship.[87] Borrowers and lenders are able to circumvent the 'contractual obligations' of the Equator Principles in myriad ways in order to avoid being classified as high risk.[88] One way for banks is to redefine their project finance activities as representing something else, e.g., corporate finance, export finance, etc. Furthermore, project financiers classify their projects as category B or C with the aim to avoid a stricter A classification (i.e., backdoor-option).[89]

X. Adoption Motives[90]

Especially NGOs accuse EPFIs of green-washing and window-dressing[91]: An often heard criticism is that the Equator Principles engagement is just a public relations exercise (i.e., CSR as a mere rhetoric device). Multinational banks, so the argument goes, are merely interested in the branding benefits and the increased reputational capital. Their main aim is to avoid naming and shaming campaigns, negative media coverage and public criticism that might threaten banks' reputational capital. As such, adopting the Equator Principles is just seen as a precautionary measure against the potential threat of public outcry and a form of managing non-financial risk (e.g., reputational risk management). Response to socio-political stakeholder pressure is seen here as the main motive behind the adoption of the Equator Principles. The adoption is, thus, mainly motivated by strategic reasons and not by intrinsic motives.

Others criticize that the EPFIs aim to avoid mandatory and formal, state-run regulations and the costs accompanied with this potential future regulatory compliance. Firms use the freedom

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[87] E.g., the alternatives analysis requires "the evaluation of technically(!) and(!) financially feasible and cost-effective(!) options" leaving enough discretionary leeway for the involved EPFIs and their clients.

[88] Cp. Marco (note 10), 470.

[89] Cp. Haack et al. (note 10), 21; Wright (note 20), 68.

[90] The main motives for financial institutions to adopt the Equator Principles include the following ones: 1. Level the playing field; 2. managing financial risks/credit risk mitigation; 3. reputational risk management/managing non-financial risks. Beside these economic and self-interested rationales for EP adoption (i.e., EPFIs are regarded as private profit seeking entities that try to minimize financial risks, legislative risks, and reputational risks and/or try to follow a differentiation-based strategy that allows them to achieve competitive advantages), altruistic motives also seem to play an at least minor role: Among them are good corporate citizenship, environmental consciousness, public goods preferences (i.e., CSR and environmental protection/sustainability as public goods), social preferences or warm-glow preferences of employees, investors and consumers, etc. (cp. Matthew Chan, What about Psychological Actors? Behavioral Analysis of Equator Principles Adoption and Its Implications, 13 German Law Journal, 1339 (2012); Conley & Williams (note 43), 550; Kulkarni (note 18); Macve & Chen (note 11), 894; see also the paragraph on philosophy and economics in this paper).

[91] Cp. for an opposing view: Scholtens & Dam (note 18), 1308: "We do not find support for the view that adoption of the Equator Principles is merely window dressing, since there are at least some costs involved" (e.g., larger operational, screening, and implementation costs; Equator Principles compliance might also lead to a delay in project completion due to the time-consuming requirements). The costs, however, are outweighed by the benefits of signing up (e.g., reduced reputational risk/better reputation, positive impact on (financial) risk profile, better market access, charging of premium prices, enhanced possibilities to recruit high quality employees, etc.).

of self-regulation to pre-empt governmental regulations. By adopting the Equator Principles, they can decrease this threat of potential regulation and the accompanied compliance costs.

Furthermore, the Equator Principles are criticized for their symbolic nature (i.e., 'economy of symbolism'): According to that, the Equator Principles are a mere symbolic gesture leaving enough flexibility and discretionary leeway and a minimal appeasement strategy aiming to appease NGOs and other stakeholder groups.[92]

It is almost impossible to figure out the particular and concrete motives of EPFIs that made them adopt the Equator Principles – most likely, it is an interdependent mixture of financial and non-financial rationales. Yet, it is clear that the adoption process has to be followed by an adequate embedding and implementation process. The 'Spirit of the Equator Principles' has to be internalized, otherwise, they remain a 'paper tiger' (i.e., high-minded commitments on paper that fail to be enforced in practice[93]) and a corporate public relations' tool for green-washing and window dressing purposes only. In case that the Equator Principles are (at least partially) backed by an intrinsic motivation (among other motives), voluntary codes of conduct such as the Equator Principles can serve as signaling devices that demonstrate positive (ethical or 'green') credentials. They help to communicate commitments to environmental and business ethics to external stakeholders with the aim to strengthen corporate reputation and organizational legitimacy.[94] In case that intrinsic motivation is entirely lacking, the danger comes up that environmentalism is a 'rich man's game', i.e., compliance with environmental and social standards is only ensured in economically prosperous times. It is rather unlikely that voluntary codes of ethics will succeed in a weak economic climate. If this would be the case, then the future of the Equator Principles would depend on the state of the global economy.[95]

XI. Free-riding and Adverse Selection

The motives behind the adoption of the Equator Principles bring us to our next point of criticism – the problem of free-riding and adverse selection[96]. EPFIs know that they potentially gain reputational benefits irrespective of their actual practices. Even EPFIs that do not intend to comply gain good publicity from their association with the Equator Principles.

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[92] Cp. O'Sullivan & O'Dwyer (note 21), 566.

[93] Due to a lack of adequate enforcement, monitoring and sanctioning mechanisms, the Equator Principles seem to exist only on paper.

[94] Cp. Wright & Rwabizambuga (note 10), 90; O'Sullivan & O'Dwyer (note 21).

[95] Cp. Conley & Williams (note 43), 564.

[96] "Adverse selection results from corporations joining the collective, gaining the benefits of the collective, while at the same time negatively affecting the collective by lowering the standards of the code […]. As the number of adoptees increases, the newer members are more likely attracted by the benefits while at the same time decreasing the level of compliance. Adverse selection reduces the incentive of strong performers to join or remain as members" (Schepers (note 65), 94).

They just imitate or mimic the behavior of good EPFIs, while project-affected communities suffer from a lack of effectiveness and practical failure of the Equator Principles. In other words: Irresponsible institutions might claim benefits of enhanced reputation and a reduced threat of government regulations with no intention of actually implementing their new commitments.[97] Strategic free-riders gain the benefits without bearing the implementation and compliance costs. The danger, therefore, comes up of attracting signatories that are not truly committed to the 'Spirit of the Equator Principles'. Free-riding behavior leads to competitive disadvantages for adopters, since they have to bear compliance costs while free-riding companies do not. Additionally, free-riding negatively affects the collective by lowering the standards of the code and by decreasing the level of compliance. In the end, the brand value of the Equator Principles diminishes.[98]

One proposed solution to overcome the problem of free-riding and adverse selection is to introduce entry criteria for the Equator Principles membership and absolute performance standards. Moreover, a two-tiered Equator Principles Association membership structure reflecting different aspirations would allow EPFIs to voluntarily apply the 'Spirit of the Equator Principles' to other fields than project finance, thus, moving beyond project finance. This European Union-like 'two speed' or 'clubs within the club'-structure would allow EPFIs to *proactively* respond to ethical and environmental issues and meet the demands of multiple stakeholder groups. EPFIs would have the strategic opportunity to 'over-comply' (Kulkarni), to go beyond what is formally/legally and informally required and gain first-mover advantages. They might boost their credibility and as a consequence gain (additional) reputational capital that directly adds to their brand value. In case that the 'Spirit of the Equator Principles' is internalized and embedded throughout the whole organization, this could also trigger a cultural change within banks and other financial institutions.

While a tiered membership structure once established would allow EPFIs to voluntarily comply with additional and strengthened environmental, social and human rights standards that go beyond the IFC Performance Standards, it would at the same time take into consideration that some EPFIs are not willing or able to comply with the respective strengthened standards (and to bear additional implementation and compliance costs). Nevertheless, these EPFIs would still be part of the Equator Principles Association. This, in turn, would ensure that at least minimum environmental, social and human rights standards are met (given that adequate monitoring and sanctioning mechanisms are established).

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[97] Cp. Wright & Rwabizambuga (note 10), 91; Macve & Chen (note 11), 895; Schepers (note 65), 93.

[98] Cp. Sarro (note 75), 1532.

A tiered membership structure is especially important when considering the rising tension between *broadening* – outreach to BRIC countries – and *deepening* – further enhancement and strengthening of the Principles – the Equator Principles Association-membership structure: The decision-making process is already slow and complicated given the conflicting views and differing priorities especially between EFPIs from high income OECD countries and EPFIs from 'non-designated countries' The more EPFIs coming from heterogeneous cultural backgrounds and having (partially) conflicting interests adopt the Equator Principles, the more difficult consensus-seeking within the Equator Principles Association gets. In several occasions, only the lowest common denominator has been found inhibiting the further advancement of the Equator Principles in general.

XII. Business and Human Rights

The Equator Principles explicitly acknowledge John Ruggie's *Protect, Respect, and Remedy-Framework* which forms the basis of the United Nations' *Guiding Principles on Business and Human Rights*.[99] In addition, they acknowledge the Universal Declaration of Human Rights, the International Covenants on Civil and Political Rights, and on Economic, Social and Cultural Rights, the core conventions of the International Labor Organization, and the UN Declaration on the Rights of Indigenous Peoples.

Human rights are closely related and interlinked with the inclusion of project-affected communities, especially indigenous peoples, but also NGOs, civil society organizations and other stakeholder groups. It is the aim of the Equator Principles to establish an ongoing and culturally appropriate stakeholder engagement, consultation, and participation process. Information has to be made readily and publicly available to the project-affected communities in their local languages.[100] The disclosure of information should occur as early as possible in the assessment process – ideally within the planning stage and before construction commences – and on an ongoing basis. Project affected communities have to have the right to participate in decision-making. Their voices have to be heard, and the interests and needs of

[99] The UN Guiding Principles on Business and Human Rights is the first global standard for preventing and addressing the risk of adverse impacts on human rights linked to business activities. It encompass three principles: 1. "the state duty to protect against human rights abuses committed by third parties, including business, through appropriate policies, regulation and adjudication", 2. "the corporate responsibility to respect human rights […] acting with due diligence to avoid infringing on the rights of others, and addressing harms that do occur" (i.e., companies need a human rights due diligence process, that enables them to be aware of, prevent, and address their adverse human rights impacts), and 3. "access by victims to effective remedy […] through judicial, administrative, legislative or other appropriate means" (i.e., effective grievance mechanism) (United Nations, Guiding Principles on Business and Human Rights (2011); available at: www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf (accessed 11 July 2013); cp. United Nations, The UN "Protect, Respect and Remedy" Framework for Business and Human Rights (2011), available at: www.business-humanrights.org/SpecialRepPortal/Home/Protect-Respect-Remedy-Framework/GuidingPrinciples (accessed 11 July 2013)).

[100] A huge problem in this regard that has to be tackled is the problem of illiteracy in developing countries.

disadvantaged and vulnerable groups have to be taken into consideration. The whole stakeholder engagement process should be free from external manipulation, interference, coercion and intimidation. Projects with adverse impacts on aboriginal or indigenous peoples even require their 'Free, Prior and Informed Consent' (FPIC). This consent, however, does not create any veto rights nor does it require unanimity. Nevertheless, FPIC aims at reaching a consensus and the term consent goes beyond the previously mentioned consultation paradigm.[101]

The Equator Principles, in theory, go beyond the pure shareholder value approach. They try to incorporate multiple stakeholder perspectives including those of project-affected communities, NGOs, civil society organizations and other stakeholder groups. A dialogue between these groups, EPFIs and their clients is aspired. As such, the Equator Principles are ideally a bottom-up approach that enhances democratic and organizational legitimacy. Stakeholder dialogue, public discourse and deliberation can be seen here as a source of organizational legitimacy.[102] The Principles also aim at reframing multinational companies' public identity as corporate citizens (going beyond pure profit-seeking organizations) and to adapt to the changing community expectations of corporate responsibilities.[103]

The protection of human rights – together with environmental protection and the fight against global warming/climate change – is, thus, at the heart of the third generation of the Equator Principles. It is remarkable that it took exactly ten years until the term 'human rights' was introduced into the Equator Principles framework for the first time. Only the latest version of the Equator Principles contains direct references to corporate human rights policy and corporate human rights due diligence.[104] As such, EP III has to be regarded as a major step forward compared to EP II with regards to (environmental protection and) human rights.

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[101] This idea of inclusion (in the sense of *Teilhabe* and integration) bears some remarkable resemblances to the work of the Nobel Prize laureates Amartya Sen and Elinor Ostrom as well as to Kantian philosophy – including Kant's notion of positive freedom, autonomy, human dignity and the Categorical Imperative which demands that people are treated as ends in themselves and never merely as means to an end; cp. Amartya Sen, The Idea of Justice (2009); Elinor Ostrom, Governing the Commons. The evolution of institutions for collective actions (1990); Immanuel Kant, The Metaphysics of Morals (1797/2013); Immanuel Kant, Groundwork of the Metaphysics of Morals (1785/2013); Immanuel Kant, The Critique of Pure Reason (1781/2011).

[102] Haack et al. ((note 10), 33) speak of "legitimation as deliberation" and the "communicative sources of legitimation" (see also the work of famous discourse theorists like Habermas et al. as well as Andreas Georg Scherer & Guido Palazzo, Toward a Political Conception of Corporate Responsibility – Business and Society seen from a Habermasian Perspective, 32 Academy of Management Review, 1096 (2007)).

[103] Cp. Wright & Rwabizambuga (note 10), 92; Andrew (note 40), 302; Dirk Matten & Andrew Crane, Corporate Citizenship: Towards an extended theoretical conceptualization; 30(1) The Academy of Management Review, 166-179; Jeremy Moon, Andrew Crane & Dirk Matten, Can Corporations be Citizens? Corporate Citizenship as a Metaphor for Business Participation in Society, 15(3) Business Ethics Quarterly, 429 (2005).

[104] Human rights due diligence requires: (1) the development of a human rights policy statements; (2) periodic assessment and reports of actual and potential adverse human rights impacts of corporations' activities and (stakeholder) relationships; (3) the integration of commitments and assessments into internal control and

However, the current version of the Equator Principles is in great need of improvement: There is only one explicit reference to the PRR-framework in a footnote. The term 'human rights' is mainly mentioned in the preamble and the exhibit; the term 'human rights due diligence' is mentioned only once and with the addition 'may be appropriate', while the terms 'Human Rights Impact Assessment (HRIA)' and 'human rights action plan' are lacking. Furthermore, EP III refers only once to gender issues (i.e., women's rights) – in exhibit II.[105]

In particular, Ruggie's (and the Equator Principles') "human rights minimalism"[106] poses serious problems: the Special Representative of the UN Secretary General on the issue of business and human rights (and the Equator Principles) clearly favor an impact-based concept of negative corporate responsibility according to the motto 'do no harm', that is avoid causing or contributing to human rights violations. Ruggie (and the Equator Principles) reject all forms of positive and leverage-based corporate social responsibility.[107] States are considered to be the primary duty-bearers; according to Ruggie, international human rights laws apply only to states, but not to non-state actors such as (transnational) corporations. Thus, any duty to protect and realize human rights is part of the exclusive domain of nation-states (i.e., nation-state centered perspective). Corporations only need to fulfill the duty to respect human rights; exercising leverage to protect and realize human rights is regarded as an optional matter, not as a moral obligation.[108]

The problem is that Ruggie's human rights 'voluntarism' clashes with the fundamental moral nature of human rights. Human rights (including social and economic rights) are moral rights

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monitoring systems, and; (4) reporting and tracking of human rights performance (cp. Michael Torrance, Human Rights, 317 (M. Torrance ed., 2012).

[105] Principles 7 and 9 (on independent review and monitoring) as well as principles 9 and 10 (on reporting) can be easily combined, thus creating space for a separate principle solely devoted to human rights issues. This principle should then precede all others and serve as an anchoring or guiding principle (cp. BankTrack (note 39), 11; BankTrack (note 46), 16).

[106] Florian Wettstein, CSR and the Debate on Business and Human Rights: Bridging the Great Divide, 22(4) Business Ethics Quarterly, 739, 745 (2012).

[107] Cp. Stepan Wood, Four Varieties of Social Responsibility: Making Sense of the "Sphere of Influence" and "Leverage" Debate via the Case of ISO 26000, 07(04) Osgoode CLPE Research Paper Series (2011), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1777505 (accessed 8 October 2013); Stepan Wood, The Case for Leverage-Based Corporate Human Rights Responsibility, 22(1) Business Ethics Quarterly, 63 (2012).

[108] Cp. John Ruggie, Business and Human Rights: Mapping International Standards of Responsibility and Accountability for Corporate Acts. Report of the Special Representative of the Secretary-General (SRSG) on the issue of human rights and transnational corporations and other business enterprises; 9 February 2007, A/HRC/4/035 (2007), available at: www.business-humanrights.org/Documents/RuggieHRC2007 (accessed 8 October 2013); John Ruggie, Protect, Respect and Remedy. A Framework for Business and Human Rights. Report of the Special Representative of the United Nations Secretary-General on the issue of human rights and transnational corporations and other business enterprises, 3(2) Innovations: Technology, Governance, Globalization, 189 (2008); John Ruggie, Business and Human Rights: Towards Operationalizing the "Protect, Respect and Remedy" Framework. Report of the Special Representative of the Secretary-General on the Issue of Human Rights and Transnational Corporations and Other Business Enterprises, 22 April 2009, A/HRC/11/13 (2009), available at: www.refworld.org/docid/49faf98a2.html (accessed 8 October 2013); John Ruggie, Just Business. Multinational Corporations and Human Rights (2013).

or entitlements which are deeply rooted in human dignity and the moral equality of all human beings.[109] They are inalienable and universal moral rights which exist a priori and independently of nation-states and legal laws. This status of human rights rules out any form of moral discretion, arbitrariness and human rights voluntariness. Thus, (transnational) corporations have direct moral obligations to unconditionally respect, protect AND realize human rights. They are direct duty-bearers – in other words: states are not the exclusive and only bearers of positive obligations. Multinational corporations' moral responsibilities must go beyond 'do no harm', and they must do more than merely respect human rights. Their scope of responsibility includes a positive duty to protect and realize human rights. Due to their political role and power (i.e., transnational corporations as political, quasi-governmental actors, de facto rule-makers, addressees and authors of regulations[110]), multinational corporations have a positive duty to speak out (i.e., avoidance of corporate complicity defined as 'aiding and abetting' in human rights violations committed by third parties), a duty to protect victims of human rights abuses, a duty to promote human rights-compatible institutions in home and host countries, and a duty to foster change or to put pressure on oppressive governments.

The Equator Principles Association is well advised to take the critique of Ruggie's PRR-framework serious: What is needed is a push for non-voluntary, mandatory and legally binding rules for business in particular with respect to human rights as well as a comprehensive impact and leverage-based conception of responsibility (make use of their leverage/ organization's capacity to influence other parties' decisions and activities, especially those which are part of the supply chain) including positive human rights obligations for corporations and a corporate human rights advocacy and activism.

G. Concluding Remarks

This paper has dealt with the special role of financial institutions as (de facto) "global sustainability regulators"[111] and standard setters.[112] In many cases, they have taken the lead in

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[109] Cp. Florian Wettstein, Beyond Voluntariness, Beyond CSR: Making a Case for Human Rights and Justice, 114(1) Business and Society Review, 125 (2009); Florian Wettstein, The Duty to Protect: Corporate Complicity, Political Responsibility, and Human Rights Advocacy, 96 Journal of Business Ethics, 33 (2010); Florian Wettstein, For Better or For Worse: Corporate Responsibility Beyond "Do No Harm", 20(2) Business Ethics Quarterly, 275 (2010); Florian Wettstein, Silence as Complicity: Elements of a Corporate Duty to Speak Out against the Violation of Human Rights, 22(1) Business Ethics Quarterly, 37 (2012); Wettstein (note 106).

[110] Cp. Andreas Georg Scherer & Guido Palazzo, Globalization and Corporate Social Responsibility, 413 (A. Crane, A. McWilliams, D. Matten, J. Moon, D. Siegel eds., 2008); Andreas Georg Scherer, Guido Palazzo & Dirk Matten, Introduction to the Special Issue: Globalization as a Challenge for Business Responsibilities, 19(3) Business Ethics Quarterly, 327 (2009).

[111] Cp. Conley & Williams (note 43).

[112] "… lenders, owing to their expertise in the project finance sector and their understanding of existing norms on managing environmental and social risk […] are relatively well-placed to set effective standards and to

fostering CSR and sustainable development especially in politically unstable and/or socially and environmentally fragile contexts such as developing countries and emerging markets. By introducing developed-country social and environmental standards into developing regions, they have adopted the role of quasi-regulators.[113]

Banks, insurance companies and the like are key factors in the transition towards a green economy. They help to catalyze this process towards economic, ecological and social sustainability and CSR by voting with their money.[114] During this process, the Equator Principles have an important function to fulfill: They (ideally) help to balance economic (profit), ecological (planet) and ethical issues (people) (cp. the 'triple P' framework). They have the potential to equally promote self-interest and the common good: EPFIs and clients pursue their own economic (pecuniary) motives[115], while the adopted principles make sure that environmental, social and human rights standards are met. Furthermore, the Equator Principles ideally(!) function as a catalyst for cultural change within banks.[116] In order to do so, some necessary reform steps have to be adopted:

According to Jeucken[117], four types of banking have to be distinguished: *defensive banking* ("… environmental laws and regulations are thought to be threats to its business. Only curative measures are taken. In this vision, care for the environment only adds to costs and there is certainly no money to be earned from it"), *preventive banking* ("… different from the previous phase in that potential costs savings are identified. […] A bank does not want to go any further than the environmental laws that exist […] it is somewhat passive, limiting external risks and liabilities and saving production costs internally"), *offensive banking* ("Banks see new opportunities in the marketplace, both in the area of specific products and new markets […]. The bank is looking for profitable, environmentally sound opportunities in the market, which can compete with alternative investment and lending opportunities. The stance can be described as proactive, creative and innovative […]. The extra steps are taken whenever there are win-win situations at the micro-level…"), and *sustainable banking* ("… the bank lays down qualitative preconditions so that all its activities are sustainable […] thanks to a consciously chosen policy […] [and] the ambition to operate sustainably in every respect"). EPFIs fall either into the preventive or offensive type of banking category where a holistic

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effectively monitor their borrowers' conduct. […] [yet] lenders are currently not well-place to enforce the [Equator Principles]. Their short-term interest in the completion of the projects they finance impairs their ability to credibly threaten to withdraw financing in the face of persistent non-compliance by borrowers" (cp. Sarro (note 75), 1524).

[113] Cp. Conley & Williams (note 43).

[114] Cp. Id., 565.

[115] By reducing various forms of economic and non-economic risks, the Equator Principles can also help to make a project a more secure investment and a safer loan.

[116] Cp. Conley & Williams (note 43), 546. This changed mind-set and institutional change within EPFIs seems to be true at least for the project finance sector. Whether it is true in general (including the investment banking sector) remains doubtful as recent financial market crises, the LIBOR scandal and other corporate governance scandals have shown.

[117] Jeucken (note 12), 72.

and all-encompassing implementation of the 'Spirit of the Equator Principles' is still lacking. What is required from an economic ethics perspective is the transformation from preventive/offensive banking towards sustainable banking. This implies that the 'Spirit of the Equator Principles' needs to be embedded throughout the whole organization. All levels of the organization should internalize the 'Spirit of the Equator Principles'. Environmental and social risk management as well as CSR should ideally be integrated into the company's core businesses. Furthermore, recruitment, outside consultation, staff and front-line training as well as awareness and consciousness rising and sensitizing are essential. Of eminent importance is the top-level commitment: The CEO and other senior or top-level managers function as role-models. A change in organizational culture also affects the incentive structures and in particular the bonus payment systems or compensation structures/packages that should be long- rather than short-term oriented. So far, investment managers are judged according to their quarterly or annual performance and not according to their multiple-years performance.[118]

In order to further strengthen the Equator Principles as a true benchmark for responsible investment practices this paper has identified the following necessary reform steps (i.e., top 6 priorities towards EP IV[119]):

1. Introduction of an enforcement pyramid including automatic sanctions like delisting and exclusion of non-compliant EPFIs;
2. Introduction of absolute performance standards, i.e., clear, verifiable metrics that are transparently and independently monitored which help to assess environmental and social performance of EPFIs and their clients;
3. Introduction of minimum entry requirements that have to be met prior becoming a member of the Equator Principles Association;
4. Tiered membership structure within the Equator Principles Association that allows to bridge the gap between broadening and deepening considerations;
5. Reform of the Equator Principles Association including enhanced funding and staffing and the establishment of an Equator Principles Forum and an Equator Principles advisory group, and last not least
6. Establishment of third-party beneficiary rights for project-affected communities.

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[118] Cp. Chan (note 90), 1345.

[119] EP III has to be considered as an improvement over EP II (cp. Equator Principles Association, Equator Principles (EP II) (2006), available at: http://equator-principles.com/index.php/ep3/ep3 (accessed 11 November 2013)), but bigger steps must be taken by the EPFIs to further strengthen the Equator Principles. Reform measures to fight global warming (climate change) and to fully realize corporate human rights responsibilities are important issues. Further fields of necessary reform include the extension of scope, an increase in transparency and accountability (see also BankTrack (note 39)).

Given that these reform steps are implemented in the near future (which implies a reform of the Governance Rules as well), the Equator Principles framework can be seen as the starting point of developing hard(er) law through soft law (i.e., hardening of inter-/transnational norms).[120] The Equator Principles have to be considered as an essential step forward in an unregulated and potentially destructive area of doing business, but they require further strengthening, especially strengthening of the governance system (i.e., enforcement, monitoring and sanctioning mechanisms).

[120] Cp. Conley & Williams (note 43), 565.