

Making Finance Sustainable: Ten Years Equator Principles – Success or Letdown?

VB verfassungsblog.de/making-finance-sustainable-ten-years-equator-principles-success-or-letdown-2/

Mohamed Aldegwy Mi 10 Apr
2013

Mi 10 Apr
2013

Collevocchio Declaration on Financial Institutions and Sustainability In 2003, a number of banks adopted the Equator Principles (EPs), a voluntary Code of Conduct based on the International Finance Corporation's (IFC) performance standards, to ensure the ecological and social sustainability of project finance. These so called Equator Principles Financial Institutions (EPFI) commit to requiring their borrowers to adopt sustainable management plans of environmental and social risks associated with their projects. The Principles apply to the project finance business segment of the banks and cover projects with a total cost of US \$10 million or more. While for long developing countries relied on World Bank and other public assistance to finance infrastructure projects there has occurred a shift in recent years to private funding. The NGOs have been frustrated by this shift of project finance as they had spent their resources to exercise pressure on the public financial institutions to incorporate environmental and social standards in their project finance activities. However, after a shift of NGO pressure to private financial institutions the latter adopted the EPs for fear of reputational risks. NGOs had laid down their own more ambitious ideas about sustainable finance in the . Legally speaking, the EPs are a self-regulatory soft law instrument. However, it has a hard law dimension as the Equator Banks require their borrowers to comply with the EPs through covenants in the loan contracts that may trigger a default in a case of violation.

Ten years after the adoption of the EPs, there has been a lively debate among academics, Equator Banks representatives and NGOs over the assessment of the EPs; whether the EPs can indeed ensure sustainable finance, whether the Equator Banks effectively implement the EPs or whether they merely adopted the EPs as a green washing strategy to counter NGO pressure and thus manage their reputational risks, whether the self-regulatory nature of the EPs provides effective accountability mechanisms. These questions are connected to a wide range of broader issues such as the legitimacy and effectiveness of new governance structures relying on self-regulation, the fragmentation of the normative orders of both sustainable finance and transnational business conduct as well as the process of societal constitutionalization that takes place at the international level.

Ph.D. Program in Law and Economics of Money and Finance To address these issues, the and the Cluster of Excellence "The Formation of Normative Orders" held a symposium "10 Years Equator Principles — Fragment of a Normative Sustainability Order or Business as Usual?" at the House of Finance at Goethe University Frankfurt/Main on 14-15 March 2013. The symposium was organized by Isabel Feichtner, Assistant Professor at Goethe University, and Manuel Wörsdörfer, Postdoctoral Researcher with the Cluster of Excellence.

AssociationThe participants of the symposium recognized that the content of the EPs is being developed through political contestation between NGOs and Banks and that banks do not deliver what the NGOs would consider to be the socially optimal model of sustainable finance. As concerns the effectiveness of the EPs, participants agreed that the environmental and social standards had to be incorporated into the banks' risk-management processes. In addition, it was acknowledged that there is a need to increase stakeholder engagement. While NGOs were allowed to submit their recommendations to the EP on the reform of the EPs, only the Equator Banks negotiate and amend the EPs. Furthermore, the participants highlighted that the EPs permit banks flexibility to develop their own environmental and social risk-management systems. Through the networks of information established and institutionalized by the EP Association, it is expected that Equator Banks will undergo a learning process which leads them to conceptualize and implement the EPs in a manner consistent with their own business models. The soft law nature of the EPs would thus enable a process of learning that would result in a diversity of risk-management systems across financial institutions and industries and would open the door for innovative management systems and situated institutionalization of the EPs. Joseph Wieland (Zeppelin University Friedrichshafen) emphasized, that if policy makers intervened with hard law they might endanger the open-ended process of the development of situated risk-management systems of transnational corporations. In addition, state regulations may incorporate standards that are costly to implement or inappropriate to the communities in which the financial projects shall operate.

Peace Research Institute, FrankfurtAs concerns the implementation, accountability and enforcement mechanisms of the EPs, lack of progress is commonly diagnosed. Yet, there is no consensus on how such mechanisms should be designed. Three proposals were made during the symposium: The first approach advocated by Joseph Wieland, is not to interfere with the self-regulatory structure of the EPs. This could be called a 'learning or commitment perspective' which is also consistent with social system theory that underlies the societal constitutionalization perspective of Gunther Teubner. A second proposal was to introduce some market-conform public regulation elements such as legal obligations on public disclosure and reporting. Proponents of this proposal expressed their dissatisfaction with the low degree of compliance of the EPFIs with reporting requirements under EP II. The third proposal, as put forward by Annegret Flohr (), is to substantially strengthen the institutional framework of the EPs by having a governance body such as the EPs that is in charge of monitoring compliance by the banks with the EPs.

the financial crisis has shown that self-regulation relying on internal risk-management programs of banks is just an oxymoronThe disagreement on how to improve the EPs reflects deeper disagreement over the effectiveness of self-regulation and the conditions under which self-regulation will work. Joseph Stiglitz, for example, holds that In fact, we may agree that the EPs were adopted to level the playing field of doing banking business and to help manage the reputational risks of banks; the EPs as an industry standard originate from the market to serve the interests of banks without compromising their

competitiveness. This is at least what rational utility maximizing banks would be expected to do under neoclassical economics. If the shift of project finance activities from Western countries to China or India unlevels the playing field again, we may expect European banks to attempt to get the Indian and Chinese banks on board. However, the latter have no incentive to adopt the EPs as this may shift project finance back to European and North American banks. We need to recognize that self-regulation is a function of market forces; when market conditions change, self-regulation will shift as well. Enabling learning and experimentation is a must but this should be enabled within an institutionalized environment that recognizes the limits of self-regulation. While legal intervention should not impede the learning process of banks, we should also not overestimate the capacity for self-regulation.

On the positive effects of the EPs, Ariel Meyerstein (Chadbourne & Parke) demonstrated in his presentation how the EPs were the driver for institutional changes within the Equator Banks, including the designation of staff to address the implementation of the EPs. Furthermore, he shows that 60% of the EP banks have excluded members of staff from the bonus scheme to ensure their independent assessment of environmental and social risks associated with projects. In addition, some of the participants observed a positive externality of the EPs in triggering cultural changes within financial institutions beyond the EPs substantive reach. Thus, banks began to engage with social and environmental risk management across different banking activities other than project finance. Other participants questioned this positive assessment invoking, for example the LIBOR scandal in which some Equator Banks have been involved. Cynthia Williams attempted to reconcile these assessments by illustrating that project finance is a commercial rather than an investment banking activity, and that commercial banking has a pro-social and conservative culture in comparison to the risky self-interested culture of investment banking. The participants agreed that more ground work at the project level needs to be done to assess empirically the effectiveness and limitations of the EPs as a new governance model.

EP III Presently, the community of practitioners and academia is looking forward to the new version of the Principles () expecting some significant changes with respect to human rights, climate change, biodiversity, gender issues, and transparency. Some of these changes will reflect the updated IFC Performance Standards such as the requirement to inquire into low carbon alternatives to projects. Overall, the participants have been optimistic about the future relevance of the EPs. They believe that the Principles will continue to play an important role as the Equator Banks represent over 70 percent of international project finance activities in emerging markets. However, it is also expected that going forward and making the EPs more effective will become harder, not easier due to the increased membership of the EPs Association (there are currently 78 adopting institutions: 76 EPFIs and 2 Associates) and also due to the geographic shift of project finance activities from Western to Indian and Chinese Banks.



While you are here...

hereIf you enjoyed reading this post – would you consider supporting our work? Just click . Thanks!

*Max Steinbeis*All the best,

SUGGESTED CITATION *Making Finance Sustainable: Ten Years Equator Principles – Success or Letdown?*, *VerfBlog*, Aldegwy, Mohamed: 2013/4/10, <https://verfassungsblog.de/making-finance-sustainable-ten-years-equator-principles-success-or-letdown-2/>.

LICENSED UNDER CC BY NC ND