Introduction

The objective of this Guidance Note is to inform financial intermediaries (FIs) and other interested parties about the role of FIs in reducing pollution and managing other adverse environmental and social (E&S) impacts of their business activities. This Note presents an overview of E&S risks and opportunities for FIs, and outlines ways FIs can reduce E&S impacts to improve their business sustainability and contribute to national E&S development goals by implementing an environmental and social management system (ESMS).

Commercial banks, leasing companies, investment funds, and other FIs act as the intermediaries between fund providers and fund users. FIs may affect the environment directly through their in-house use of energy and resources, and indirectly through the financial products and services they offer to enable their clients (industrial and commercial borrowers, investee companies, or projects) to conduct activities having a range of E&S impacts. This Note focuses on mitigating such indirect E&S impacts.

Description and Application of Environmental and Social Policy for Financial Intermediaries

The central objective in FIs’ management of E&S risk is to avoid or mitigate any adverse impacts that their financing activities have on the environment and surrounding communities. This requires proactive identification, assessment, and management of E&S risks before they become significant or result in adverse outcomes. An FI can achieve this objective by implementing an ESMS to systematically assess and manage the E&S risks during the entire client...
relationship or project life cycle. An effective ESMS should contain or address the following:

**E&S policy and objectives.** The policy shall state the FI’s commitment to managing E&S risks associated with its client activities. Typically, this will include a policy statement committing the FI to ensure that its clients or financing activities will meet the requirements of applicable national E&S laws and regulations, and applicable internationally recognized performance standards or best practices. The policy may also identify activities that the FI will not support, for example, the production or trade of products or activities deemed illegal or subject to international bans under host country laws or international conventions and agreements.

**Transaction screening and risk categorization.** The FI shall screen all its transactions or clients against established criteria and categorize them according to their potential E&S risks. This screening and categorization will determine the scope of the FI’s E&S due diligence. The categorization will enable the FI to prioritize its transactions and focus more on clients or client activities with high E&S risks.

**E&S due diligence and corrective action plan.** The FI shall conduct E&S due diligence (ESDD) for all its transactions, although the extent of ESDD may vary transaction by transaction. For low-risk transactions such as retail finance, the ESDD may be a simple review of the client’s operations to confirm that the FI’s financing will be used for the intended purpose and is consistent with the FI’s business principles. For medium-risk transactions such as financing that is provided to small and medium enterprises, the ESDD will include an overview of the client’s operations, which may require a site visit to identify potential E&S risks and impacts. E&S risks and impacts of this scale are typically reviewed within the host country’s E&S regulatory framework. The FI needs to ensure that the client complies with all applicable regulatory requirements.

For high-risk transactions such as large corporate or project financing, the FI should carry out an in-depth ESDD to assess potential E&S risks and impacts, and identify proper action plans to manage these risks and impacts. Depending on the complexity of the client’s business and the associated E&S risks, the FI should, where necessary, retain outside experts. Based on the ESDD (or subsequent monitoring) of the client’s E&S performance, the FI shall require clients to implement corrective actions within a specified timeframe.

**E&S covenants.** The FI shall incorporate the corrective action plan and other E&S requirements in its legal agreement with the client. The scope of E&S clauses depends on the transaction type (loan, equity investment, or risk-sharing) and the E&S risks of the client operations. To strengthen these clauses, FIs often set the satisfactory execution of certain critical corrective actions as conditions of (first or subsequent) disbursement or conditions of payment in the risk-sharing case. FIs shall consider including remedy clauses in the financing agreement and
exercise them in case the E&S risks cannot be appropriately mitigated.

**Monitoring E&S performance.** The FI shall monitor client’s compliance with the E&S requirements as determined in the ESDD and in the E&S covenants by requiring periodic reports from clients and conducting periodic site inspections by qualified personnel on behalf of the FI. Performance gaps should be discussed with the client and resolved within a reasonable time.

**Supporting tools, systems, and documentation.** To help FI staff and clients properly assess E&S risks, and monitor corrective actions and ongoing E&S performance, the ESMS should include proper tools such as checklists, templates, reporting forms, and reference materials. The ESDD for all transactions and monitoring activities should be properly documented.

**Roles, responsibilities, and capacity building.** The FI shall establish the necessary organizational structure, and assign roles and responsibilities to its various departments and staff positions for carrying out the tasks above. The FI should appoint an ESMS officer from senior management to oversee the FI’s overall E&S risk management and ESMS implementation.

Depending on the FI’s portfolio size and complexity, the ESMS officer could have assistance from coordinators responsible for day-to-day ESMS implementation. The ESMS officer should bring E&S issues to investment-review sessions and decision meetings. Relevant staff should be trained on E&S policies and procedures, and on use of supporting tools and guidance materials.

The FI’s ESMS officer should periodically review ESMS implementation at the aggregate portfolio level and at the individual transaction level, and recommend improvements to senior management. The scope and implementation of an FI’s ESMS should be appropriate to its portfolio activities. Box 1 describes the businesses and ESMS requirements for four types of FIs that are typical in developing countries.

**Environmental and Social Risks — Assessment and Management**

Environmental issues range from temporary to permanent changes in the atmosphere, water, and land due to human activities, which can result in irreversible impacts on the environment. Social issues may emerge in the workplace of companies or in surrounding communities affected by the companies’ operations. Table 1 displays the areas in which E&S impacts should be monitored.
Box 1: ESMS and FIs

**Commercial banks** may finance different business entities or activities, such as large corporations, small and medium enterprises, housing developments, trade and other short-term financing, and retail banking. As a result, commercial banks’ exposure to E&S risks varies significantly according to their clients and clients’ activities in different industries and geographic locations. For example, E&S risks will be more significant for large corporate or project finance transactions, which are typically large size and of long duration, and usually tied to clients whose operations are complex and have potentially high E&S impacts.

E&S risks will be lower for short-term finance transactions or transactions that support the activities of small and medium enterprises. For retail transactions such as mortgages or consumer loans, the E&S risks are generally considered minimal. As a starting point, a commercial bank should review its portfolio, broken down by transaction type and by exposure to different industry sectors. The bank may thus adopt a tiered approach and apply E&S risk-management requirements and procedures suited for different types of transactions and business segments. In general, the procedure shall be substantial for high-risk transactions, and streamlined for low-risk transactions.

**Leasing companies** provide financial or operational leases that vary in duration and in the leased asset, such as office equipment, vehicles, real estate, and specialized equipment and machinery. Leasing companies’ exposure to E&S risks is generally related to the installation, operation, and maintenance of the leased assets and will be more significant for transactions involving specialized or heavy equipment or machinery for use in certain industry sectors such as forestry operations, cargo shipping, oil and gas, and mining activities. Similar to banks, leasing companies should apply E&S risk-management procedures commensurate to each transaction type as part of their overall risk-management framework.

**Microfinance institutions** (MFIs) offer small loans (often in the range of a few hundred to a few thousand dollars) to families and to owners of small businesses whose operations are generally small. As a result, MFIs’ exposure to E&S risks is typically low, requiring in most cases some simple E&S risk-management procedures to screen transactions against a list of pre-established excluded customers or activities such as those involving the use of child labor or hazardous chemicals. These procedures can easily be incorporated into the MFI’s credit manual or risk-management framework.

**Private equity funds (PEF)** make long-term equity investments in companies (generally small and medium enterprises); those investments will later be sold for price above the amount the PEF invested, thereby yielding a profit for the PEF. Because such transactions make the PEF a partial or full owner of an investee company, the PEF is directly exposed to, and could be liable for, the E&S risks of an investee company. A PEF thus has a keen interest in mitigating potential E&S risks that would otherwise reduce an investee company’s market value and affect the PEF’s timed exit from the company.

A PEF’s ownership gives it a unique position to advocate for sound E&S management and to identify E&S opportunities that enhance an investee company’s financial value. PEFs should apply their ESMS across the investment portfolio during the entire investment cycle, from deal sourcing and due diligence, on through investment agreement, portfolio management, and exit. For portfolio investments involving high E&S risks, an in-depth E&S analysis shall be performed as compared to those portfolio companies having low E&S risk.
Table 1. E&S Impact Areas for FIs

<table>
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<th>Resource Management</th>
<th>Air and Water Quality</th>
<th>Water Use and Conservation</th>
<th>Energy Use and Conservation</th>
<th>Biodiversity and Natural Resources</th>
<th>Land Acquisition and Contamination</th>
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<tbody>
<tr>
<td>Waste Management</td>
<td>Wastewater</td>
<td>Solid Waste</td>
<td>Hazardous Material</td>
<td>Air Emissions</td>
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Management of E&S Risks to Financial Intermediaries. E&S risk associated with a client’s operations will likely be passed on to the FI that finances the client in different forms and at different times. Thus an FI’s financing decisions should take into consideration the E&S risks described below.

1) **Liability risk** By taking possession of collateral assets or involving itself in a client’s business operations, an FI is exposed to liability risk stemming from the client’s legal obligations. This may include fines, penalties, and costs for third-party damage claims for actual or potential land contamination. If the FI is a principal shareholder, it may become directly liable for all E&S risks.

2) **Credit risk** An FI is exposed to credit risk when a client does not fulfill its contractual obligations to the FI as a result of E&S incidents that reduce the client’s cash flow. Credit risk also arises if a client faces increased costs of complying with mandatory E&S standards, or if absent or expired operating and emission discharge permits result in regulatory fines or penalties.

3) **Market risk** E&S problems may cause an FI to incur market risk from a reduction in the value of assets or collateral it holds as security in its client companies. For example, if a client’s production site is found to be contaminated, the market value of the client company or the underlying collateral will fall.

4) **Reputational risk** Negative publicity or loss of reputation associated with a client’s poor E&S practices can harm the FI’s brand value and image in the broad public, including its customers, neighbors, employees, as well as in the business and financial communities, which consequently will affect the FI’s ability to raise funds or do business.

Management of E&S Risks to FI Clients. An industrial or commercial client’s exposure to E&S risks is due to improper planning or management. Such risks may have unexpected implications for the client and jeopardize the client’s financial and operational viability through the following channels:

1) **Disruption of operations** A client’s operations may be disrupted by changing social conditions such
as high staff turnover, protest by communities, or changing environmental conditions such as accidents or deterioration of resources on which the operation depends.

2) Legal issues. A country’s E&S regulations establish requirements for operating licenses, occupational health and safety standards, and emission and discharge permits. A client’s failure or continuous neglect to comply with these requirements will result in fines and penalties.

3) Loss of market share. Due to existing or new E&S regulations or market demands for socially responsible or environmentally preferable products and services, a client may lose market share if it cannot meet these requirements or expectations.

4) Market devaluation. The client may face E&S liabilities such as costly land or groundwater remediation required by environmental regulations. It can also face claims for damages individuals or communities for E&S damages by its operations. This would represent a significant financial burden to the client and result in market devaluation of assets.

5) Poor reputation. With communities’ E&S awareness growing, FI clients face increased public scrutiny for good management and accountability. Poor E&S performance can result in opposition to a client’s presence in the community and operational delays or interruptions. Negative reputation or public perception can decrease demand for clients’ products or services.

E&S Risk Categorization. In assessing and managing clients’ E&S risks, FIs often categorize these risks into different levels to indicate potential E&S impacts and to determine the appropriate level of E&S due diligence. The level or category of E&S risks depends on the characteristics of the client activities supported by the FI financing, such as industry sector, size of operation, location, sensitivity, and magnitude of impact.

Many FIs categorize their client activities or projects using three risk levels: Category A represents potentially significant adverse E&S risks or impacts that are diverse, irreversible, or unprecedented; Category B represents medium or potentially limited adverse E&S risks or impacts that are few in number, generally site-specific, largely reversible, and readily addressed through mitigation measures; and Category C represents minimal or low E&S risks. Table 2 shows examples of activities with different E&S risk levels (A, B, C). A portfolio breakdown by these categories can provide an indication of the overall level of E&S portfolio risks for the FI. There are many ways by which financial intermediaries can mitigate their E&S risk. Box 1 (above) gives several examples from a range of financial intermediaries.
Prerequisite Factors for Environmental and Social Policy for Financial Intermediaries

Understanding and managing E&S risks associated with financing transactions is still relatively new to many FIs. FIs see E&S issues as a private matter of their clients that should be addressed by the government regulators. Furthermore, FIs do not have the necessary knowledge and in-house capacity to address such issues themselves. FIs in emerging markets may also worry that increased E&S oversight by them or required by their international investors may damage their competitiveness, since there would not be a level playing field among their peers unless a mandatory government policy or voluntary industry-wide self-regulation came into existence.

However, despite unevenness in both playing fields and the implementation of ESMS, there is a clear business case for FIs to think and act strategically regarding E&S risks and impacts in their financing activities, and the long-term sustainability of their businesses. FIs that implement an effective ESMS will be better positioned to deal with, and benefit from, the challenges of climate change, environmental degradation, natural resource depletion, and other E&S issues that will drive new regulations, and shape the future market and economy.

Understanding and managing E&S risks and impacts will be a defining aspect of success in modern financing activities. As shown in the few cases below, FIs should act now and implement proper systems and procedures to manage E&S risks and prepare themselves for present and future business development opportunities.
Advantages and Limitations of Environmental and Social Policy for Financial Intermediaries

Better Risk Management. Implementing an ESMS enables an FI to systematically assess the E&S risk of financial transactions within specific industries or geographic contexts. ESMS implementation also helps an FI understand its exposure to E&S risks in different portfolio subsets. Although exposure to some level of E&S risk is unavoidable in many cases, an ESMS improves the FI’s ability to control its overall E&S risk exposure, thereby supporting the FI’s long-term business sustainability.

New Business Opportunities. Implementing an ESMS is important for risk management. ESMS implementation can also help the FI identify new business opportunities and design new products and services to reduce such risks. These opportunities include the promotion of energy efficiency, renewable energy production and distribution, the manufacturing of pollution-control equipment, green buildings, recycling services, sustainable tourism, carbon trading, and even global market penetration. Opportunities such as these will initiate new partnerships and create a new client base, thus contributing to the overall development of economies.

Competitive Advantage. Issues such as good governance, greater accountability, and increased lender liability are relevant to all FIs. FIs that endeavor to address E&S risks can improve their reputation among current and prospective clients, and among the general public. Implementing ESMS can also increase an FI’s ability to attract investors, clients, or new business opportunities. Having an effective ESMS is a core competency that an FI can use to differentiate itself from others for competitive advantages.

Increasingly, clients are looking at an FI’s position on E&S issues when deciding where to take their business; investors and lenders, particularly international FIs, are expecting their investee FIs to adopt an ESMS. External stakeholders are pushing FIs to comply with international E&S standards, and policy makers are sending regulatory signals to FIs on improving E&S performances of FI portfolios.

Limitations. FI officials have expressed the view that they face many barriers in implementing an effective ESMS, as indicated in a survey conducted by the International Finance Corporation (IFC 2005b) with a group of commercial bankers. Many (58%) of these bankers, when asked about barriers to implementing ESMS, endorsed the view that one such barrier was “Lack of best practice cases about social and environmental management for financial institutions in the emerging markets.”

A sizable number (40%) of the commercial bankers who were surveyed endorsed the view that “Lack of know-how/in-house capacity” was another such factor. Furthermore, 40% endorsed the view that “Cost of developing and implementing internal
guidelines and procedures is too high” was another barrier to the implementation of ESMS.

**Interaction with other Tools**

Implementation by FIs of environmental and social policies and procedures contained in an ESMS requires the interaction with a number of other management tools. These include information disclosure, land use planning, market-based instruments/economic incentives, occupational health and safety, and promoting active citizenry. Modern FIs respond to global drivers by incorporating or promoting E&S standards or technologies into their lending or investment decisions. To facilitate managing their E&S risks, FIs may want to consider using the other World Bank *Guidance Notes*, such as Environmental Information Disclosure, Environmental Licensing, Land Use Planning, Market-Based Instruments/Economic Incentives, Occupational Health and Safety, and Promoting Active Citizenry.
Box 2. Toward Sustainable Banking: Three Cases from Emerging Markets

**Center-Invest Bank** is one of the largest regional banks in Russia and serves both large corporations and SMEs. It developed an ESMS based on IFC’s Exclusion List, project categorization, and applicable local environmental laws and regulations. During appraisal of new loans, Center-Invest Bank uses environmental impact assessments and site visits to evaluate social and environmental criteria of funded projects and takes on environmental liability insurance. The bank also routinely carries out consultations with clients on E&S risk management and, with participation of local E&S authorities, assists in developing an action plan to mitigate and monitor the identified risks.

**The Cuscatlan Group** is one of the leading commercial and retail banking institutions in Central America. It has introduced a comprehensive and well-coordinated environmental management system (EMS), which includes unified annual reports from all country subsidiaries. The bank makes a continuous effort to mainstream E&S components into overall lending operations. The EMS contains detailed procedures and checklists for environmental appraisal, screening, and monitoring, including the requirements of IFC’s Exclusion List. The E&S impacts are analyzed according to the checklist. An Environmental Action Plan is tailored for each project financed.

The bank also offers innovative products in cleaner production and energy efficiency, and finances projects for environmental improvements. With USAID as the guarantor, the bank finances and provides guarantees for cleaner production projects to small and medium enterprises in Central America.

**Industrial Bank of China** is a joint stock bank with branches across all major Chinese cities. In October 2008, the bank became the first bank in China to adopt the Equator Principles that are based on IFC’s Performance Standards. Industrial Bank has established a dedicated Sustainable Development Unit to implement the Equator Principles and developed internal E&S policy and procedures (ESMS). It has integrated E&S considerations into its credit-review process and trained loan officers and other relevant staff of all levels in headquarters and local branches. To enlist support from clients, the bank also reaches out to educate clients on its E&S requirements.

Supporting the clients through sustainability, both Center-Invest Bank and Industrial Bank have grown their businesses in energy efficiency and other environmentally friendly projects. They are the first bank in Russia and China, respectively, to offer innovative financing packages to energy efficiency projects that reduce production costs as well as carbon dioxide emissions. For their pioneering and successful work in such areas, both banks have won multiple sustainability awards, including the Financial Times-sponsored Sustainable Banking Awards in recent years.

References and Resources on Environmental and Social Policy for Financial Intermediaries


This guidance note is part of World Bank Group publication: Getting to Green—A Sourcebook of Pollution Management Policy Tools for Growth and Competitiveness, available online at www.worldbank.org.