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Client briefing
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Broadening the Equator Principles beyond Project Finance - New Proposals

A review of the Equator Principles (EPs) has made recommendations to change a number of aspects of the EPs framework and these could have a significant impact on finance transactions. In particular, use of the EPs could extend beyond pure project finance to corporate loans where the majority of funds are used to finance a single asset.

These suggested changes to the EPs framework will need to go through the formal EPs institutions' deliberation process before the EPs can be changed and this will take several months. Signatories and non-signatories to the EPs alike should start to assess now the impact that the proposed changes could have on finance transactions and consider taking part in the update process.

Main Findings

The newly published summary findings of the study conducted by ERM Consultants, on behalf of the EP Association, identify the four main challenges for the Equator Principles as:

- Their limited scope and whether they need to "go beyond" project finance;
- Expanding membership to India, China and other emerging markets;
- Improving consistency of implementation across members;
- Promoting transparency.

Extending the scope of the Equator Principles

ERM recommended that the scope of the Equator Principles be extended to encompass both project finance and corporate loans where 50% or more of the proceeds are being used to finance a single asset. It is not clear whether this 50% threshold will be taken forward or another threshold chosen instead. The EP's governing body the Equator Principles Association issued a summary response to the recommendations and paraphrased this recommendation as "extending the scope of the Equator Principles to corporate loans with *known use of proceeds (i.e., corporate loan tied to a defined specific asset)*". It remains to be seen how this will be interpreted.

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The recommendation to extend the EP's scope came about after some Equator Principle Financial Institutions (EPFIs) expressed concerns to the independent consultant that a narrow definition of "project finance" diminished the relevance of the Equator Principles to a "small and declining portion of their financial portfolios". The consultants' findings also identified that projects with challenging issues may be disguised as corporate loans in order to avoid EP compliance.

Increasing transparency and consistency of implementation
The consultants found that EP implementation reporting is inconsistent and often limited, and that there are no agreed standards for audits. They recommended:

- that EPFI disclosure requirements should include, at minimum, project names (with client consent) and related EP categorisation;
- the development of an EP assurance standard to use for third party auditing;
- the creation of an independently managed EP "league table"; and
- the delisting of EPFIs that do not meet a minimum required implementation threshold.

The increasing transparency and emphasis on implementation is likely to provide more opportunity to environmental lobby groups to investigate and intervene to challenge transactions / projects where they feel that the EPs should be adopted. This along with the potential for delisting of errant EPFIs, is likely to increase the pressure on banks to err on the side of caution when considering whether to use EPs for a particular transaction and comply fully with EP requirements.

Increasing membership and coverage
The findings also concluded that there was less awareness of the EPs outside of Europe and North America. It recommended that a comprehensive outreach strategy be targeted to China, India and other emerging markets. The EP Association has committed to the development of such a strategy and already has in place an Outreach Working Group established to explore how best to achieve this objective.

Background
The EPs are a framework used by project finance institutions to assess and manage the environmental and social risks of projects where total project capital costs exceed US$10 million. EPFIs commit to not finance projects anywhere in the world (including any extension or upgrade to an existing project) where a borrower will not, or is unable to, comply with certain social and environmental policies. Annex A provides a brief summary of the EPs.

In October 2010, the Equator Principles Association, which governs membership and use of the EPs, announced the commencement of a strategic review process of the EPs. The intention of the strategic review is to produce a five year strategic vision to ensure that "the EPs continue to be viewed as the 'gold standard' in environmental and social risk management practice for project finance within the financial sector".

In order to undertake the strategic review, the EP Association commissioned independent consultants ERM to facilitate an airing of the issues, and to offer perspectives and recommendations. In May 2011, the EP Association released the Executive Summary of the consultants' Equator Principles Strategic Review Report as well as the EP Association's Summary Response.

Next Steps
Many of the recommendations are considered by the EP Association to be "medium term" and they will be deliberated during an "EP III Update Process". This is scheduled to commence in Quarter 3/4 of 2011. It is intended that the process will include public comment and stakeholder feedback processes, with a draft of the proposed revised EPs being made publicly available for comment.

The implementation of many of the recommendations referred to above (including the extension to corporate loans) would require formal amendment of the EPs and the EP Association Governance Rules and a voting process of the entire EP Association membership.

Comment
If the recommendations to expand the reach of the EPs into more general corporate lending are taken forward, it is clear that a larger number of transactions (including new types of transaction) will be forced into the rigour of EP compliance. Enhanced reporting and disclosure requirements and enforcement will heighten the profile of the EPs and potentially lead to more project challenges.

Whilst EPFIs have an interest in demonstrating that their lending activities are being carried out sustainably and responsibly, wide-scale extension of the EP to a EPFI's portfolio will come with additional costs and EPFI's will want to ensure that the boundaries of the extension are reasonably justified.

EPFIs should therefore monitor the current EP review process and, if they are not already doing so, consider actively participating in the EP III Update Process commencing in Quarter 3/4 of 2011.

In particular EPFIs should review the types of transactions that they enter into to determine the impact that a move to encompass both project finance and corporate loans where 50% or more of the proceeds are being used to finance a single asset will have on their business, including their internal policies and procedures.

This will also be an issue for non-EPFIs to follow. They will also be impacted if they enter into financial transactions with EPFIs in the future, for example a syndication involving non-EPFIs and EPFIs.

Annex A

THE EQUATOR PRINCIPLE FRAMEWORK

The Equator Principles ("**EPs**") are a framework used by project finance institutions to assess and manage the environmental and social risks of projects where total project capital costs exceed US$10 million. Equator Principle Financial Institutions ("**EPFIs**") commit to not finance projects (including any extension or upgrade to an existing project) where a borrower will not, or is unable to, comply with certain social and environmental policies.

The EPs have to date been adopted voluntarily by 72 financial institutions, and cover over seventy percent of international project finance debt in emerging markets. They provide a standard for environmental and social sustainability due diligence based on International Finance Corporation ("**IFC**") Performance Standards and World Bank Group Environmental, Health and Safety Guidelines.

Projects are categorised by EPFIs as either Category A, Category B or Category C projects (depending on their social and environmental impacts) and borrowers then have social and environmental assessment, management and consultation obligations, the level of which depends upon whether a project is located in a non-OECD country, an OECD country not designated as High-Income[1], or a High-Income OECD country. There are mechanisms for addressing community grievances, and independent review and reporting requirements. For all Category A projects and, where appropriate, Category B projects, borrower covenants will be incorporated into finance documentation, for example, in relation to borrower compliance with environmental and social law, regulations and permits.

1 As defined by the World Bank Development Indicators Database

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