C L I F F O R D

C H A N C E

EQUATOR PRINCIPLES IV FINALISED

The Equator Principles Association (EPA) has published a finalised version of Equator Principles IV (EPIV) following consultation. EPIV broadens the scope of the Equator Principles (EPs) to cover a wider range of loans, including project refinancing and acquisition financing, as well as tightening standards in high-income OECD countries and addressing human rights and climate change issues in more detail. While the form of EPIV broadly follows the form of the draft published in June 2019 (discussed here), a few significant changes have been made and these are discussed below. We also include in the Appendix, a summary of major changes since Equator Principles III (EPIII).

Key issues

- Finalised EPIV revised since draft version:
  - Community Engagement: Independent Consultant to advise in case of uncertainty over indigenous peoples' consent and on any corrective action
  - Climate Risk Assessment references to TCFD strengthened
  - Clarity on types of corporate loans included within the EPs
- EPIV will apply from 1 July 2020
- Appendix contains summary of Key changes since EPIII

COMMUNITY ENGAGEMENT

EPIV contains amendments aimed at enhancing the protection of indigenous peoples through the process of obtaining free prior and informed consent (FPIC) where specified impacts on indigenous peoples are envisaged. It requires EFPIs to appoint an independent consultant to assess the engagement process and its outcomes against host country laws and IFC Performance Standard 7 ('IFC PS7' which sets out in detail how community engagement should take place and in what circumstances FPIC is required). Where there is uncertainty over whether FPIC has been achieved, the EPFI must determine whether there is a justified deviation from the detailed requirements of IFC Performance Standard 7, and whether any further action is required to comply with the objectives of IFC PS7. The independent consultant may be either the Independent Environmental and Social Consultant who carries out the Independent Review required under Principle 7 of the EPIV or another qualified independent consultant, such as a lawyer. While seeking advice on these questions is required by EPIV, ultimately the decision is for the EFPI. The inclusion of an independent consultant in this process is new to the finalised EPIV and seems a constructive addition to incorporate relevant expertise into FPIC.

EPIV also contains a proposed working definition of FPIC for the first time. This recognises that FPIC focuses on meaningful engagement of indigenous peoples although there is no universally accepted definition. It recognises that achieving "*FPIC does not require unanimity, does not confer veto rights on* *individuals or sub-groups and does not require the [project developers] to agree to aspects not under their control*".

Where the host government is responsible for the engagement process, clients are now required by EPFIs to collaborate with that government.

It is anticipated further guidance to assist with the implementation of this provision will be available in Q2 2020.

CLIMATE RISK ASSESSMENT

Finalised EPIV places increased emphasis on the recommendations of the Task Force on Climate-related Financial Disclosure (TCFD). While not directly requiring all climate risk assessments to be carried out in accordance with the TCFD, the finalised EPIV strengthens references to TCFD in a number of places. For example, climate change risk assessment must assess both 'physical' and 'transition' risks and these must follow the TCFD definitions (see box inset).

- **Physical Risks:** Risks resulting from climate change, which involve event driven (acute) or longer-term shifts (chronic) in climate patterns, e.g. extreme weather events or sustained higher temperatures.
- **Transition Risks:** Risks which can arise from the process of adjusting to a lower carbon economy, e.g. policy and legal risks, water or land use restrictions or incentives, shifts in supply or demand, or reputation risks.

This follows a trend more generally in the financial and corporate worlds towards encouraging assessment and disclosure in line with the TCFD.

CLARITY ON PROJECT-RELATED CORPORATE LOANS

One of the major developments beyond EPIII is the inclusion of project-related corporate loans. It has been potentially unclear as to whether some forms of corporate financial support would be included. The finalised version of EPIV now contains helpful clarification that Export Finance in the form of 'buyer credit' is included. It usefully lists some other types of finance that are excluded and therefore will not be subject to EPs compliance:

- Export Finance in the form of supplier credit;
- Asset finance, hedging leasing, letters of credit, general corporate purposes loans and general working capital expenditures where these do not finance underlying projects.

TIMING

EPIV will apply to all relevant transactions from 1 July 2020. In the meantime, EFPIs can apply EPIV on a voluntary basis.

The EPA expects to publish implementation guidance in the second quarter of 2020.

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APPENDIX – SUMMARY OF KEY CHANGES IN EPIV

GENERAL OVERVIEW

EPIV is the fourth version of the EPs adopted by the EPA since they were first introduced in 2003. EPIV now broadens the scope of the EPs to cover a wider range of loans, including project refinancing and acquisition financing, as well as tightening standards in high-income OECD countries and addressing human rights and climate change issues in more detail.

EXPANSION IN SCOPE

EPIV amends the scope of application of the EPs in respect of project-related corporate loans of over two years; the aggregate of the loan and the EPFI's individual commitment must now each be at least US $50 million to be caught by the EPs, a reduction from the US $100 million threshold in EPIII.

It also widens the definition of 'Project' to include non-contiguous developments over one or more geographic areas, including expansions and upgrades to existing developments.

In addition, the EPs will now cover project-related refinancing and acquisition financing, provided:

- the underlying Project was financed in accordance with the EPs;
- there has been no material change in the scale or scope of the Project; and
- Project completion has not yet occurred at the time of the signing of the facility or loan agreement.

Widening the scope of the EPs to cover refinancing and acquisition financing will ensure that expansions and upgrades to projects where new EPFI signatories are involved will now fall under the environmental and human rights best practice of the EPs.

ENHANCED REQUIREMENTS FOR PROJECTS IN OECD COUNTRIES

Under EPIII, the EPs distinguished between projects in Non-Designated and Designated countries, placing more onerous EP duties on Projects being developed in the former. In Designated countries – high-income OECD nations such as the USA, UK, Japan and Germany – the assumption is that domestic laws and regulations already offer a high standard of environmental and social protection.

However, following concerns around local standards and community engagement for projects in Designated Countries, EPIV places an obligation on EPFIs financing projects in Designated Countries to evaluate the "specific risks of the Project" to determine whether one or more of the IFC Performance Standards can be used as guidance to address those risks, in addition to host country laws. For project sponsors, this amendment will mean that merely complying with local environmental and social laws in Designated Countries may not be enough to satisfy EPFIs that risks are being adequately addressed.

HUMAN RIGHTS

The EPFIs now refer more prominently in the Preamble to their commitment to respect human rights in line with the UN Guiding Principles on Business and Human Rights (UNGP) by carrying out due diligence when financing projects that fall within the scope of EPIV.

The EPFIs also acknowledge that they have broader responsibilities for identifying and managing adverse environmental and social risks and also for respecting human rights in connection with financial products that fall outside the scope of EPIV. For the first time, under Principle 2, EPIV expressly requires clients to include human rights risks (in line with the UNGP) and climate change risks (discussed further below) in their ESIA and assessments for Category A and, as appropriate, Category B projects. This now includes including measures in the Assessment Documentation for remediating risks and impacts to workers and affected communities in appropriate circumstances. Further, clients must now provide information to affected communities and workers about grievance mechanisms as part of the stakeholder engagement process, and in line with the effectiveness criteria in the UNGP. As discussed above, all projects that affect indigenous peoples need to be subject of informed consultation and participation which now includes FPIC. Guidance to be issued in Q2020 will assist with clarifying the EP's expectations in relation to these new provisions.

CLIMATE CHANGE

EPIV, in its Preamble, now highlights the significance of the 2015 Paris Climate Change Agreement for the EPs. This new focus will be of particular relevance for host countries seeking to ensure that project development takes place in a manner that is compliant with their Nationally Determined Contributions (NDCs) under the Paris Agreement.

Notably, Principle 2 of the EPs has been amended to require Environmental and Social Impact Assessments (ESIAs) to include a Climate Change Risk Assessment as a mandatory requirement for:

- All Category A ('significant' risk) projects; and, as appropriate, Category B ('potential limited' risk) projects; climate 'physical' risks (i.e. arising from changes in acute or long term climate patterns) would be assessed for these projects.

- All projects where combined scope 1 and scope 2 GHG emissions are likely to exceed 100,000 tonnes of TCO2 equivalent. The assessment for these projects must also cover climate 'transition' risks (i.e. arising from a move to a low carbon economy), and an analysis of possible, less GHG-intensive, alternatives to the project.

In addition, ESIAs should also consider the project's compatibility with the host country's most recent relevant climate and energy policies including its NDCs.

EFPIs also have to require borrowers to report annually on GHG emission levels, providing a GHG efficiency ratio where appropriate.

EPIV explicitly recognises the importance of the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD), both in the Preamble and references to various reporting metrics. The implicit suggestion is that EPFIs use the reporting approach of the TCFD in complying with the EPs.

Principle 10 of the EPs is also expanded to require enhanced reporting requirements on biodiversity issues.