Environmental and Social Management System

Environmental Risk Management for the Financial Sector
Agenda

The basics of an Environmental and Social Management System (EMS)
  • Objectives and conditions for success

The building blocks of an EMS
  • Supporting policies and procedures
  • Roles and responsibilities to apply the EMS

Implementation of a tailor-made EMS within your own FI
  • Drafting an EMS Action Plan
  • Gaining commitment and buy-in from all levels

Using the EMS once it is in place
  • Monitoring risks at different levels enable to focus and prioritize
  • The business case for an EMS
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In order to really manage E&S risks and opportunities, a structured management approach is needed

Such a management approach is called:

*Environmental and Social Management System (EMS)*

The objective of an EMS is to support an FI to:

1. *(Better)* understand the environmental and social risks in its portfolio
2. Evaluate, mitigate and monitor these risks on a structural basis
3. Maximize opportunities for environmental and social benefits to arise
4. Comply with national standards and applicable international covenants
5. Establish a good reputation among clients, investors and other relevant stakeholders

The idea is to develop a pragmatic and effective approach to risk management, not a bureaucratic paper tiger
The EMS is applied at all stages of an FI’s credit cycle

Identification
- Exclusion list
  - Client engagement
  - Industry/client assessment
    - Preliminary risk categorization (A, B, C)

Evaluation
- Revision of risk categorization
  - E&S risk assessment
  - Definition of mitigation measures

Mitigation
- Definition of loan conditions
  - Negotiation on mitigation measures
    - Incorporation in loan agreement
  - Evaluation of mitigation measures
  - Redefinition of mitigation measures
And it should perfectly match your FI’s operational process in order to be effective

The EMS has to be applied in all phases of the credit process

It should be integrated in your core operations and not be a stand-alone process

It should be firmly and visibly supported by top management
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The EMS is supported by a number of policies and procedures

1. **Exclusion list**
   Selection of activities that are excluded from financing

2. **Environmental & Social Policy**
   General declaration on the FI’s position regarding environmental and social issues

3. **Risk categorization model (A, B, C)**
   Risk estimation based on international standards

4. **Sector guidelines**
   Legislation, E&S impacts and risks, best practices and mitigation measures

5. **Standard documentation**
   Credit procedure forms (identification, evaluation, mitigation, monitoring)

6. **EMS Manual**
   Description of procedures, forms and responsibilities

7. **E&S reporting**
   Periodic reporting on E&S risks in the loan portfolio (internally and externally)
An exclusion list defines what activities may not be financed

IIC Exclusion list (Refer to complete list of Excluded activities on IIC website)

- Production or activities involving harmful or exploitative forms of forced labor,\(^1\) or harmful child labor, or practices that are discriminatory or prevent employees from freely exercising their right to association and collective bargaining.\(^2\)
- Production or trade in any product or activity deemed illegal under host country laws or regulations or ratified international conventions and agreements.
- Production or trade in weapons and munitions.
- Production or trade in tobacco.\(^3\)
- Gambling, casinos, and other similar activities.\(^3\)
- Trade in endangered species of wildlife or wildlife products regulated under CITES,\(^4\) or products derived thereof.
- Production or trade in radioactive materials.\(^5\)
- Production or trade in or use of unbonded asbestos fibers.\(^6\)
- Production or trade in wood or other forestry products from forests that lack sustainable management.
- Plantation projects that would require the removal of existing non-degraded natural forest.
- Production or trade in products containing PCBs.\(^7\)
- Production, trade, storage, or transport of significant volumes of hazardous chemicals, or commercial scale usage of hazardous chemicals.\(^8\)
- Transboundary trade in waste or waste products,\(^9\) except for non-hazardous waste destined for recycling.
- Production or trade in pharmaceuticals subject to international phase-out or bans.\(^10\)
- Production or trade in pesticides/herbicides subject to international phase-out or bans\(^11\) and persistent organic pollutants (POPs).\(^12\)
- Production or trade in ozone depleting substances subject to international phase-out.\(^13\)
- Drift net fishing in the marine environment using nets in excess of 2.5 km in length.
- Production or activities that impinge on the lands owned, or claimed under adjudication, by indigenous peoples, without full documented consent of such peoples.
An Environmental & Social Policy is a pre-requisite for sound E&S risk management

<table>
<thead>
<tr>
<th>Policies should be …</th>
<th>Examples of international framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>Embedded in an umbrella statement</td>
<td>Universal Declaration of Human rights</td>
</tr>
<tr>
<td>As universal as is possible</td>
<td>• Civil and political rights</td>
</tr>
<tr>
<td>Concrete and relevant when needed to deal with specific sector of geography risk</td>
<td>• Economic, social and cultural rights</td>
</tr>
<tr>
<td>Guided by laws and regulations applicable to client companies:</td>
<td>World Bank safeguard policies</td>
</tr>
<tr>
<td>• National, local, tribal law</td>
<td>• Harmful child and forced labor</td>
</tr>
<tr>
<td>• International conventions</td>
<td>• Involuntary resettlements</td>
</tr>
<tr>
<td>• Law of the export market (EU,US)</td>
<td>• Forestry</td>
</tr>
<tr>
<td>Approved by and lived by top management</td>
<td>• Safety of dams</td>
</tr>
<tr>
<td></td>
<td>International Labor Organization</td>
</tr>
<tr>
<td></td>
<td>• Core labor standards</td>
</tr>
<tr>
<td></td>
<td>• Primary labor conditions</td>
</tr>
</tbody>
</table>
The risk categorization determines the evaluation process

<table>
<thead>
<tr>
<th>Environmental and Social Impact</th>
<th>Low risk (category C)</th>
<th>Medium risk (category B)</th>
<th>High Risk (category A)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Environmental and social impacts are expected to be negligible</td>
<td>Environmental and social impacts can be readily identified and standard preventative and/or remedial measures can be prescribed</td>
<td>There may be highly significant, negative and/or long-term environmental and social impacts, the magnitude of which are difficult to determine at the application stage</td>
</tr>
<tr>
<td>Assessment</td>
<td>No environmental appraisal required</td>
<td>Environmental and social compliance check as integrated part of the due diligence and site visit of a potential client</td>
<td>Environmental Impact Assessment or Environmental Audit by a qualified external consultant</td>
</tr>
<tr>
<td>Environmental and Social Requirements</td>
<td>Compliance with applicable local laws</td>
<td>Compliance with applicable local laws</td>
<td>Compliance with applicable local laws</td>
</tr>
<tr>
<td></td>
<td></td>
<td>If necessary, remedial measures to be included into the loan contract</td>
<td>Compliance with applicable Word Bank / IFC guidelines and safeguard policies</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>If necessary, remedial measures to be included into the contract</td>
</tr>
</tbody>
</table>
Sector guidelines help to identify and evaluate E&S risks and impacts

Each sector guideline will consist of the following topics

1. Overview of relevant international, national and local legislation
2. Summary of most important items mentioned in Worldbank and IFC guidelines (skip the technical details, focus on big risks)
3. Some best practices, preferably current clients
4. Maximum of 6 criteria that need to be fulfilled

Annually review and update the policy with the team

Sector guidelines should be more than 3 pages long

But one does not have to reinvent the wheel:

- IFC has already developed E&S guidelines for 79 sectors
Incorporation of E&S requirements in documentation is the aim of control and mitigation

<table>
<thead>
<tr>
<th>Mitigation measures are included in the loan documentation…</th>
<th>… on which progress is monitored periodically</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit committee decides on conditions and covenants</td>
<td>Two possibilities:</td>
</tr>
<tr>
<td>For example:</td>
<td>1. Progress is satisfactory</td>
</tr>
<tr>
<td>• E&amp;S clauses</td>
<td>No further action</td>
</tr>
<tr>
<td>• E&amp;S action plan (AP)</td>
<td>2. Progress is not satisfactory</td>
</tr>
<tr>
<td>• E&amp;S monitoring report format</td>
<td>Further action needed:</td>
</tr>
<tr>
<td>Conditions in form of negative and positive covenants, management systems, etc.</td>
<td>Relationship Manager contacts client:</td>
</tr>
<tr>
<td></td>
<td>• A new agreement is reached</td>
</tr>
<tr>
<td></td>
<td>• More serious measures</td>
</tr>
</tbody>
</table>

Realism is important: one doesn’t want to push the client over the edge
Possible clauses in client contract

**Low/medium risk client**
The borrower must commit to:
1. compliance with all relevant host country social and environmental laws
2. IDB/IIC Exclusion List

**Medium/high risk client**
The borrower must commit to:
1. compliance with all relevant host country social and environmental laws
2. compliance with the Action Plan in the construction and operation of the project
3. demonstrate proof of compliance on a yearly basis
4. assign responsibility for E&S issues within management
5. where applicable, report on progress regarding the agreed plan

Where a borrower is not in compliance with its E&S covenants, the Bank will engage the borrower to seek solutions to bring it back into compliance.
Three positions are responsible for applying the EMS

<table>
<thead>
<tr>
<th>Loan and credit officers</th>
<th>E&amp;S coordinator</th>
<th>General Management/ Credit Committee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dialogue with client on E&amp;S issues</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Evaluation of E&amp;S risks at individual investment level</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Suggestion of E&amp;S conditions for the client</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Monitoring of client’s progress</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Development/updating of procedures and documents</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Evaluation of E&amp;S risks at portfolio level</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assistance to loan and credit officers in evaluation and monitoring of clients</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commitment to policies and objectives</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Approval of suggested E&amp;S conditions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Internal and external communication</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

It is crucial to coordinate the EMS from a central and influential position within the organization
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Draft a practical and feasible EMS Action Plan

1. Draft an Environmental and Social Management System procedure (EMS)
2. Get input from all relevant disciplines to gain knowledge and buy-in
3. Present the EMS to the Management Board for commitment to next steps
4. Create coordination group for EMS
5. Define which documents should be modified or developed
6. Define a pilot project
7. Set up a capacity building program
8. Plan roll-out and continuously improve once in operation

This whole process can be executed in 8 - 12 months
Gaining commitment internally and externally

People often fear that E&S requirements negatively affect their work
  • They have the incentive to sell and fear a longer process
  • They might think addressing E&S issues will discourage clients

But this is often unjustified:
  • Many clients (especially in higher-risk sectors) are already used to environmental assessments and will not consider it strange

  • One does not need to talk in a negative way about E&S requirements but rather present it as a way to improve the clients business and chances for success

  • MFI funding and Equator principles create a level playing field in your market

However, this does indicate that it is crucial to involve commercial people in the development of the Environmental and Social Management System
Enrich and check the draft EMS by asking for input from all relevant disciplines

Present draft action plan to:
• Commercial managers
• Individual Board Members

Involving the commercial people is crucial as:
• They have the real knowledge on sectors and clients
• They are the ones who have to apply the EMS in the field

Finalize EMS plan based on comments and suggestions from internal stakeholders

Present the EMS to the Management Board and ask for (formal) approval
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Once the SMS functions at individual level, monitoring at portfolio level can take place.

**Portfolio level**

- **Client’s E&S Risk mgt quality**
  - Limited (1)
  - Average (2)
  - Intensive (3)

- **E&S Risk level**
  - High (3)
  - Medium (2)
  - Low (1)

**Sector level**

- **E&S Risk level**
  - High (3)
  - Medium (2)
  - Low (1)

- **Client’s E&S Risk mgt quality**
  - Limited (1)
  - Average (2)
  - Intensive (3)

**Actions**

- **I** Mitigate
- **II** Monitor closely
- **III** Stay alert
Possible indicators for identifying risks of a client

<table>
<thead>
<tr>
<th>Determination of E&amp;S risk level</th>
<th>Determination of E&amp;S risk mgt quality</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Client size</strong></td>
<td><strong>E&amp;S policy</strong></td>
</tr>
<tr>
<td>1: low</td>
<td>1: Absent</td>
</tr>
<tr>
<td>2: intermediate</td>
<td>2: General E&amp;S policy</td>
</tr>
<tr>
<td>3: high</td>
<td>3: Sector policy</td>
</tr>
<tr>
<td><strong>Loan amount</strong></td>
<td><strong>Knowledge level</strong></td>
</tr>
<tr>
<td>1: low</td>
<td>1: One (E&amp;S) staff person</td>
</tr>
<tr>
<td>2: intermediate</td>
<td>2: Sufficient knowledge risk officers</td>
</tr>
<tr>
<td>3: high</td>
<td>3: Sufficient knowledge of</td>
</tr>
<tr>
<td></td>
<td>commercial officers</td>
</tr>
<tr>
<td><strong>Risk categories</strong></td>
<td><strong>E&amp;S assessment</strong></td>
</tr>
<tr>
<td>1: C</td>
<td>1: Absent</td>
</tr>
<tr>
<td>2: B</td>
<td>2: Standard questionnaire</td>
</tr>
<tr>
<td>3: A</td>
<td>3: External E&amp;S Assessment</td>
</tr>
</tbody>
</table>
Once the EMS is in place, continuous improvement is required through yearly review.
The business case for applying the EMS approach is clear

<table>
<thead>
<tr>
<th>While the EMS offers many benefits to management…</th>
<th>…it only requires a limited effort from the operational people</th>
</tr>
</thead>
<tbody>
<tr>
<td>It gives a clear overview of the E&amp;S risk in your portfolio at different levels</td>
<td>The procedure itself takes very little time in an existing process</td>
</tr>
<tr>
<td>It enables you to prioritize and focus on the real issues</td>
<td>It is only applied to the top-end loans (to be defined)</td>
</tr>
<tr>
<td>It provides a potential value to your FI</td>
<td>Suggestions are easily made</td>
</tr>
<tr>
<td>It creates easier access to funding</td>
<td>Heavy requirements are only defined for loans of large amounts and high risk</td>
</tr>
</tbody>
</table>