Environmental and Social Management System (ESMS)

Environmental Risk Management for the Financial Sector
The basics of an Environmental and Social Management System (ESMS)
- Objectives and conditions for success

The building blocks of an ESMS
- Supporting policies and procedures
- Roles and responsibilities to apply the ESMS

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

Using the ESMS once it is in place
- Monitoring risks at different levels enable to focus and prioritize
- The business case for an ESMS
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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 (ESMS)*

The objective of an ESMS 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 ESMS 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

- **Monitoring**
  - Evaluation of mitigation measures
  - Redefinition of mitigation measures
And it should perfectly match your FI’s operational process in order to be effective.

The ESMS 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.
Agenda

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The ESMS 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. ESMS 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, or harmful child labor, or practices that are discriminatory or prevent employees from freely exercising their right to association and collective bargaining.

- 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.

- Gambling, casinos, and other similar activities.

- Trade in endangered species of wildlife or wildlife products regulated under CITES, or products derived thereof.

- Production or trade in radioactive materials.

- Production or trade in or use of unbonded asbestos fibers.

- 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.

- Production, trade, storage, or transport of significant volumes of hazardous chemicals, or commercial scale usage of hazardous chemicals.

- Transboundary trade in waste or waste products, except for non-hazardous waste destined for recycling.

- Production or trade in pharmaceuticals subject to international phase-out or bans.

- Production or trade in pesticides/herbicides subject to international phase-out or bans and persistent organic pollutants (POPs).

- Production or trade in ozone depleting substances subject to international phase-out.

- 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

Policies should be …

- Embedded in an umbrella statement
- As universal as is possible
- Concrete and relevant when needed to deal with specific sector of geography risk
- Guided by laws and regulations applicable to client companies:
  - National, local, tribal law
  - International conventions
  - Law of the export market (EU, US)
- Approved by and lived by top management

Examples of international framework

- Universal Declaration of Human rights
  - Civil and political rights
  - Economic, social and cultural rights
- World Bank safeguard policies
  - Harmful child and forced labor
  - Involuntary resettlements
  - Forestry
  - Safety of dams
- International Labor Organization
  - Core labor standards
  - Primary labor conditions
The risk categorization determines the evaluation process

<table>
<thead>
<tr>
<th></th>
<th>Low risk (category C)</th>
<th>Medium risk (category B)</th>
<th>High Risk (category A)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental and Social Impact</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>
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</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 no more than 3 pages long

But one does not have to reinvent the wheel:

- IFC has already developed E&S guidelines for 79 sectors

http://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+sustainability/sustainability+framework/environmental%2C+health%2C+and+safe+ty+guidelines/ehsguidelines
Incorporation of E&S requirements in documentation is the aim of control and mitigation

Mitigation measures are included in the loan documentation…

<table>
<thead>
<tr>
<th>Credit committee decides on conditions and covenants</th>
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</thead>
<tbody>
<tr>
<td>For example:</td>
</tr>
<tr>
<td>• E&amp;S clauses</td>
</tr>
<tr>
<td>• E&amp;S action plan (AP)</td>
</tr>
<tr>
<td>• E&amp;S monitoring report format</td>
</tr>
</tbody>
</table>

Conditions in form of negative and positive covenants, management systems, etc.

… on which progress is monitored periodically

Two possibilities:

1. Progress is satisfactory
   *No further action*

2. Progress is not satisfactory
   *Further action needed:*

Relationship Manager contacts client:

• A new agreement is reached
• More serious measures

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 ESMS

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

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

1. Draft an Environmental and Social Management System procedure (ESMS)
2. Get input from all relevant disciplines to gain knowledge and buy-in
3. Present the ESMS to the Management Board for commitment to next steps
4. Create coordination group for ESMS
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 ESMS 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 ESMS in the field

Finalize ESMS plan based on comments and suggestions from internal stakeholders

Present the ESMS to the Management Board and ask for (formal) approval
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Once the ESMS 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:
    - Low (1)
    - Medium (2)
    - High (3)

- **Sector level**
  - E&S Risk level:
    - Low (1)
    - Medium (2)
    - High (3)
  - Sectors:
    - Telecom
    - Manufacturing
    - Mining
    - Agriculture

- **Actions**
  - Mitigate
  - Monitor closely
  - Stay alert
Possible indicators for identifying risks of a client

<table>
<thead>
<tr>
<th>Determination of E&amp;S risk level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Client size</strong></td>
</tr>
<tr>
<td>1: low</td>
</tr>
<tr>
<td>2: intermediate</td>
</tr>
<tr>
<td>3: high</td>
</tr>
<tr>
<td><strong>Loan amount</strong></td>
</tr>
<tr>
<td>1: low</td>
</tr>
<tr>
<td>2: intermediate</td>
</tr>
<tr>
<td>3: high</td>
</tr>
<tr>
<td><strong>Risk categories</strong></td>
</tr>
<tr>
<td>1: C</td>
</tr>
<tr>
<td>2: B</td>
</tr>
<tr>
<td>3: A</td>
</tr>
</tbody>
</table>

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<thead>
<tr>
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</thead>
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<tr>
<td><strong>E&amp;S policy</strong></td>
</tr>
<tr>
<td>1: Absent</td>
</tr>
<tr>
<td>2: General E&amp;S policy</td>
</tr>
<tr>
<td>3: Sector policy</td>
</tr>
<tr>
<td><strong>Knowledge level</strong></td>
</tr>
<tr>
<td>1: One (E&amp;S) staff person</td>
</tr>
<tr>
<td>2: Sufficient knowledge risk officers</td>
</tr>
<tr>
<td>3: Sufficient knowledge of commercial officers</td>
</tr>
<tr>
<td><strong>E&amp;S assessment</strong></td>
</tr>
<tr>
<td>1: Absent</td>
</tr>
<tr>
<td>2: Standard questionnaire</td>
</tr>
<tr>
<td>3: External E&amp;S Assessment</td>
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</tbody>
</table>
Once the ESMS is in place, continuous improvement is required through yearly review.
The business case for applying the ESMS approach is clear

<table>
<thead>
<tr>
<th>While the ESMS 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>