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**The Equator Principles: A Step Towards
Sustainability?**

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THE EQUATOR PRINCIPLES: A STEP TOWARDS SUSTAINABILITY?

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Abstract

On June 4, 2003, ten leading banks from seven countries announced the adoption of the “Equator Principles”. The Principles set out a series of guidelines on the management of social and environmental risks that banks voluntarily commit to follow in their project financing activities across all industry sectors globally.

This paper presents a preliminary economic analysis of the Equator Principles, and draws from this analysis some ideas regarding the potential impact and evolution of the Principles. We formulate three hypotheses about the economic drivers underlying the Equator Principles. All three are based on the assumption that companies that have promoted and/or signed the Principles have done so because they believe it will enhance firm value. The first hypothesis is based on considerations over the structure of competition between different companies within the industry; the other two refer to factors that bear on the profitability of the industry as a whole.

The paper draws from this analysis an assessment of the contribution that the Equator Principles can make to sustainability.

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1 Introduction

On June 4, 2003, ten leading banks from seven countries announced the adoption of the Equator Principles (EP) – a basic framework for the management of social and environmental risks in project finance. Banks commit to apply this framework to all projects with a capital cost above US\$ 50 million, across all industry sectors, globally. They will do so voluntarily and independently, and will develop appropriate internal practices and policies for that effect.

One the day of the announcement, the ten banks represented approximately 30% of the project loan syndication market globally. A year later, fifteen other banks have adopted the Principles, and altogether, these 25 signatories represent around 75% of the market. In the process the Equator Principles has rapidly become the more visible and concrete financial services industry initiative promoting sustainable development, based on the understanding that financiers have “significant opportunities to promote responsible environmental stewardship and socially responsible development”¹.

The Equator Principles is a case of industry self-regulation at the global level. As other instances of industry self-regulation, it raises two basic questions for social scientists. The first one relates to the motives underlying the initiative. If the banks’ overarching aim is to maximise firm value, what is their interest in participating in a self-regulatory initiative? As is often the case with the economics of self-regulation, the problem resides in identifying the expected benefits, as the costs are easily identifiable.

The second question relates to the consequences of industry self-regulation for social welfare. On one hand, some authors, e.g. Garvin (1983), have pointed out that industry self-regulation will have negative consequences for social welfare when they unduly serve to restrict the level of competition. On the other hand, Gunningham and Rees (1997), Sinclair (1997), and Eisner (2003), among others, welcome industry self-regulation as a new form of governance that can provide an effective and/or efficient alternative, or complement, to state regulation.

¹ Quote from the Preamble of the Equator Principles. Other significant financial services industry initiative include the UNEP Financial Initiative, a joint initiative between UNEP and the financial services industry based on the 1992 UNEP Statement by Financial Institutions on the Environment and Sustainable Development; a statement by 11 CEOs and Chairmen of financial companies at the 2002 WSSD in Johannesburg WBCSD (2002); recommendations developed within the frame of the UN Global Compact and endorsed by 20 financial companies on how to better integrate environmental, social and governance issues in analysis, asset management and securities brokerage (The Global Compact (2004)), a theme also taken up by Zadek, Merme, and Samans (2005) and the World Economic Forum. Peeters (2003) provides an overview of some of these and other initiatives.

This paper addresses these two questions. After a brief review of the Equator Principles and the costs related to their implementation (section 2), we formulate three hypotheses about the economic drivers underlying the Equator Principles (section 3). The three hypotheses rely on micro-economic arguments and are based on the assumption that banks have adopted the Principles to enhance firm value. The first hypothesis is based on considerations over the structure of competition between different companies within the industry; the other two refer to factors that bear on the profitability of the industry as a whole, taking inspiration from Porter (1980). Our intent is to suggest the plausibility of these hypotheses on the basis of economic arguments and relevant characteristics of the Equator Principles.

Section 4 draws from these hypotheses to assess whether the Equator Principles may contribute to the objective of sustainable development in Southern countries, and section 5 concludes.

2 The Equator Principles

The Equator Principles set a framework to assess the social and environmental risks of projects banks consider financing.² The banks pledge to apply this framework to all projects with a capital cost above US\$ 50 million, in all industries globally, and commit 'not to provide loans directly to projects where the borrower will not or is unable to comply with [the banks'] environmental and social policies and processes'. The principles are presented as 'a framework for developing individual, internal practices and policies'. Thus, 'Banks are adopting and implementing these principles voluntarily and independently'.

In a first step, banks will categorise a project in one of three groups, A, B, or C, (group A comprises the more risky projects) following the environmental and social screening criteria of the International Finance Corporation (IFC), the private sector arm of the World Bank Group. For all group A and B projects, sponsors are requested to carry out an Environmental Assessment (EA) in line with the IFC Safeguard Policies, and World Bank and IFC Pollution Prevention and Abatement Guidelines. For all group A projects and certain group B projects the sponsor will also prepare and implement an Environmental Management Plan (EMP), consult with various stakeholders, and report on the implementation of the EMP. A number of quality controls are envisaged: compulsory independent expert reviews of EAs and EMPs for group A projects;

² EP banks have set up a web-site which contains basic information on the Equator Principles. See www.equator-principles.com. Thomas (2004) (available on the website) provides a good and more detailed introduction to the EP than the one provided here.

and independent expert review of compliance when judged necessary. However, the Principles do not specify who will carry out these reviews nor their timelines, what recourse there will be for potentially affected persons, and do not clarify the circumstances under which independent monitoring will be considered necessary. Table 1 summarises the main documents project sponsors will have to prepare and corresponding quality control mechanisms.

Table 1: Key documents to be prepared by borrowers

| Documents | Projects affected | Disclosure requirements | Quality controls |
|---|---------------------------|---|--|
| Environmental Assessment (EA) | All A and B projects | EA, or summary thereof, made available to the public... (all A and some B projects) | Independent expert review (A projects) |
| Environmental Management Plan (EMP) | All A and some B projects | Not mentioned | Independent expert review (A projects) |
| Regular reports on compliance with EMPs | All A and some B projects | Not mentioned | As necessary, independent expert to provide additional monitoring and reporting services |
| Decommissioning plan | When appropriate | Not mentioned | |

Implementation of the Equator Principles will impose costs on both project lenders and sponsors, with the latter carrying most of the burden as they are responsible for preparing the EA and EMP, and for managing operations in line with the EMP. Yet the banks will incur significant costs as well. Costs for EP banks comprise (i) the costs of identifying the potential environmental and social risks of a project at an early stage in order to categorize the projects in groups A, B, or C, (ii) the costs of checking the quality of the EA and EMP prepared by the project sponsors prior to lending (due diligence), (iii) the costs of monitoring compliance during operations (iv) the costs of engaging with borrowers who are not in compliance in the operation phase, and (v) the opportunity cost of turning down potentially lucrative deals when ‘the borrower will not or is unable to comply with [the signatories’] environmental and social policies and processes’. (i)-(iv) require in-house capacities, time to review the projects, or resources for out-sourcing to independent experts. As noted above, each EP bank will carry out these tasks independently.

A general problem of industry self-regulation is to ensure that all actors in the industry abide by the voluntary regulation (e.g. Garvin (1983), Wotruba (1997), Reinhardt (2000) chapter 3), and this problem arises for the Equator Principles as well. Firstly, a number of banks may refuse to adopt the EP and finance projects from which EP banks will withdraw, with the conse-

quence of undermining the capacity of the initiative to improve project quality³. Secondly, some banks may formally adopt the principles, but fail to implement them. Each action that EP banks commit to perform opens free-riding opportunities, in the sense that a bank may wait for other EP banks to undertake it effectively (see Table 2). In this respect, an important feature of the Equator Principles is the absence of any common organisational structure set-up to oversee implementation. Lessons learnt from other industry self-regulation initiatives suggest that this absence is a significant drawback. Wotruba (1997), for instance, concludes from his review of such initiatives that ‘[a] necessary prerequisite for the implementation of any industry self-regulatory code of conduct is the existence of an organization for its administration.’ (p. 50). Similarly, Reinhardt (2000) notes that ‘any [industry self-] regulatory program must have credible mechanisms for standard setting, monitoring, and enforcement.’ (p.54)

Table 2: Implementation costs for EP banks and free-riding opportunities

| Bank actions | Estimated cost | Collective process | Quality risks in implementation | Free riding risks |
|--------------------------------|----------------|---|--|---|
| Categorisation of projects | Low | Need for agreement among lenders to set borrowers’ obligations ⁴ | Leniency in categorisation of projects | Low |
| Due diligence | Medium | Carried out independently by banks ⁵ | Insufficient due diligence | EP banks expect other EP banks to carry out thorough due diligence |
| Acceptance/refusal of projects | High | EP suggest banks will refuse to finance projects collectively, but does not mention procedures that will be followed to reach agreement | Projects with low standards are financed | EP banks are lenient in due diligence process and finance bad projects. |
| Monitoring of compliance | Medium | Carried out independently by banks | Insufficient appraisal | EP banks expect other EP banks to carry out thorough appraisal |
| Engagement | Medium | EP state engagement will be carried out collectively, but no mention of actual procedures that will be followed | Insufficient engagement | EP banks expect other EP banks to engage borrowers. |

³ In their assessment of the Equator Principles at the occasion of its first anniversary, the NGO network BankTrack (2004) notes that ‘it is rumoured that some non-Equator banks have proudly advertised their lack of environmental and social standards as a way of attracting less scrupulous clients’ (p.10).

⁴ ‘In applying the Equator Principles, the lead arrangers, among other things, will have to reach a consensus on the categorisation of the project (A, B or C) and on nature of the appropriate environmental assessment and covenant package.’ From <www.equator-principles.com/faq>.

⁵ ‘While the Equator Principles are based on IFC/World Bank standards, individual financial institutions are using their own judgements [to assess whether projects they have financed meet World Bank/IFC standards]’. From <www.equator-principles.com/faq>.

3 Three explanations of the Equator Principles

Any explanation of the Equator Principles should come-up with reasonable answers to the following questions:

- Timing: what factors triggered the creation of the Equator Principles in 2003?
- Objective of the initiative: what benefits do banks derive from the existence of the Equator Principles, considered as a shared industry standard?
- Economic rationale of leading banks: why did a small group of banks take the lead in launching the Equator Principles?
- Economic rationale to participate: what benefits do banks derive from adopting the Equator Principles? Put differently: what are the costs of free-riding?

We formulate below three hypotheses that provide different, internally coherent sets of answers to these questions. Furthermore, we draw from the logic of each hypothesis answers to the following two questions:

- What is the rationale for having chosen the IFC standards?
- What predictions can be made in terms of implementation, notably regarding the capacity to mitigate free-riding risks among EP banks in the absence of clear enforcement mechanisms?

3.1 Hypothesis 1: The Equator Principles serve to level the playing field in the industry among players facing different reputation risks

Background

Over the past decade, a number of banks engaged in project financing have been the targets of NGO-led public campaigns accusing the banks of providing support to and benefiting from projects that have negative social and environmental consequences. These campaigns aim to undermine the reputation of the banks, and by doing so, to engage banks' clients and employees in actions that will eventually bear on a bank's bottom-line⁶.

Banks' reputation risk can be defined as the probability of being a target of a public campaign multiplied by the cost for the bank of such a campaign. It is reasonable to assume that both

⁶ NGOs campaigns on the financing of large development projects focused first on the role of multilateral development banks in the early 1980s; in the mid 1990s, with financial flows to the Global South overtaking public monies, NGOs began to give attention to the role of export-credit agencies in supporting FDI; finally, in the later 1990s, they started targeting private sector banks engaged in project finance. For a brief review of this history, see the introductory pages of BankTrack (2004).

the probability and the cost of a campaign will vary across the type, size, and geographical location of banks. Banks with a well established brand name and located in countries with strong non-governmental organisations, are by and large more likely to be the target of public campaigns than small specialised banks located in countries with weak NGOs; and banks involved in commercial retail banking and thus vulnerable to consumer boycotts will likely incur higher losses than specialised boutiques from NGO-led public campaigns. Hence we can reasonably assume that banks differ in terms of reputation risk.

This disparity in reputation risks generates a competitive advantage for some banks at the expense of others. At its simplest, the more exposed banks are obliged to adopt voluntary standards in their project financing business in order to deflect NGO criticisms, while the less exposed ones are not.

The hypothesis

In this perspective, we advance the hypothesis that the Equator Principles is a strategy devised by high reputation risk banks to restore a level playing field with their less exposed competitors⁷. The purpose of the initiative is to impose the voluntary standards developed by the more exposed banks on all members of the industry. High reputation risk banks will benefit from this in two possible ways: by preventing less exposed banks from gaining a competitive advantage by participating in projects they must pass on; by increasing the number of projects they can participate in by imposing higher project standards on project sponsors.

This hypothesis predicts that the ten banks which launched the initiative are among the more exposed ones. A cursory examination of these banks – ABN AMRO; Barclays; Citigroup; Calyon; CSFB; HVB Group; Rabobank Group; The Royal Bank of Scotland; WestLB; Westpac Banking Corporation – confirms the prediction: these banks have large retail activities (except WestLB), and are based in countries with strong NGOs and previous cases of public campaigns on social and environmental issues (except Calyon). They would thus fall in the category of highly exposed banks. However, most of the banks that joined the initiative in the course of the past year have similar characteristics – so a much closer examination would be required to test our hypothesis in this way.

⁷ More generally, Reinhardt (2000) argues that industry self-regulation can be a way for some companies to gain a competitive advantage over their competitors. He analyses the Chemical Manufacturers Association's Responsible Care Program in this light.

A critical question raised by our hypothesis is what motivated other banks to join the initiative (15 additional banks did so in the first year after the launching): if the less exposed banks were threatened by it, why did they not oppose it?⁸

The answer to this question may reside in the specific nature of project finance. Project finance requires loan syndications: a lead arranger brings together a group of banks that together provides the finance needed for the project. If a sufficiently large group of banks adopts a new standard – as it was the case with the Equator Principles since the 10 original banks held together 30% of the market – leading arrangers may find it difficult to get a deal through that does not conform to the this standard. The costs of arranging a deal without the participation of banks having adopted it will increase and may supersede the costs of abiding by the standard. If this is the case, leading arrangers will decide to adopt the new standard, and *de facto* all lenders will also abide by it. The plausibility of the argument is confirmed by the analysis of the Principles conducted by Norton Rose (2003), a law firm, for its corporate clients in June 2003:

“The ten commercial banks that have already adopted the guidelines account for a significant share of the project finance market and more institutions may adopt the guidelines in the future. In that context, arranging banks should carefully consider how much appetite (if any) there will be in the syndication market for projects that do not comply with the Equator Principles. Underwriting and arranging banks in that position may consider it appropriate to apply the guidelines to individual loans in order to maximise the prospects of achieving a successful syndication.”⁹

Finally, since banks can reap of reputation benefit from announcing adoption of the Equator Principles, they have an obvious interest to formally join the initiative when they *de facto* abide by its principles. In this regard, it is interesting to point out that promoters and followers have expressed different motivations for joining the initiative. While five out of the ten promoters mentioned the importance of a joint industry standard, none of the 15 followers did so, and instead they emphasized their commitment to act in a socially responsible manner (see Annex).

To summarise, hypothesis 1 is based on the following basic assumptions and logic:

- i) Commercial banks differ by reputation risks

⁸ See Reinhardt (2000), chapter 3, on necessary conditions for successful private regulation.

⁹ Note that not all commentators share in this view. Thomas (2004), also a lawyer, believes that ‘undoubtedly, there will continue to be a market for banks which do not adopt the Equator Principles’ (p.14).

- ii) More exposed banks were obliged to adopt higher standards of corporate behaviour in order to manage their reputation risks, putting them at a disadvantage in the market
- iii) The purpose of the Equator Principles is to restore a level playing field by imposing an industry standard on all actors
- iv) Less exposed banks were forced to adopt the new standard because of the specific structure of the project finance market

Choice of standard and implementation

According to hypothesis 1, the optimal standard for banks would be the one defined as exposed banks' optimal response to their stakeholders' expectations, or, as a first approximation, to NGOs' expectations.¹⁰ The choice of the World Bank and IFC's Guidelines and Safeguard Policies would stem from this concern. This seems reasonable since NGOs have been the main advocates of these Guidelines and Policies within the WBG, and though they may consider them as insufficient, they still regard them as best practice in the industry.

The hypothesis allows us to make some prediction regarding outcomes in the implementation phase. Banks with high reputation risks have a keen interest to ensure success of the initiative. Unless they can show that the Equator Principles are effective in improving project design and operations, and in denying financing to bad projects, they will soon face high levels of reputation risk again.

There are reasons to believe that high reputation risk banks will be able to carry forward their co-operation into the implementation phase. In game theoretic terminology, implementation of the Equator Principles is an infinitely repeated game, where each sequence of the game consists in ensuring proper implementation of the EP in a new project. Participants in such games find it rational to co-operate as long as other players co-operate as well. Applying this general result to the EP would mean that high reputation risk EP banks would be ready to cover implementation costs as long as their peers do so as well.

By contrast, low reputation risk EP banks have no intrinsic interest in the EP, and thus no interest to ensure success of the initiative. While they are denied to finance bad projects by the

¹⁰ More formally: let N be the number of projects a bank finances, π^* average revenue per project, p and c respectively the probability and cost of a NGO-led campaign. Banks can invest in a technology S that screens projects for environmental and social risks, at level s , and a cost $q(s)$, increasing in s . N and p are decreasing functions of s . A bank will choose s as to maximise $R(s)=N(s). \pi^* - p(s).c - q(s)$.

specific structure of the market for project finance (syndication), they will not bear implementation costs, and should be expected to free-ride in this phase.

Hypothesis 1 therefore predicts a very different level of implementation across banks. The high reputation risk banks that have initiated the initiative should take concrete steps towards implementation as long as their peers do so as well. Other banks will take a back seat and not incur significant implementation costs. This difference across banks could explain why no clear monitoring and enforcement mechanism has been set-up.¹¹

3.2 Hypothesis 2: The Equator Principles serve to screen projects for social and environmental risks

Background

Large infrastructure projects often carry significant environmental and social risks that are not immediately observable to the banks¹². Environmental risks may have a direct bearing on project returns, when, for instance, the life-expectancy of a dam is shortened by unexpected ecological processes; and social risks, in the form of local resistance against unpopular projects, can delay construction and normal operations (e.g. attacks against pipelines).

These environmental and social risks thus pose a significant financial risk to lenders, specially given that project finance arrangements stipulate that lenders have little recourse beyond the revenues generated by the project itself. The collateral in these arrangements being lower than in normal credit transactions, credit risks are automatically higher, and there is a direct link between the social and environmental risks of the project and the credit risks borne by the lenders.

In order to manage these risks properly, banks would have to undertake costly, in-depth environmental and social risk assessments in their due diligence process. However, when screening exhibits economies of scale, and when project sponsors need the funds of several investors (which is typically the case in project financing), de-centralised screening (i.e. undertaken by each bank independently) may not be efficient. Diamond (1984) showed that delegation of

¹¹ We may add that it is probable, under this hypothesis, that the EP will be used to screen other financing schemes provided by banks, beyond project finance *stricto sensu*, as these other schemes will generate reputations risks as well.

¹² See Akerlof (1970) for the classic statement of the economic problem that arises from the interaction between unequal quality and uncertainty.

monitoring to a third-party is more efficient when the costs of delegation are less than the surplus gained from exploiting scale economies.

Consider the role played by the World Bank Group (WBG) (and other multilateral banks) in this light. The WBG screens all projects it finances according to strict social and environmental guidelines it has developed over the past decade. In doing so, it provides a public good for other lenders, and acts *de facto* as a delegated monitor. Furthermore, project sponsors can signal the high quality of their projects to commercial banks by securing WBG financing. However, the WBG is an imperfect delegated monitor since it does not review all large projects in emerging countries. If the fixed costs of screening are significant, commercial banks will not incur them to review projects the WBG (or other MDB) does not screen, with the implication that the market for project financing is limited by multilateral banks' level of activities. Consequently, the system will function only as long as the WBG and other multilateral banks sustain a large enough market for commercial banks¹³.

The novel element that would have triggered the Equator Principles resides precisely in the expected breakdown of this condition. Under pressure from NGOs and other stakeholders, the WBG and other multilateral banks may be forced to reduce significantly their engagement in large and controversial projects, thereby reducing the market for project finance (according to the logic laid down in the previous paragraph) and putting the financial industry under stress. A number of recent events did give credence to this threat. For instance, the WBG and other multilateral development banks were forced to pull out of such large projects as the Three Gorge Dam project in China, and the Narmada Valley series of dams in India. At a strategic level, the World Commission on Dams, the US Congress Metzler report, and the Extractive Industries Review recommended, for different reasons, that the WBG reduce its financing of large projects in emerging countries. If this happens, commercial banks would face the prospect of having to undertake the screening of social and environmental risks themselves.

¹³ One can advance another reason as to why the project financing market in emerging markets is limited by the level of engagement of MDBs. The quality stamp provided by the MDBs may lead to a credit rationing due to adverse selection effects, i.e. that sponsors of low quality projects are unable to raise funds even though they may be ready to pay higher prices for credit. The economic logic is that of Akerlof (1970)'s Lemons Principles: the rise of the price of credit to cover screening costs would bear on sponsors' decisions to seek WBG's engagement. As a consequence, lenders would "adversely select" projects which are, on average, more risky than what would correspond to the banks' proposed price for credit. Stiglitz and Weiss (1981) show that this effect may lead to project rationing in equilibrium.

The hypothesis

We are now in the position to formulate hypothesis 2. In the perspective of a possible retreat of the WBG from the financing of large infrastructure projects, the Equator Principles is an arrangement to screen the quality of projects (according to environmental and social risks) that shifts the main costs of the screening process onto project sponsors. The categorisation of projects in groups A, B, and C serves to identify those projects that need additional quality guarantees, and, when needed, sponsors are required to undertake EAs, formulate and implement EMPs, and consult with various stakeholders. Put in strategic management terms, the Equator Principles embodies a strategy the aim of which is to increase the profitability of the industry as a whole by reducing clients' bargaining power¹⁴.

The Preamble of the Equator Principles provides support to this hypothesis. Therein signatory banks declare that "[w]e believe that adoption of and adherence to these principles offers significant benefits to ourselves, our customers and other stakeholders. These principles will foster our ability to document and manage our risk exposures to environmental and social matters associated with the projects we finance...". But this allusion to risk exposure does not provide, in itself, a sufficient rationale for launching a collective self-regulation process such as the Equator Principles. It leaves two questions unanswered: What is the novel element that triggered the Equator Principles? Why do banks act collectively, rather than compete, to manage effectively their risk exposures to environmental and social matters? In our hypothesis, the novel element is the retreat of the WBG from its function as a delegated monitor; and the need for collective action arises from the inefficiency of decentralised screening and the gains to be reaped from imposing screening costs onto project sponsors.

Unlike hypothesis 1, hypothesis 2 does not explain why a specific group of banks took the lead in launching the initiative. Following Olson (1965), we may conjecture that the group was small enough and with sufficient interests at stake to act collectively. On the other hand, hypothesis 2 suggests a specific explanation for why other banks have been quick to embark on the initiative. But before we get to this, we must first address the question why project sponsors did not try to break the initiative at the outset – a question that echoes the question as to why less-exposed banks did not try to oppose the initiative when considered in the perspective of hypothesis 1.

¹⁴ According to Porter (1980), the intensity of this competition varies from an industry to another, and is the resultant of five competitive forces – threat of entry, threat of substitution, bargaining power of buyers, bargaining power of suppliers, and rivalry among current competitors.

Various explanations may be advanced. Firstly, sponsors may find it more difficult to organise collectively than banks. (Recall that the 25 banks that undersigned the Equator Principles represent 75% of the market). Secondly, sponsors would have had to struggle, not just against the 10 original signatory banks, but also against the leverage that these banks had given the specific nature of the industry, as we discussed under hypothesis 1. Finally, sponsors of high quality projects do not have the same incentives as sponsors of low quality projects. Sponsors whose projects abide by the Equator Principles can reduce the price of credit by working with all banks. The corollary is that sponsors who refuse to work with signatories of the Equator Principles send the signal that their project is of low quality.

This last point provides the other explanation as to why banks signed the Equator Principles. The corollary of the previous corollary is that non-signatory banks who would carry out in-depth reviews of projects outside of the Equator Principles framework would face a higher probability to find out that the projects they review is of lower quality than on average and cannot be financed. If they loose money in this way by screening low quality projects, they will eventually have an interest to join the Equator Principles initiative.

In summary, hypothesis 2 is based on the following basic assumptions and logic:

- i) Projects differ according to social and environmental risks
- ii) The screening of these risks is costly
- iii) Multilateral development banks (MDBs), particularly the World Bank Group, acted as a delegated monitor that allowed commercial banks to effectively address the problem arising from the lack of information about project quality
- iv) Banks expected a retreat of MDBs from key projects, with the consequence that they would have to cover the costs of screening projects for social and environmental risks
- v) The Equator Principles provide a mechanism to shift most of the costs of screening (and managing) these risks on project sponsors
- vi) Sponsors could not resist the initiative because
 - a. They are more atomised and cannot organise themselves collectively as easily as the banks
 - b. The specific structure of the project finance market reinforced the power of the ten original banks

- c. Sponsors of good projects have an interest to support the EP to signal the quality of their projects and thus reduce the price of credit

Choice of standard and implementation

Under hypothesis 2, the optimal standard banks would like to adopt is one which screens out projects that raise too high social and environmental risks. As with hypothesis 1, the IFC standard can be seen as a proxy of this ideal standard – although in this case there is no evident reason that justifies this choice.

Another difference between hypotheses 1 and 2 is that, under hypothesis 2, all banks have an interest in the success of the EP: all banks genuinely want their clients to bear the costs of managing social and environmental risks. In itself this does not, of course, alleviate the risk of free-riding.

Avoidance of free-riding in implementation may emerge as the outcome of rational decisions given banks' shared interest in the success of the initiative, and the fact that the issue of implementation arises recurrently with every new project (infinitely repeated game). However, because the number of banks involved in active implementation is higher than under hypothesis 1, the risk of defection is also greater. Furthermore, it is now unclear why banks would not agree to set-up a joint organisation to ensure monitoring and enforcement during the implementation phase, since this is widely seen as a necessary condition for industry self-regulation initiatives to be successful.¹⁵

3.3 Hypothesis 3: The Equator Principles serve to counter critics of large development projects

Background

Over the past years, NGOs, academics, and multi-stakeholder initiatives such as the World Commission on Dams and the Extractive Industries Review – both initiated by the World Bank – have challenged the hitherto prevailing view that properly designed large infrastructure projects promote sustainable development.

Consider the case of dams. In 1998, the World Bank and IUCN – a large environmental NGO – launched a multi-stakeholder initiative – the World Commission of Dams (WCD) – to review

¹⁵ Under this hypothesis, it is unlikely that the EP principles extend to other financing products banks provide. Here the advent of the EP is closely linked to the non-recourse nature of project finance.

the contribution of large dams to the development process, to put forward a framework to assess various options for the provision of water resources and energy services, and to develop acceptable criteria and guidelines for the building of dams. In its final report (World Commission on Dams (2000)), the WCD does not dismiss the possibility that large dams can be beneficial for sustainable development, but defines stringent conditions under which this will be the case. It notably draws attention to the importance of the policy framework, which must guarantee, among other things, public acceptance for key decisions, and the carrying out of a comprehensive assessment of available options to the building of dams.

The other main multi-stakeholder process assessing large development projects in developing countries, namely the Extractive Industries Review (EIR), reached a similar conclusion. The World Bank launched the EIR in 2000 to address the following question: “Can extractive industries projects be compatible with the [World Bank Group]’s goals of sustainable development and poverty reduction?”. Two years of consultations and research yielded this answer:

“ The Extractive Industries Review believes that there is still a role for the World Bank Group in the oil, gas, and mining sectors – but only if its interventions allow extractive industries to contribute to poverty alleviation through sustainable development. And that can only happen when the right conditions are in place. The three main enabling conditions are:

- pro-poor public and corporate governance, including proactive planning and management to maximize poverty alleviation through sustainable development
- much more effective social and environmental policies; and
- respect for human rights.” (Extractive Industries Review (2003), p.1; emphasis in original)

Like the WCD, the EIR thus insists on the importance of framework conditions to ensure that large infrastructure projects contribute to sustainable development. However well designed and implemented a project may be, it is unlikely that it will make a positive contribution to sustainable development unless these framework conditions are in place.

These recent debates challenge directly the adequacy of the IFC Safeguard Policies, and the World Bank and IFC Specific Guidelines – i.e. the criteria used by the Equator Principles – to guarantee that projects will contribute to sustainable development. The critical question is whether, on top of these criteria that apply to project design, considerations should be given to framework conditions, i.e. to issues related to the context within which projects are to be realised rather than to the projects themselves.

Commercial banks have a stake in these debates. A change in the World Bank Group's philosophy regarding large development projects may hurt them (i) by reducing the demand for such projects by developing countries (as the WBG plays a leading role in shaping development thinking and policies around the world), (ii) by leading to a disengagement of multilateral banks from large projects (and affect commercial banks according to the delegated monitor logic spelled out under hypothesis 2), (iii) and by increasing the risk of NGO-led public campaigns.

The hypothesis

Hypothesis 3 asserts that the purpose of the Equator Principles is to provide banks an entry into current debates on the sustainable development effectiveness of large projects. By adopting voluntarily the IFC standards, banks would become a stakeholder in discussions within the World Bank Group, and would use this position to resist any further upgrading of existing standards and defend the view that the legitimacy of a specific project should be considered independently of the adequacy of the framework conditions within which it is implemented.

The letter addressed to James Wolfensohn, President of the World Bank, by 11 signatories of the Equator Principles regarding the outcome of the EIR gives some credence to this hypothesis. The signatories present themselves as "important stakeholders of the World Bank Group ("WBG") by virtue of our adoption of the WBG Safeguard Policies and Sector Guidelines through the Equator Principles, and through our role as co-financiers with the WBG of projects in the extractive industries and other sectors". The point is made again in the last paragraph of the letter: "Should implementation of any EIR recommendations or other considerations require change to the Safeguard Policies or Sector Guidelines, we expect that the banks which have adopted the Equator Principles, as important stakeholders to the WBG, will be fully consulted in this process, given our role in the application of these Policies and Guidelines in our day to day business".¹⁶ The rest of the letter exposes the banks' position on the EIR. While they accept the EIR's recommendations that relate to project design and implementation – environmental, health and social policies related to a project; increased transparency on revenues paid to governments – they oppose the ones that relate to framework conditions:

¹⁶ The point is re-iterated in a subsequent letter addressed to Rachel Kyte, Director, Environment & Social Development Department, IFC, on December 14, 2004, in relation to the review of the IFC performance standards: "the revision of the Safeguard Policies is an unusual and unprecedented process for IFC because of the existence of the Equator Principles. IFC is not just setting new policy for itself but also potentially setting policy for project finance globally. (...) Therefore, the financial institutions want to work closely with IFC in an iterative fashion to ensure that the Performance Standards are appropriate for use by private-sector financial institutions as well as for IFC as a development institution'. Both letters are available on www.equator-principles.com.

“Setting as a precondition of WBG investment that countries already have robust governance criteria negates the concepts of progress and development (...) We are concerned about the EIR recommendations concerning “prior informed consent””.

Hypothesis 3 makes it clear why the Equator Principles had to be a collective process: only through such a process could the defence line of the industry – self-regulation – be presented in a credible manner. Less clear is why a group of banks took the lead in the process. As under hypothesis 2, we may conjecture that the stakes were sufficiently large and the initial group sufficiently small to trigger collective action. Furthermore, given the structure of the industry, the group could be confident that other banks would join in, thereby resolving the free riding issue.

In summary, hypothesis 3 is based on the following basic assumptions and logic:

- i) Recent debates and multi-stakeholder processes challenge the view that properly designed large infrastructure projects promote sustainable development
- ii) A change in the mainstream view about large projects may hurt banks:
 - a. by reducing developing countries’ demand for large development projects
 - b. by leading to a disengagement of WBG and other multilateral banks (see hypothesis 2)
 - c. by increasing the risks of NGO-led public campaigns
- iii) The Equator Principles provide banks an entry into the debates, and a way to resist the upgrading of standards in a way that would run against the banks’ interest
- iv) Other banks joined in the initiative because of the specific structure of the industry

Choice of standard and implementation

Hypothesis 3 is stronger than hypothesis 1 or 2 in explaining the choice of the IFC standard. While the choice of this standard does not match perfectly banks’ interests under the previous hypotheses, under hypothesis 3 it corresponds precisely to banks’ objective of getting engaged in current debates within the World Bank Group. As mentioned in the letter of the banks to Wolfensohn, “We [i.e. the banks] consider ourselves to be important stakeholders of the World Bank Group (“WBG”) *by virtue of our adoption of the WBG safeguard Policies and Sector Guidelines through the Equator Principles*” (emphasis added).

Unlike under the other two hypotheses, success of the Equator Principles according to hypothesis 3 does not require effective implementation. Its success resides, rather, in the capac-

ity to manage dissent against large infrastructure projects. This hypothesis suggests, therefore, that implementation will be very loose.

3.4 Synthesis

The hypotheses provide three different, logically consistent and plausible explanations for banks' adoption of voluntary standards in project finance. They are based on three different risks: reputation risk of NGO-led public campaigns; credit risk that stem directly from the environmental and social risks of projects; risk of a change in the dominant development philosophy that will reduce the demand for project finance.

Table 3: Synthesis of the three hypotheses

| | Hypothesis 1 | Hypothesis 2 | Hypothesis 3 |
|--|--|---|---|
| Basic assumption | Banks differ according to reputation risks | MDBs acted as delegated monitors to assess the environmental and social risks of projects | MDBs as agenda setters |
| Triggering factor | NGO led public campaigns against commercial banks | Retreat of MDBs from project financing under NGO pressure | Criticism of development effectiveness of large scale infrastructures |
| Objective of the initiative | Restore level-playing field within the industry | Enhance profitability of the industry | Enhance profitability of the industry |
| Leading banks' interest | High reputation risk banks defend their positions | Small group had sufficient interest at stake | Small group had sufficient interest at stake |
| Reasons for other banks to participate | Structure of project financing <i>de facto</i> imposes standard on all lenders | | |
| | | Increase probability of success of initiative | Increase probability of success of initiative |
| Rationale for standard chosen | To deflect NGO attacks | To ensure efficient management of social and environmental risks | To become a stakeholder in debates over role of projects in development |
| Need for implementation | Yes | Yes | No |
| Capacity to address free-riding in implementation | Yes among banks with high reputations risks (repeated games) Low for other EP banks | Medium (repeated games): why no joint organisation? | No |

These three hypotheses are not mutually exclusive. Rather they provide three different perspectives to understand banks' behaviour. In fact, a combination of hypotheses 1, 2, and 3, may provide the more plausible story line to explain the advent of the Equator Principles. The more likely triggering point was NGO-led campaigns which prompted a few high reputation risk banks to act. However, the reason as to why other banks so readily joined the initiative may be to defend the overall profitability of the industry in case of a retreat of MDBs by shift-

ing project screening costs onto clients, as envisaged under hypothesis 2,. Finally, the banks used the opportunity offered by the adoption of the Equator Principles to enter the intellectual debate on the role of large infrastructure projects in sustainable development.

4 Can the Equator Principles contribute to sustainable development?

The declared objective of the Equator Principles is to contribute to improving the quality of large development projects around the world, and ensure that they contribute, rather than undermine, sustainable development. In the Preamble of the Principles, signatory banks 'recognize that our role as financiers affords us significant opportunities to promote responsible environmental stewardship and socially responsible development'.

What is the issue at hand? For our purpose, and following Solow (1974) we define sustainability as the condition that the aggregate level of capital in society – comprising natural, physical (i.e. man-made), social, and human capital and assuming that these different forms of capital are perfectly substitutable – does not decrease over time. A large development project will generally create physical capital while often depleting natural and social capital. Such a project will make a positive contribution to sustainable development if its overall impact on the aggregate stock of capital is positive, i.e. if the value of the physical capital created outweighs the value of the environmental and social capital depleted. The ideal social planner whose aim is to promote sustainable development would decide to undertake only those projects that contribute positively to sustainable development in the above sense.

It is in the absence of this ideal social planner that the contribution of the Equator Principles must be assessed. To make a positive contribution, it will have to achieve two things: first, to set appropriate standards to screen projects; and second, to ensure effective implementation of these standards in practice¹⁷. The analysis developed in the previous section sheds some light on these two questions, in particular the former one. (We leave aside hypothesis 3 here, since the objective of the Equator Principles cannot be reconciled with the promotion of sustainable development under this hypothesis.)

¹⁷ If these two conditions are met, than the EP should lead to (a) an improvement in the quality of some projects (so that they meet the standards set), and (b) to the rejection of projects that cannot meet the standards by project finance banks. While this does not guarantee that bad projects will not be carried out through alternative financing schemes, it remains a necessary condition to ensure the effectiveness of the EPs.

Let us first assume, as in hypothesis 2, that banks launched the Equator Principles to screen projects for social and environmental risks. Can this be sufficient to align banks' commercial interests with the requirements of sustainable development?

In the frame of hypothesis 2, banks take into account environmental risks to the extent that they impact the project itself and generate credit risks. They thus disregard the overall impact that a project may have on a country's natural capital. For this reason, attention to environmental risks cannot be sufficient to align banks' commercial interest with sustainable development.

Similarly, banks will consider social risks to the extent that they create credit risks. In sufficiently open and democratic countries, social pressure against projects undermining sustainable development, damaging the environment, or harming specific groups, may indeed raise sufficient risks to align banks' interests with the broader objective of sustainable development. But these are situations in which one expects the state to function well and to have put in place binding standards on projects in the first place. By contrast, in countries where states fail to promote sustainable development and suppress local resistance against unpopular projects, social and related credit risks will be low and not sufficient to align commercial interests in the project with sustainable development.

In sum, if banks developed the Equator Principles to screen projects for social and environmental risks, the initiative will make only a limited contribution to the pursuit of sustainable development. The basic reason is that the initiative does not help to improve the policy framework conditions in the countries where projects are realised, the importance of which was underlined by both the World Commission on Dams and the Extractive Industry Review.

Let us now assume that hypothesis 1 is the correct one. Under this hypothesis, NGOs play a key role, and may be able to mitigate between banks' commercial interests and the objective of sustainable development. However, while their pressure bears on the behaviour of high reputation risk banks, it has little effect on low reputation banks. In this game, through the Equator Principles, high reputation risk banks become the unlikely allies of NGOs in the pursuit of the objective of disciplining low reputation risk banks – NGOs, to promote their own objectives, high reputation risk banks, to restore a level playing field in the project finance market.

The potential of the Equator Principles in contributing to sustainable development remains unclear under this hypothesis. It will notably depend on NGOs' specific objectives, on the level of reputation risk they create for both high reputation risk and less exposed banks, and on the strength of the alliance NGOs and EP banks will forge. (Let us note that two meetings be-

tween EP banks and NGOs have already taken place, in London in June 2004, and in Zürich in February 2005)

In further exploring this potential, we would have to shift perspective from looking at the Equator Principles as a one-shot response to specific micro-economic incentives –as we have done in this paper –, to looking at it as opening a space and launching a process for the re-
definition of the standards under which banks operate in interaction with their stakeholders¹⁸. The challenge is to facilitate an evolution of the standards towards those that would correspond to sustainable development – a standard that could emerge as a compromise between banks' commercial interests and NGO's environmental and social concerns – without undermining the capacity of mitigating free-riding before and during implementation.

5 Conclusion

This paper has presented different plausible explanations of the Equator Principles, assessed the potential of the initiative according to these different explanations, and explored the extent to which the initiative can make a significant contribution to the pursuit of sustainable development.

Whether motivated by considerations over reputation risks (hypothesis 1), or credit risks stemming from the existence of social and environmental risks at project level (hypothesis 2), the initiative is one step towards aligning banks' interest with the objective of sustainable development. The question is whether this step goes far enough. If hypothesis 2 is the correct one, as suggested by the Equator Principles document itself, the answer is, in general, negative. Indeed, under many circumstances in emerging countries, the proper management of credit risks offers no guarantee that projects will make a positive contribution to sustainable development.

The potential of the Equator Principles is, a priori, greater if hypothesis 1 is correct. This is due to the pivotal role NGOs play under this hypothesis. EP banks and NGOs should work closely together (i) to refine standards to be used by EP banks to ensure that projects do not undermine sustainable development, taking inspiration, for instance, from the work of the World Commission on Dams, and (ii) to device appropriate monitoring mechanisms that can ensure effective implementation of the standards by all banks. It is only through such a close and

¹⁸ Zadek (2004) illustrates with a number of examples this shift from one-shot responses to the launching of a process for the redefinition of standards under which companies operate. For a theoretical discussion, see Scherer and Palazzo (2004)'s concept of the corporation as a politicized actor.

appropriately oriented co-operation that the Equator Principles can evolve into an effective device for the promotion of sustainable development.

Calendar of adoption and justification thereof of the Equator Principles

| Banks | Type of banks | Country | Date of adoption | Justification of adoption |
|-----------------------------|----------------------|----------------|-------------------------|----------------------------------|
| ABN AMRO | Universal | Netherlands | June 4, 2003 | Set standard |
| Barclays | Universal | UK | June 4, 2003 | CSR |
| Citigroup | Universal | US | June 4, 2003 | Set standard |
| Crédit Lyonnais | Universal | France | June 4, 2003 | Set standard |
| Crédit Suisse First Boston | Universal | Switzerland | June 4, 2003 | CSR |
| HVB Group | Universal | Germany | June 4, 2003 | Set standards/ Value |
| Rabobank Group | Universal | Netherlands | June 4, 2003 | CSR |
| The Royal Bank of Scotland | Universal | UK | June 4, 2003 | Value/ CSR |
| West LB | Specialised | Germany | June 4, 2003 | n.a. |
| Westpac Banking Corporation | Universal | Australia | June 4, 2003 | Set standard |
| ING Group | Universal | Netherlands | June 23, 2003 | CSR |
| Royal Bank of Canada | Universal | Canada | July 21, 2003 | Risk management |
| MCC | Universal | Italy | July 29, 2003 | CSR |
| Dresdner Bank | Universal | Germany | Aug 18, 2003 | CSR |
| HSBC | Universal | UK | Sept 4, 2003 | CSR |
| Dexia | Specialised | France/Belgium | Sept 18, 2003 | CSR |
| Standard Chartered | Universal | UK | Oct 8, 2003 | CSR |
| Mizuho | Universal | Japan | Oct 27, 2003 | CSR |
| CIBC | Universal | Canada | Dec 3, 2003 | CSR |
| KBC | Universal | Belgium | Jan 27, 2004 | CSR |
| Bank of America | Universal | US | April 15, 2004 | CSR |
| EKF | Credit Agency | Denmark | May 14, 2004 | CSR |
| BBVA | Universal | Spain | May 18, 2004 | CSR |
| EIB | Specialised | Luxembourg | May 28, 2004 | |
| Unibanco of Brazil | Universal | Brazil | June 1, 2004 | CSR |

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