Social accountability and the finance sector: the case of Equator Principles (EP) institutionalisation
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CHAPTER 5: INTRODUCTION TO CASE FINDINGS

5.1 Introduction

The aim of this chapter is twofold. Firstly, it aims to introduce some “contextual” information about the Equator Principles (EP) case study “site” or domain i.e. where the EP phenomena “plays out”. This includes a discussion about the nature of project finance and the EP initiative. The objective is to “set the scene” for the case narrative on the EP institutionalisation process in the following chapters. Secondly, this chapter aims to briefly introduce the manner in which the case narrative chapters will be structured, in order to provide a “roadmap” for the discussion of the research findings.

5.2 An Introduction to Project Finance

There are many definitions for project finance, but the one that has been adopted by EPFIs, and will thus be the basis of further discussions below, is the following:

“Project finance is a method of funding in which the lender looks primarily to the revenues generated by a single project, both as the source of repayment and as security for the exposure. This type of financing is usually for large, complex and expensive installations that might include, for example, power plants, chemical processing plants, mines, transportation infrastructure, environment, and telecommunications infrastructure. Project finance may take the form of financing of the construction of a new capital installation, or refinancing of an existing installation, with or without improvements. In such transactions, the lender is usually paid solely or almost exclusively out of the money generated by the contracts for the facility’s output, such as the electricity sold by a power plant. The borrower is usually an SPE (Special Purpose Entity) that is not permitted to perform any function other than developing, owning, and operating the installation. The consequence is that repayment depends primarily on the project’s cash flow and on the collateral value of the project’s assets.” (Equator Principles II, 2006, p.1)43

Project finance deals are financed by both debt and equity, with an average ratio of 70% debt to 30% equity. Depending on the project, more than one type of debt provider may be involved, for example, a bank syndicate, multilateral agencies (e.g. World Bank, International Finance Corporation and regional development banks), bilateral agencies

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43 This is the definition for project finance found in the Basel II Capital Accord (2005).
(development agencies and export-import financing agencies) and/or Export Credit
Agencies (ECAs). Equity for projects is normally provided by the project sponsor(s)\textsuperscript{44} and
may be supplemented by equity raised in national and international capital markets
(Hoffman, 2008; Esty and Sesia, 2005). However, this research specifically focuses on the
nature and process of commercial bank lending to project finance deals through bank
syndication.

In contrast to other loan transactions, a project finance loan is non (or limited) recourse to
the project sponsor. This means there is “no potential liability to the project sponsor for the
debts or liabilities of an individual project. It would be \textit{non-recourse}” (Hoffman, 2008, p.5).
Here, the lender “receives as collateral, a security interest in all of the assets of the project
company\textsuperscript{45}” (Hoffman, 2008, p.78). However, in the case of project failure/loan default, the
lender has no recourse to the project sponsors’ possible portfolio of assets, as may occur in
normal commercial loans.

Hence, banks normally base their credit appraisals on the projected revenues from the
operation of the facility (project), rather than the general assets or the credit of the sponsor
of the facility. Any unexpected events that could lead to greater expense or less revenue
than anticipated by the bank, for example, unforeseen E&S risks, could result in project
failure. Therefore, project financing is designed to minimise such risks, as reflected in the
loan covenants for the borrower. Usually a “special purpose entity (SPE)” is formed to
“own” the project and to segregate it from the project sponsors’ other assets and non-project
related risks (Hoffman, 2008), thus making the SPE a “legally independent entity” (Esty
and Sesia, 2005, p.3). Project finance therefore represents a form of “off-balance sheet”
finance, meaning “project assets and liabilities do not appear on the sponsor’s balance
sheet” (Ibid).

Syndication is a typical financing structure for project finance as it spreads out the potential
risks associated with a project. An average project finance deal may have 10-15 banks

\textsuperscript{44} “The project sponsor is the entity, or group of entities, interested in the development of the project and that
will benefit, economically or otherwise, from the overall development, construction, and operation of the
project. It is sometimes called the developer. The project sponsor can be one company or a group of
companies” (Hoffman, 2008, p.71).
\textsuperscript{45} “The project company is the special-purpose entity that will own, develop, construct, operate and maintain
the project” (Hoffman, 2008, p.71). The project company is often called the “borrowing entity” (Ibid).
involved in the syndicate, including the “lead arranger”. The lead arranger agrees with the client to underwrite the loan, that is to retain a portion of it on its own books and to sell the remaining amount to other FIs, with the guarantee to the borrower that it will retain the entire loan if it cannot find buyers. This creates a syndication of banks that purchase the loan and thus provide debt financing for the project. “Second tier banks”, for example, smaller project financiers or emerging market banks, normally make up the majority of this syndicate of lenders (UK EPFI 1, Interviewee 2).

Within the syndicate there are a number of roles the banks may adopt. For example, the lead arranger may also act as the “Technical Agent” (UK EPFI 1, Interviewee 2), or “Engineering Bank”, which is responsible for “compliance with technical performance covenants and progress [and] coordinates with technical consultants and project engineers and reports this information to the bank group” (Hoffman, 2008, p.72). In addition, there is the “Facility Agent” or “Documentation Agent” (UK EPFI 1, Interviewee 2). This bank is “responsible for administration of the credit and the collateral. It coordinates loan drawdowns, monitors covenant compliance by the borrower, issues and receives notices to and from the borrower [and] polls the bank group [syndicate] members in situations in which a vote is required such as whether to declare a default” (Hoffman, 2008, p.72). Finally, there is also a “Security Agent” which is responsible for “holding security interests as an agent for the project lenders” (Hoffman, 2008, p.72). The lead arranger usually decides which bank adopts which role, and if there are two lead arrangers one normally becomes the technical agent and one the documentation agent.

A more detailed discussion about the project financing process (and the integration of the EP within this) is undertaken in Chapter Nine. The following section will now provide an overview of the EP.

5.3 The Equator Principles (EP)

The EP were launched by ten international commercial banks: ABN Amro, Barclays, Citigroup, Crédit Lyonnais (now Calyon), Credit Suisse First Boston, HVB, Rabobank,

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46 If there is more than one lead arranger, for example in very large or risky projects, they often agree to underwrite equal amounts (UK EPFI 1, Interviewee 2).
Royal Bank of Scotland, WestLB and Westpac, on June 4th, 2003, at the International Finance Corporation (IFC) headquarters in Washington, D.C. (EP Press Release, 2003). The Principles were designed as a set of voluntary environmental and social (E&S) risk management guidelines for project finance activities. Based on the then IFC safeguard policies, the original set of nine principles requested adopting FIs to apply them in their execution and management of project finance deals of $50 million dollars and upwards. Adopting FIs were to categorise projects as either “A” (high risk), “B” (moderate risk) or “C” (low risk) as per IFC classifications (See Appendix 4, Exhibit I) when financing a project. The original principles made no provision for EPFI reporting on their EP implementation (See Table 5).

On July 6th 2006, a revised version of the principles, Equator Principles II (EP II), was launched largely to mirror the new IFC performance standards launched earlier that year. The revised set of principles reduced the project threshold from $50 to $10 million and was now applicable to both advisory and direct financing of projects. The new principles also streamlined EP application for countries with existing high E&S standards, as well as making a new provision for their application to the expansion or upgrade of existing projects with significant E&S effects. In addition, social, as well as environmental, dimensions were now also to be included in project assessments, action plans and management systems. Furthermore, a new condition for the establishment of a project level grievance mechanism for project-affected communities and a legal compliance covenant were also incorporated (see Appendix 4 and Table 5). Finally, a new reporting principle, “Principle 10”, was established. This requested each adopting EPFI to report publicly, at least annually, on their EP implementation procedures and experiences, whilst taking client confidentiality into consideration (EP II, 2006; see Appendix 4). The differences between EP I and II are outlined in Table 5 below.

The “formal” existence of the EP comprises a document (i.e. Appendix 4) located on the EP website (www.equator-principles.com). The principles were originally designed for

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47 In February 2006 the IFC launched a new set of E&S Performance Standards (see Appendix 4/Exhibit III) to replace the former IFC E&S Safeguard Policies. The Performance Standards define E&S roles and responsibilities for industries and are accompanied by a set of Guidance Notes for further interpretation (IFC 2008; EP II, 2006, p. 9). The IFC is currently undertaking a new review and update of the Performance Standards, following three years of their implementation. It is yet to be seen what affect this will have on the existing EP.
discretionary implementation by individual EPFIs, with no specific adoption or “membership” requirements, and no formal internal or external accountability mechanisms to monitor compliance. Adoption was, and still is, primarily enabled through an official press release posted on the EP website.

While the application and implementation of the Principles is still discretionary, a new provision for EP reporting as the sole basis for continued EP membership was introduced in 2008. This means that the EP website now hosts a list of all EPFIs that have reported on their EP implementation as well as those that currently have not. The objective is to entice any “non-reporters” to produce a report in order to remain EPFIs. Failure to report would mean removal from the EPFI network.49 The EP “Secretariat”, 50 whose identity is not revealed on the EP website, is responsible for this “monitoring” of EPFI reporters51 as well as general website management.

An EP Management Structure was established in early 2008 and comprises of: (1) an EPFI Chair; (2) a Steering Committee of 14 EPFIs; and 3) seven Working Groups led by, and including, various EPFIs. The most recent management structure (as of April 2010) is depicted in Appendix 5. As of April 2010, there are 68 EPFIs from 27 countries, which operate in over 100 countries. These FIs include commercial banks, investment banks, export credit agencies (ECAs), an insurance organisation, a development bank and a clean energy investment firm. All are collectively referred to as Equator Principles Financial Institutions (EPFIs) and a list of current EPFIs is provided in Appendix 6. Commercial banks52 are however the main focus of this research.

The case findings chapters will now be introduced in the following section.

48 The EP initiative or the EPFI network is not a formal association; therefore the term “member” is used loosely by most EPFIs, as it is in this research.
49 A one-year grace period for EP reporting is applicable to new adopters.
50 An independent consultant employed by EPFIs, as confirmed by the EPFI Chair at the UNEP FI Global Roundtable in Cape Town, South Africa, October 2009, when questioned by this researcher.
52 Many of the commercial banks considered in this case research also have active retail, investment or asset management arms.
<table>
<thead>
<tr>
<th>Issue</th>
<th>Equator Principles I</th>
<th>Equator Principles II</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligible Parties</td>
<td>Equator Banks</td>
<td>Equator Principles Financial Institutions (EPFIs)</td>
</tr>
<tr>
<td>Financial Threshold</td>
<td>$50M US</td>
<td>$10M US</td>
</tr>
<tr>
<td>Object of Assessment</td>
<td>Projects only</td>
<td>Projects plus expansions and upgrades of projects if the E&amp;S impact of the expansion or upgrade is significant.</td>
</tr>
<tr>
<td>Scope of Activities</td>
<td>Lending</td>
<td>Lending plus advisory activities.</td>
</tr>
<tr>
<td>Scope of Assessment (For category A and B projects)</td>
<td>Environmental assessment (EA) only.</td>
<td>Environmental assessment plus social assessment (SEA).</td>
</tr>
<tr>
<td>Action Plan and Management System</td>
<td>Environmental Management Plan (EMP) for A and where appropriate B projects.</td>
<td>Action Plan (AP) and Management System for A and B projects.</td>
</tr>
<tr>
<td>Independent Expert Review</td>
<td>EA, EMP and consultation for category A projects.</td>
<td>SEA and AP compliance and consultation for category A and where appropriate category B.</td>
</tr>
<tr>
<td>Consultation (For category A and where appropriate category B projects).</td>
<td>In a structured and culturally appropriate way with project affected groups. Aim for broad community support for projects. EA and EMP to take account of consultations.</td>
<td>In a structured and culturally appropriate way with project affected communities. Prior informed consultation (not prior informed consent) for projects with significant adverse impacts. Consultation process and results to be documented in AP.</td>
</tr>
<tr>
<td>Grievance Procedures</td>
<td>No requirement.</td>
<td>New requirement for borrower to establish grievance procedure for project affected communities throughout the project life cycle</td>
</tr>
<tr>
<td>Annual Reporting Obligations</td>
<td>No requirement.</td>
<td>New requirement for at least annual reporting by EPFI</td>
</tr>
<tr>
<td>Legal Compliance Covenants</td>
<td>No requirement.</td>
<td>New requirement for borrower to comply with local, state and host country E&amp;S laws, regulations and permits in all material respects.</td>
</tr>
<tr>
<td>Action Plan Compliance Covenant</td>
<td>Borrower to comply with EMP.</td>
<td>Borrower to comply with AP (where applicable) in all material respects.</td>
</tr>
<tr>
<td>Reporting Compliance Covenant</td>
<td>Borrower to provide regular reports on compliance with EMP.</td>
<td>Borrower to provide regular reports of compliance with AP and host country laws, regulations and permits.</td>
</tr>
<tr>
<td>Decommissioning Covenant</td>
<td>Borrower to decommission facilities in accordance with Decommissioning Plan, where applicable.</td>
<td>Same as EP I.</td>
</tr>
<tr>
<td>Remedial Steps to Remedy Covenant Breach</td>
<td>Lender to engage with borrower to remedy non-compliance with covenants if borrower in default.</td>
<td>EPFI reserves rights to exercise remedies for non-compliance or default; and discretion to work with borrower on covenant compliance.</td>
</tr>
<tr>
<td>Appointment of Independent Expert</td>
<td>Lender discretion to appoint independent environmental and/or social expert, or borrower to retain qualified and experienced external experts to verify its monitoring information for EPFIs over life of loan.</td>
<td>EPFI to require appointment of independent environmental and/or social expert, or borrower to retain qualified and experienced external experts to verify its monitoring information for EPFIs over life of loan.</td>
</tr>
</tbody>
</table>

(Adapted from Watchman et al., 2007; Equator Principles I, 2003; Equator Principles II, 2006)
5.4 Brief Introduction to Case Findings

The case study narrative on the EP institutionalisation process is structured over the proceeding four chapters as follows.


Having discussed EP institutionalisation over societal, organisational field and organisational levels between 2003 and 2008 in Chapters Six to Eight, Chapter Nine conducts an in-depth analysis of EP institutionalisation at EPFI intra-organisational level i.e. through the actual project finance process. The objective is to evidence the EP as a fully “accepted” or institutionalised facet of project financing for EPFIs. In doing so this chapter also attempts to extend the Dillard at al. (2004) framework to intra-organisational level (see Figure 8 below). Throughout Chapters Six to Nine the effects of the EP institutionalisation process on EPFI social accountability will be discussed, highlighting how EP accountability processes affected, and were effected by, EP institutionalisation between 2003 and 2008. Figure 7 presents an overview of the case narrative in diagrammatic form.
Throughout the case narrative EPFI and NGO interviewee perspectives are drawn upon to “illuminate” the complexity of the EP institutionalisation process, while broader EP stakeholder perspectives are also incorporated into Chapter Nine. In doing so, the Dillard et al. (2004) model is used, and expanded upon, as a conceptual guide to explain interviewee perspectives on the emergence and evolution of the EP institutionalisation process over socio-economic and political, organisational field, organisational and intra-organisational levels. Here, EP institutionalisation is portrayed as a structuration process through an in-depth discussion of the iterative and recursive dynamics between EP related structures (signification, domination and legitimation) and EP agents; as mobilised through the interaction between daily EP criteria and practice; and manifested in the emergence and “acceptance” of the EP as the institution/standard for more responsible project finance. To help guide this discussion, the Dillard et al. (2004) model is included once more in Figure 8.
5.5 Chapter Summary
Firstly, this chapter introduced some “contextual” information on the EP case study “site” i.e. the nature of project finance and the EP, in order to “set the scene” for the case narrative on the EP institutionalisation process in the following chapters. Secondly, this chapter briefly introduced the manner in which the case narrative is structured in order to provide a “roadmap” for the discussion of the research findings.