Environmental Risk Management

Sustainable Finance: Opportunities and Challenges
Environmental and Social Credit Risk
May 21, 2008
“No matter how competitive you are and how globally you trade, if you are environmentally irresponsible someone can, and will—and should—padlock your door.”

A McKinsey & Company interview with former Dow Chemical CEO and Chairman, Frank Popoff
DEFINITION

_Environmental and Social Risk Management (ESRM) can be defined as the conscious and coordinated effort in appraising the potential and/or existing impact of various productive activities on their environment and people._
Who are the stakeholders?

- Employees
- Customers
- Suppliers
- Competitors
- Community
- NGOs
- Media
- Customs
- Environmental Regulators
- Health Regulators
- Labor Regulators
- Rating Agencies
- Insurers
- Lenders
- Bank Regulators
- Depositors
- Shareholders
What are they interested in … ?

- Biodiversity
- Environmental quality
- Public health and safety
- Worker health and safety
- Major hazards
- Site contamination
- Child labor
- Indigenous peoples
Why bother … ?

- **Ethics** *(Because we should)*
- **Regulations / Liability** *(Because we have to)*
- **Bottom Line** *(Because if we don’t it will cost us money and, moreover, there is an opportunity here)*
Sectors most at risk …

<table>
<thead>
<tr>
<th>Wood processing</th>
<th>Dairy</th>
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<tbody>
<tr>
<td>Fisheries</td>
<td>Coffee, tea</td>
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<tr>
<td>Tuna</td>
<td>Flowers</td>
</tr>
<tr>
<td>Bananas</td>
<td>Diamonds</td>
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<tr>
<td>Textiles</td>
<td>Mining (gold, coal, iron ore, copper)</td>
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<tr>
<td>Pulp and paper</td>
<td>Oil and gas</td>
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<td>Fur products</td>
<td>Petrochemicals</td>
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<tr>
<td>Nuclear</td>
<td>Mobile phones</td>
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<td>Hydropower</td>
<td>Shrimp</td>
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<tr>
<td>Tourism</td>
<td>Tanneries</td>
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<tr>
<td>Asbestos mining</td>
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<td>Asbestos construction</td>
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Linking Sources and Impacts …

- **Dry Cleaners**
  - Pollutants: Solvents/Spillage
  - Impact: Contamination of Soil and Water

- **Vehicle Repair Shop**
  - Pollutants: Oil, Grease and Solvents
  - Impact: Contamination of Soil and Water

- **Fossil Fuel Energy Production**
  - Pollutants: CO₂, NOₓ, Acid Rain
  - Impact: Global Warming

- **Banana Plantation**
  - Pollutants: Fungicides / Pesticides
  - Impact: Contamination of Soil and Water
Bankers: Risks and Opportunities
Environmental issues for bank clients ...
Environmental issues for clients become issues for the bank …

**Issues for Bank**
- Equity Cost \(\uparrow\)
- Asset Cost \(\uparrow\)
- Operating Expense \(\uparrow\)
- Market Share \(\downarrow\)
- Impaired Assets \(\uparrow\)
- Legal Liability \(\uparrow\)
- Reputation \(\downarrow\)

**Opportunities for Bank**
- Improved Efficiency
- Cost Savings
- New Market Opportunities

**Impact on the Bank**

**FINANCIAL**
- Loan Repayment
- Asset Value
- New Business

**LEGAL LIABILITY**
- Damages
- Cleanup

**REPUTATION**
- Improvement in Reputation and Profitability
Risks to your client …

- **START UP**
  - Obtaining Permits
  - Contract Delays

- **OPERATIONS**
  - Plant Closure
  - Plant Downtime
  - Civil Liability
  - Criminal Liability
  - Public Protests

- **SALES**
  - Loss of market share
  - Product Liability
  - Product Boycott

- **WORKERS**
  - Health
  - Safety
  - Exposure
Risks to your client may be horizontal or vertical

**Horizontal Causes**
Your client is not alone

- Sectoral regulators
- Regional regulators
- Broad multi-sectoral issues

**Vertical Causes**
Your client is affected in a chain

- Vertical integration
- Supply and distribution chains
- SME impact

The result could be non-performing loans …
Risks to the Banking Institution …

- **CREDIT**
  - Default
  - Rescheduling

- **EQUITY**
  - Fall in Share Price

- **SECURITY**
  - Shortfall in Collateral

- **FUNDING**
  - Access
  - Cost of Funds

- **LEGAL**
  - Potential transfer of liability from borrower to Lender

- **REPUTATIONAL**
  - National / International
Effects on the bank’s franchise ...

- **Shareholders**: withdrawal or resolutions
- **Raters**: watch notices
- **Analysts**: downgrades
- **Central Bank Regulators**: increased supervision, conditions
- **IFIs**: withdrawal of funds, reduced terms
- **Lenders**: withdrawal of funds, reduced terms
- **NGOs/Consumers**: boycott of products and investment
- **Co-financiers**: liabilities for negligence and misrepresentation
- **Insurers**: reduced coverage and increased cost
CITI Environmental and Social Risk Management Policy (ESRMP)
PURPOSE

Citi’s goal is to be the world’s most respected financial services company, committed
to conducting business in an environmentally and socially responsible manner,
consistent with our goal of being a good corporate citizen, sensitive to the
communities in which we do business.

EQUATOR PRINCIPLES

Citi was instrumental in launching, and subsequently adopting, the Equator

These principles are a voluntary set of guidelines and benchmarks for the financial
industry to manage social and environmental issues in project financings, and are
based on the policies and guidelines of the International Finance Corporation (IFC).
SECTOR BASED STANDARDS

• SUSTAINABLE FORESTRY

• NUCLEAR RELATED TRANSACTIONS

• CLIMATE CHANGE POSITION

• HUMAN RIGHTS POSITION
SHARED RESPONSIBILITIES

Implementation is a shared responsibility:

• ESRM Approvers.

• ESRM Director & Unit - providing technical support & counsel.

• Transactors (Bankers) – ensure compliance with approval, analysis, documentation and categorization of transaction.

• Risk Officer/Portfolio Banker – confirms categorization and monitoring
ESRM SCREENING AND CATEGORIZATION CRITERIA

Based on the type and magnitude, impending transactions are subjected to ESRM screening to appraise their potential environmental and/or social risk.

ESRM Categorization:

- **CATEGORY A** – use of proceeds are likely to have potential significant adverse social or environmental impacts that are diverse, irreversible or unprecedented

- **CATEGORY B** – use of proceeds are likely to have potential limited adverse social or environmental impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures

- **CATEGORY C** – use of proceeds expected to have minimal or no social or environmental impacts.
PRECLUDED ACTIVITIES

- Precluded Activities are activities and/or transactions that involve adverse social or environmental impacts of such a serious nature that Citi cannot and will not execute such transactions.

- Activities, or Transactions, that involve significant conversion or degradation of a critical habitat; and Activities, or Transactions, that utilize forced labor or harmful child labor.
AREAS OF HIGH-CAUTION AND SPECIAL FOCUS

- Critical Habitat and Areas of High Conservation Value
- Areas of Significant Cultural Heritage and Value
- Indigenous people
- Large-scale resettlement
ESRM MANAGEMENT

• Independent review: this involves the engagement of an independent social and environmental expert (not associated directly to the borrower). He will report to Citi on the clients ESRM status and compliance to equator principles.

• Client commitment and Capacity: here there is need to substantiate the client’s commitment and capacity to address their ESRM issues. This serves as mitigant to potential adverse environmental and social issues.

• External Reporting on ESRM Policy implementation: this is a commitment to report on Citi’s ESRM issues annually to external stakeholders and the public
Environmental management of bank clientele …

Credit Review Cycle

Identification

Screening

Appraisal

Formal Approval

Negotiation

Disbursement

Supervision

Credit and Environmental Review

Sales / Risk Management

Informal risk review feedback
Environmental categorization

Environmental review
Full credit appraisal
Term sheet preparation

Loan contract negotiation

Credit / Legal / Marketing / Operations

Credit / Environmental
Environmental reviews …

OBJECTIVE

To ensure that all projects include adequate provision for actions and costs necessary to prevent, control and mitigate negative impacts on the environment and to improve environmental quality.
Environmental reviews (cont.) …

- Assessment of baseline environmental situation
- National regulatory and standards compliance
- Sustainable use of natural resources
- Pollution controls (liquid effluents and air emissions) and solid and chemical waste management
- Use of dangerous substances
- Major hazard analysis
- Occupational health and safety
- Fire and life safety
- Protection of human health, cultural properties, tribal peoples, endangered species and sensitive ecosystems
- Resettlement issues
Environmental audit outputs …

- Project description
- Regulatory framework and standards
- Areas of concern

- Mitigation measures
- Corrective action plan with estimate of costs
- Annexed documentation
Environmental Health and Safety Guidelines Published by The IFC

1. Airports
2. Ceramic Tile Manufacturing
3. Construction Materials Plants
4. Electric Power Transmission and Distribution
5. Fish Processing
6. Food and Beverage Processing
7. Forestry Operations; Logging
8. Gas Terminal Systems
9. General Health and Safety
10. Geothermal Projects
11. Hospitals
12. Life & Fire Safety (L&FS)
13. Office Buildings
14. Offshore Oil & Gas
15. Polychlorinated Biphenyls (PCBs)
16. Pesticide Handling and Application
17. Plantations
18. Port and Harbor Facilities
19. Rail Transit Systems
20. Roads and Highways
21. Telecommunications
22. Tourism and Hospitality
23. Development
24. Wildland Management
25. Wind Energy Conversion Systems
26. Wood Products Industries
27. Waste Management Facilities
28. Wastewater Reuse
1. Aluminum Manufacturing
2. Base Metal and Iron Ore Mining
3. Breweries
4. Cement Manufacturing
5. Chlor-Alkali Plants
6. Coal Mining and Production
7. Coke Manufacturing
8. Copper Smelting
9. Dairy Industry
10. Dye Manufacturing
11. Electronics Manufacturing
12. Electroplating Industry
13. Foundries
14. Fruit and Vegetable Processing
15. General Environmental Guidelines
16. Glass Manufacturing
17. Industrial Estates
18. Iron and Steel Manufacturing
19. Lead and Zinc Smelting
20. Meat Processing and Rendering
21. Mini Steel Mills
22. Mixed Fertilizer Plants
23. Monitoring
24. Nickel Smelting and Refining
25. Nitrogenous Fertilizer Plants
26. Oil and Gas Development (Onshore)
27. Pesticides Formulation
28. Pesticides Manufacturing
29. Petrochemicals Manufacturing
30. Petroleum Refining
31. Pharmaceutical Manufacturing
32. Phosphate Fertilizer Plants
33. Printing Industry
34. Pulp and Paper Mills
35. Sugar Manufacturing
36. Tanning and Leather Finishing
37. Textiles Industry
38. Thermal Power Guidelines for New Plants
39. Thermal Power Rehabilitation of Existing Plants
40. Vegetable Oil Processing
41. Wood Preserving Industry