Environmental Risk Management in Corporate Lending

Sustainable Finance in Turkey

Istanbul 22 January 2009
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Bank Austria was created in 1991 due to the merger of Zentralsparkasse and Österreicherische Länderbank.

Merger history of Bank Austria:

- **2007**: Direct subsidiary of UniCredit
- **2005**: Member of UniCredit Group
- **2002**: Full merger of Bank Austria and Creditanstalt to form BA-CA
- **2001**: Member of HVB Group
- **1997**: Acquisition of Creditanstalt
- **1991**: Merger of Zentralsparkasse and Länderbank to form Bank Austria
REGIONAL COMPETENCE OF BANK AUSTRIA FOR CEE WITHIN UNICREDIT GROUP

2,623 outlets
23 million customers
€ 147 bn combined total assets of UCG in CEE

Bank Austria country responsibilities

Current presence:
- Austria
- Azerbaijan
- Belarus
- Bosnia-Herzegovina
- Bulgaria
- Croatia
- Czech Republic
- Hungary
- Kazakhstan
- Kyrgyzstan
- Macedonia
- Montenegro
- Romania
- Serbia
- Slovakia
- Slovenia
- Estonia
- Latvia
- Lithuania
- Russia
- Turkey
- Ukraine**

Countries without existing units:
- Albania
- Armenia
- Cyprus
- Georgia
- Moldova

* under management of UniCredit
** recent acquisition Ukrsotsbank under management of Bank Austria
Environmental Risk Management in the Context of Responsible Business Practices (CSR, Sustainability)

CABERNET

Environmental risk Management

NGO/ Stakeholder-dialogue

Memberships

Lending/ Real estate Financing

Brownfields revitalisation

Responsible business practices

Asset Management

Social Responsibility

Sustainability Report

Sustainable Banking Operations
Integrity Charter of the UniCredit Group

- It sets out the **principles** that should **direct and guide us in our daily business**
- It provides a **framework of values**
Further voluntary and legal Commitments

- **Sustainability/CSR/ERM**
- **Project financing**
  - World Bank Standards
  - Equator Principles
- **Export Financing**
  - OECD
  - OeKB (Austrian ECA)
- **Global Compact**
- **Environmental Risk = Credit Risk – soft facts**
- **Reputation risk**

CEE-Task Force

OECD Common Approaches on Environment and Officially Supported Export Credits

Integrity Charter

Sector Policies:
- Nuclear
- Arms
- Dams

Basel II
Commitment due to international conventions

**indirect**

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- EU- Directives
  - VOC
  - SEVESO II
  - EU Environmental Liability Directive
  - Directive on Waste Electrical and Electronic Equipment (WEEE)
  - REACH: Registration, Evaluation and Authorization of Chemicals
  - Kyoto Protocol
    - Emissions Trading
    - Climate Change Risk
  - JI-Projects
  - CDM-Projects

**direct**

- The European Union Green Paper: "Promoting a European Framework for Corporate Social Responsibility"
- BASEL II
  - International Convergence of Capital Measurement and Capital Standards
- EMAS II: Annex VI 6.3
  - Indirect environmental aspects:
    - Capital investments
    - Lending
    - Insurance services
Environmental risks in Lending Operations

- Environmental risks
  - Potential costs and liabilities for bank clients that operate in environmentally sensitive industries

- Financial implications
- Environmental impacts

- Direct Risk
  - Polluter pays e.g.
    - Bank as owner or operational control

- Indirect Risk
  - Impact of environmental regulations on our customers

- Reputation Risk
  - Government, regulators, NGO’s and media scrutinise our lending policy
Sources of Environmental Risk

- **Customers current operation, environmental practices and historical use of the site:** old fashioned production systems, used materials, deposits, and storage and waste of hazardous materials, asbestos, bulk gases (propane, butane, carbon dioxide, nitrogen, ammonia)

- **Environmental Laws and Regulations**
  - **Costs:** Punitive fines or charges, environmental taxes, EMS, environmental monitoring
  - Revocation of operating permits, licenses or consents
  - Administrative orders or injunctions requiring a cessation of polluting activities
  - Remedial actions designed to restore polluted property to its former condition

- **Obsolescent technology**

- **Border area** contains NATURA 2000 sites faces a risk of environmental pollution (due to stronger emissions limits for protected areas)

- **Accidents, natural hazards, natural disaster** (site or the border area)

- **Reputation Risk:** Community concerns, public opposition against projects viewed as to have a significant adverse effect on living and working conditions in their localities

- **Social Risks:** behaviour and actions of the employees operational risk

- **Customer supply chain standards**

- **Changing end consumer preferences** in favour of more environmentally friendly products and services (poor environmental image of collaterals decreasing in value) or obsolete products costs (switching to greener raw materials and products)

*These risks can even lead to liquidation and foreclosure* → environmental risk = credit risk
Basel II- International Convergence of Capital Measurement and Capital Standards

Clause 510
- The bank must appropriately monitor the risk of environmental liability arising in respect of the collateral, such as the presence of toxic material on a property.

Clause 518
- The bank must maintain a continuous monitoring process that is appropriate for the specific exposures (either immediate or contingent) attributable to the collateral to be utilised as a risk mitigant. This process may include, as appropriate and relevant, ageing reports, control of trade documents, borrowing base certificates, frequent audits of collateral, confirmation of accounts, control of the proceeds of accounts paid, analyses of dilution (credits given by the borrower to the issuers) and regular financial analysis of both the borrower and the issuers of the receivables, especially in the case when a small number of large-sized receivables are taken as collateral. Observance of the bank’s overall concentration limits should be monitored. Additionally, compliance with loan covenants, environmental restrictions, and other legal requirements should be reviewed on a regular basis.

- BASEL II has been implemented in the EU Directive 2006/48/EC
Environmental Risk

- Operations & processes
  - Industrial sector: indicator of potential environmental risk
  - Sector specific questionnaire

- Land & liability
  - Contamination may arise
    - From the borrower's processes
    - From past industrial uses
    - By migration from adjacent contaminated land

- Environmental impact on
  - Air, water, noise
  - Punitive charges to restore the environment (exceeding permitted values for emissions conflicts with neighbours, warranties)

- Environmental Management
  - Environmental Due Diligence
  - Legal compliance (current & anticipated laws)
  - ISO 14001, EMAS...???
  - Others? Voluntary commitments (e.g. Ecotourism?)

Identification
Assessment
Management
Risk Identification and Assessment Tools in Unicredit Bank Austria

- **Information** – obtain, dissemination
  - *External* (Internet research, technical journals – *environmental*, *legal* and market research)
  - *Internal* (provide credit officers with gained information, sector specific questionnaire, checklists. These checklists are updated as required to reflect changing regulatory requirements and regional operating contexts.)

- **Education** – obtain, dissemination
  - *External* (Courses like ESRA, Climate Change and *national Law*)
  - *Internal* (Environmental Desk provides Training & awareness raising programmes to the risk managers and credit officers)

- Consideration in the **credit application form**

- **Integrate environmental risk into credit appraisal processes (internal RATING)**
  - Credit worthiness- also in accordance with BASEL II:
    - Warning signals → environmental credit risk
    - In overruling → EMAS, ISO 14001 (positive aspects, upgrading)

- **Site inspection, interview** with key site personnel owners and operators, review of permits and licences, review of public and private records of the local physical environment, geographic studies, worker health issues, suspect site inventories…

- Co-operation with **external experts, lawyers and consultants**: physical sampling and analysis to confirm or deny the existence and if any the degree of contamination or pollution, Environmental Due Diligence, Environmental Impact Assessment, feasibility survey…

- **Policies**: Environmental issues is part of the credit policies (ethical values)
Risk Assessment versus Risk Management and Decision Making

- **Risk assessment:**
  is the process evaluating the likelihood of an adverse effect. Risk assessment does not determine what level of risk is allowable or acceptable.

- **Risk Management:**
  Determining what we will be allowed or accepted is a part of Risk Management

- **Decision Making - Risk-Benefit Analysis**
  Balancing costs and benefits is also a very important factor in decision making. 
  Risk-Benefit Analysis: to measure or quantify the level of risk and the level of benefit associated with a particular regulatory decision.

Balancing costs and benefits, cost effectiveness, driving forces of the project, future use, economic viability, involving stakeholders, managing uncertainties, feasibility study, legal framework and sustainable development are important issues in the risk management in corporate lending.
Risk alleviation

Bank:
- Environmental assessment, due diligence, environmental impact assessment
- Consulting environmental lawyers and engineering experts
- Avoiding delay (additional costs: new regulatory changes)
- Additional assurances, indemnification, escrows
- Diversification
- Covenants in contracts and agreements, environmental clauses, assignments about liability, cost sharing, diversification, adequate compliance with laws

Customer:
- Decontamination in accordance with regulations
- Reduce noise level
- Encapsulate the waste gas ventilations fans
- Removal of toxic waste by well-known waste disposal company
- New waste gas filter unit
- Low-NO\textsubscript{x} burner in the boiler
- Risk transfer → Insurance (accident, disaster), recovery planning
- Social: employees → motivation, satisfaction; health and care education
Additional Assurances

- Ask for another mortgage, inventory and equipment
- **Cash flows**, personal guarantees, insurance products
- **Constructing** the buildings in several phases to make funds available for the latter phases
- **Subdividing into smaller parcels** (while the seller cleans up the contaminated section, the buyer can redevelop the clean parcels)
- Agreements in the purchase contract (seller-buyer)
- **Joint-ventures** (seller has a share in the financial returns from the redevelopment)
- **Purchase options**: buyer holds the right to purchase the property, but does not take title until the site is clean
How to check out environmental risks e.g. contamination

Loan Application

1st phase: general investigation
- Possible site contamination (historical and current site review) *
- Risk in industry branch and surrounding area – current zoning -
  industrial, residential, recreational, agricultural, vacant?

Suspicion?

2nd phase: in-depth interview
- Eco-technical aspects
  - Environmental profile of the customer (awareness)
  - Environmental assessment of the property? Extent of contamination
  - Insurance coverage
- Investments (intended use-, technical status)
- Environmental management (implemented? Legal compliance?)

3rd phase: in-depth investigation
- Detailed risk assessment by internal and/or external professionals.

Loan assessed according to environmental risk status, costs & liabilities
Costs and Risks in case of Contamination

- **Costs:**
  The **mere suspicion** can increase the loan transaction **costs**: Information, EDD, environmental site assessment, removal of the contaminated soil, ornamental planting-backfill, demolition or renovation,…

- **Risks (legal and financial):**
  - **Liability risk**
  - **Claims** by third parties, restriction of the rights of use
  - **Cleanup costs liability** (even if borrower is not the polluter)
  - **Collateral risk:** if we have to **foreclose** at a later date: lower value of our collateral or lose the full collateral value
  - Will the full **economic potential** of site reuse be **achieved**?
  - **Market risk:** Demand of properties, viability of the revitalisation project
IFC classifies the proposed project into one of three categories, depending on the type, location, sensitivity, and scale of the project and the nature and magnitude of its potential environmental impacts, as follows:

- **Category A:** A proposed project is classified as Category A if it is likely to have significant adverse environmental impacts that are sensitive, diverse, or unprecedented. These impacts may affect an area broader than the sites or facilities subject to physical works;

- **Category B:** A proposed project is classified as Category B if its potential adverse environmental impacts on human populations or environmentally important areas — including wetlands, forests, grasslands, and other natural habitats — are less adverse than those of Category A projects. These impacts are site-specific, few if any of them are irreversible, and in most cases mitigative measures can be designed more readily than for Category A projects;

- **Category C:** A proposed project is classified as Category C if it is likely to have minimal or no adverse environmental impacts. Beyond screening, no further EA action is required for a Category C project.
EDD (environmental Due Diligence) and Risk management e.g. Renewable Energy Projects

- **Regulatory framework** including national regulations, international standards, and good practice guidelines.
  - **Existing laws** and regulations that currently affect the project
  - **Anticipated laws** and regulations that may change the conditions of the project. (Turkey’s EU membership)

- **Environmental appraisal of the project**
  - Assessing the **environmental risk**
  - Determining **mitigation measures**;
  - estimating the **cost of risk**
  - **management**; and reporting the results

- **Monitoring** the project after approval
  - to ensure that the project sponsor complies with the applicable environmental standards included in legal agreements;
  - to keep track of ongoing environmental impacts associated with project operations and of the effectiveness of any mitigation measures.
Checklist for Environmental and Social Risk Assessment of a Wind Energy System

- Effluent emissions, on-site contamination, hazardous materials issues
- Biodiversity protection issues
  - Habitat damage from plant-construction activities
  - Bird strikes and disturbance
  - Habitat damage from generation activities
- Worker health and safety issues
  - Accidents from plant construction activities
  - Accidents from generation activities
- Environmental issues sensitive to public opinion
  - Land use
  - Noise emissions
  - Visual impacts
  - Electromagnetic interference
  - Accidents involving the public
  - Local community approval
  - Air traffic safety
  - Shadow casting and shadow flickering (proximity to roads and residences)
Example for EU-chemical regulatory framework: REACH

- REACH is the Regulation for Registration, Evaluation, Authorisation and Restriction of Chemicals.
- REACH places greater responsibility on industry to manage the risks that chemicals may pose to the health and the environment.
- In principle REACH applies to all chemicals: not only chemicals used in industrial processes but also in our day-to-day life, for example in cleaning products, paints as well as in articles such as clothes, furniture and electrical appliances.
- All manufacturers and importers of chemicals must identify and manage risks linked to the substances they manufacture and market. For substances produced or imported in quantities of 1 tonne or more per year per company, manufacturers and importers need to demonstrate that they have appropriately done so by means of a registration dossier, which shall be submitted to the ECHA (European Chemical Agency).
- Once the registration dossier has been received, the Agency may check that it is compliant with the Regulation and shall evaluate testing proposals to ensure that the assessment of the chemical substances will not result in unnecessary testing, especially on animals.
REACH will affect exporters, importers, manufacturers, downstream users in the EU and in other countries

- Where appropriate, authorities may also select substances for a broader substance evaluation to further investigate substances of concern.
- REACH also foresees an authorisation system aiming to ensure that substances of very high concern are adequately controlled, and progressively substituted by safer substances or technologies or only used where there is an overall benefit for society of using the substance. In addition, EU authorities may impose restrictions on the manufacture, use or placing on the market of substances causing an unacceptable risk to human health or the environment.
- Manufacturers and importers must provide their downstream users with the risk information they need to use the substance safely. This will be done via the classification and labelling system and Safety Data Sheets (SDS), where needed.
Example for Sector specific (shipping companies) regional and international regulatory framework

Shipping – Sustainability & Corporate Social Responsibility:

- Climate change, carbon dioxide emissions and energy efficiency:
  The European Commission has announced that it will draft legislation aimed at tackling the shipping industry’s rapidly growing contribution to climate change, by including the sector in Europe’s carbon dioxide cap-and-trade system.

- The treatment of employees such as seafarers

- Operational performance and safety:
  - discharges of oil, chemical cargo residues, garbage and cleaning agents, anti-fouling paint, exhaust and other air emissions and non-indigenous species from ballast water have an ongoing adverse impact on life in the world’s seas.
  - waste generated on board of ships (empty oil drums, jerry cans, strapping bands, industrial packaging, spray cans, plastics, paint brushes, metal scrap etc.)
Solutions (shipping industry)

- Clean shipping (ships, port, cargo)
  - Risk analysis
  - Loading operations (vetting of the equipment used, fleet replacement if necessary- tank trucks, railcars…)
  - Transportation
  - Offloading operations
- Incentives (innovation, education- public awareness, logistic chains, regulation (Maripol)
- CSR, codes of ethics, codes of conduct, environmental friendly activities…
- Commitment to sustainability, particularly in respect of the safe transport of hazardous substances.
- Contracts to optimise logistics
- ISM (International Safety Management Code)
- EMAS, ISO 14001…..
Example for Sector specific (shipping companies) and voluntary regional (Black Sea) commitment

e.g.
CONVENTION ON THE PROTECTION OF THE BLACK SEA AGAINST POLLUTION

- To prevent, reduce and control the pollution by dumping;
- To prevent, reduce and control the pollution caused by or connected with activities on the continental shelf, including exploration and exploitation of natural resources;
- To prevent, reduce and control the pollution from or through the atmosphere;
- To protect the biodiversity and the marine living resources
- To prevent the pollution from hazardous wastes in trans-boundary movement and the illegal traffic thereof
- To provide framework for scientific and technical co-operation and monitoring activities
Sector specific (tourism) – voluntary commitments

Sustainable travel, ecotourism

- Eco-Certification
- The Global Partnership for Sustainable Tourism Criteria (initiated by Rainforest Alliance, UNEP, the United Nations Foundation, and the United Nations World Tourism Organization (UNWTO)
  www.SustainableTourismCriteria.org
  - maximizing tourism’s social and economic benefits to local communities
  - reducing negative impacts on cultural heritage
  - reducing harm to local environments
  - planning for sustainability
- Voluntary Initiative for Sustainability in Tourism (VISIT) was created within the frame of an EU funded LIFE project in tourism eco-labelling.
- Sustainable Tourism Stewardship Council
Climate Change: Risks and opportunities

Risks:
- The *greenhouse gas risk* factor
  Economic impacts: in ski tourism, floods, but also in the “Kyoto” sectors of the European Union's *Emissions Trading* System (Cap-and Trade)
  - oil and gas
  - power generation
  - pulp and paper
  - cement and glass and
  - steel
  These companies are allocated **tradable emissions allowances** annually. If they fail to take action, the companies have to pay penalties.
  Additional expenses: risk management, monitoring, staff capacity and training.

Opportunities
- New markets, project finance, solar energy (JI CDM Projects)
Thank you for your attention!

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