

Managing Environmental and Social Risks

A Guide for Financial Institutions and Private Equity Funds

The sound management of environmental and social risks is a key element of business success and sustainability for all financial institutions and private equity funds. As a responsible development finance institution, DEG is fully committed to supporting this good business practice.

ESMS IN INTERMEDIARY FINANCING

The implementation of environmental and social standards is a critical element of long-term business success. As a responsible development finance institution, DEG is fully committed to supporting our clients in understanding and applying these standards. Managing environmental and social (E&S) risks can be challenging in intermediary financing – via national or multi-national banks ('FIs') or Private Equity Funds ('PEFs') – as they are not directly involved in their clients' daily operations.

An Environmental and Social Management System (ESMS) provides the procedures required to identify, assess and control the risks associated with a financial transaction whilst guiding the investment decision-making process. This Guide provides an introduction to the requirements and the processes of ESMS, shows the benefits, benchmarking data and examples of the challenges and solutions (p.3-4) of ESMS implementation and explains where to go for help (p.5).

ESMS REQUIREMENTS



An ESMS is different for each financing institution. For example, a long-established FI may have a mature ESMS covering all of its operations and regions with multiple investor involvement; a new FI may only be at the pilot stage.

For an ESMS to be successful, the system needs to address E&S risk 'on the ground' and not be restricted to pure compliance assessment or documentation review. Pure reliance on a client's permits or E&S monitoring data may not be enough to obtain a true picture of E&S risks.

The role of ESMS is to identify the E&S risk category of a client's operations through a systematic review process in order to adequately manage these risks. In addition and where higher risk operations are involved, the ESMS will require further investigation and/or due diligence involving site visits as far as possible.

In all cases, there are a number of critical common factors which contribute to a successful ESMS:

- a) Senior level commitment and responsibility,**
- b) Customised procedures and tools adapted to capacities and context,**
- c) Trained E&S Officers and Credit/Investment Officers able to identify and manage E&S risks.**

To promote efficient E&S management with its clients, DEG requires all of its FI and PEF clients to meet the following ESMS requirements.

DEG'S REQUIREMENTS FOR AN ESMS

The following elements are essential for a well-functioning ESMS. Efficient implementation requires a tailored approach for each DEG client.

Senior Management Commitment

- › Develop an E&S policy signed off by senior management and Board.
- › Allocate overall E&S responsibility to a senior manager or Board Member and ensure the availability of adequate resources.

Procedures

- › Implement ESMS procedures fully integrated with the credit appraisal (FI) or investment process (PEF)
- › Screen all projects against DEG's Exclusion List to ensure compliance
- › Identify and categorise E&S risks and allocate appropriate resources.
- › Ensure compliance with national standards – and IFC Performance Standards for high risk projects – including environment, health, safety, labour and working conditions and human rights. Conduct site visits and due diligence as appropriate.
- › Include E&S clauses defining positive undertakings, restrictions etc. in loan and shareholder agreements with clients or investee companies.
- › Prepare an Environmental and Social Action Plan (ESAP) for high risk projects where E&S risks need to be mitigated.
- › Monitor and report annually own and portfolio E&S performance to management and stakeholders
- › Notify DEG of any environmental incidents or accidents.

Human Resources

- › Appoint an E&S Officer responsible for E&S co-ordination and allocate adequate resources.
- › FIs / PEFs with a higher risk profile (e.g. focus on infrastructure or large agribusiness portfolio) should consider hiring a full-time E&S expert.
- › Train Credit/Investment Officers in E&S procedures.

ESMS IMPLEMENTATION IN DEG'S FI/ PEF PORTFOLIO

During 2016, DEG commissioned an evaluation study of ESMS implementation across its global portfolio of FIs and PEFs (a combined investment of more than EUR 3.5 billion).

Two key elements of this study were a representative web-based survey of more than 100 clients together with individual case studies in different operating regions and covering countries with different E&S exposures.

The main conclusions of the evaluation were:

- › Most PEFs and FIs have a fully-implemented ESMS which meets DEG's requirements.
- › For the PEFs, a fully-integrated ESMS is perceived as essential for good business and for adding value to investee companies.
- › FIs are more focussed on risk management, including E&S compliance, although some are starting to identify new environmental and social investment opportunities.
- › Some FIs have met with challenges, usually associated with the volume of transactions and availability of adequate resources to implement due diligence and other 'on the ground' assessment.

BENEFITS OF ESMS

PEFs and FIs experience a range of specific business benefits. These are in line with common findings from other studies.

Major benefits are:

- › **Reducing portfolio risks** through the avoidance of excluded investments or adequate management of those with high E&S risks.
- › **Increasing returns on investments** through sound environmental management and the careful use of natural resources.
- › **Attracting finance** from other development finance institutions.
- › **Enhancing reputation** and brand.
- › **Improving relationships** with local communities.
- › **Attracting and retaining motivated staff.**
- › **Identifying further investment opportunities.**

EXAMPLES OF ESMS BUSINESS BENEFITS

The following cases are selected examples taken directly from the evaluation study.

Reducing risks: Avoiding social conflict and developing an Environmental Impact Assessment (EIA) for a high-risk investment: an Indonesian bank's ESMS expectations helped a toll road project to get built on time without social conflict. The FI required that the client set up an E&S team responsible for the EIA and for stakeholder engagement and a Grievance Mechanism. The project established good relations with the local community and set up a Livelihood Restoration Programme for those who had to be resettled.

Reducing risks and meeting stakeholder interests: In response to increasingly stringent safety standards, a China-based regional PEF identified the need for external expertise to assess fire risks and advise on workshop upgrading therefore reducing the risk of property loss in the event of fire and the risk of penalties.

Increasing returns: Applying an ESMS improved resource use and reduced costs at an Indian PEF client. The ESMS highlighted opportunities to adapt the boilers at a food processing factory to use organic waste from nearby cotton farms, reducing fuel costs by 30%, reducing air pollution and providing an additional income source for local farmers.

Strengthening reputation, brand and market share: A Central American FI client has successfully implemented a practical and easy-to-use ESMS across its portfolio of SME loans. The bank has identified the construction sector as a key area where it can help improve clients' E&S performance. Working with local E&S consultants they have provided training on sustainable construction to 100 clients. The next step is to identify 'green' investment opportunities, particularly in the fast-growing renewable energy sector.

Assisting with project permitting and avoidance of resettlement to improve relationships with local communities: The application of international E&S standards allowed a Central American high risk wind farm project – funded by a syndicate of local and international FIs – to proceed smoothly. The wind project operators carried out an IFC compliant EIA selecting a site with no resettlement requirements.

ESMS CHALLENGES AND SOLUTIONS



Despite the recognised business benefits, there are also challenges when setting up and operating an ESMS, particularly in countries where E&S legislation and enforcement is at an early stage. A major challenge common to several of the PEFs and FIs is the identification and retention of qualified E&S staff. Additional challenges, identified through the 2016 evaluation, include:

- › The overall scale of investment portfolios – both in terms of geographic spread and number of transactions – resulting in difficulties to assess project risks;
- › Tailoring an ESMS to operations in jurisdictions with either emerging E&S legislation or emerging market conditions;
- › Tailoring an ESMS to different types of financial products offered by the FI or PEF – the potential to ensure adequate E&S risk management may differ depending on the type of financing;
- › Design of an ESMS which allocates the appropriate resources to the right level of E&S risk;
- › Understanding the E&S risks applied to different industry sectors;
- › Use of data and reports from customers to help to ‘add value’ and effect change;
- › Identifying suitable external help and knowing when to use this for due diligence or other activities;
- › Addressing market competition with other FIs where implementation of an ESMS may be seen as onerous;
- › Securing senior management buy-in to the process when they may not be familiar with environmental and social issues.

The study found that solutions to these challenges always had to be adapted to the specific FI or PEF context and were developed in a collaborative effort by management and staff alike.

Some of DEG’s clients have come up with effective solutions to the challenges many FIs and PEFs encounter.

“By applying our ESMS and E&S principles it enhances our brand value and our reputation so we can obtain direct access to international financing markets and subordinated loans from ADB and the World Bank”

(Asian FI)

EXAMPLES OF INNOVATIVE /EFFECTIVE SOLUTIONS TO ESMS CHALLENGES

The following examples are taken directly from the evaluation and show how DEG’s clients have identified solutions to ESMS challenges.

Recruiting and retaining qualified E&S Officers:

- › Accessing staff training to increase the competency levels of E&S Officers;
- › Identifying suitable external resources to support the due diligence of high risk projects;
- › Implementing knowledge-sharing platforms across regional PEFs and FIs;
- › Seeking help from DEG to identify tools and sources of information;

Implementing ESMS in countries with poorly-developed E&S legislation and/or FIs at start-up:

- › Ensuring senior management buy-in right from the start and keeping it high through the implementation process;
- › Implementing ESMS with a step-by-step process, e.g. a “light touch” ESMS pilot phase and focussing on clients with the highest E&S risk profile or specific products first (project finance, large corporate loans) or specific high-risk sectors;

Dealing with large and varied E&S risk portfolio:

- › Design of a standardised E&S risk categorisation matrix/tool which allows the rapid assignment of a category and the appropriate allocation of resources;
- › Developing proportionate systems which cover all projects but focus E&S resources on the high risk projects;

Moving to the next stage of ESMS:

- › Use ESMS risk groups or specific sector knowledge gained through ESMS application to support specific target groups, e.g. E&S related training for SMEs in the construction sector;
- › Accessing information on the performance and innovations of other FIs and PEFs which can help to further improve own systems;
- › Identify opportunities for ‘green’ and socially beneficial investment;

DEG SUPPORT FOR ESMS IMPLEMENTATION



DEG has significant experience in helping clients to identify and implement tailored E&S solutions for their respective business.

DEG provides support on different levels:

- › **DEG’s investment managers** are trained in E&S assessment. They can either provide immediate responses or are the entry point for further support by DEG.
- › **The sustainability team** of DEG actively manages all high risk clients in the portfolio and provides expert service for E&S questions of each DEG client.
- › DEG actively supports clients with its **Business Support Services** (BSS) team, providing customized expert solutions to clients’ needs, e.g. in relation to ESMS implementation or improvement.

DEG actively supports clients with a wide range of services, such as:

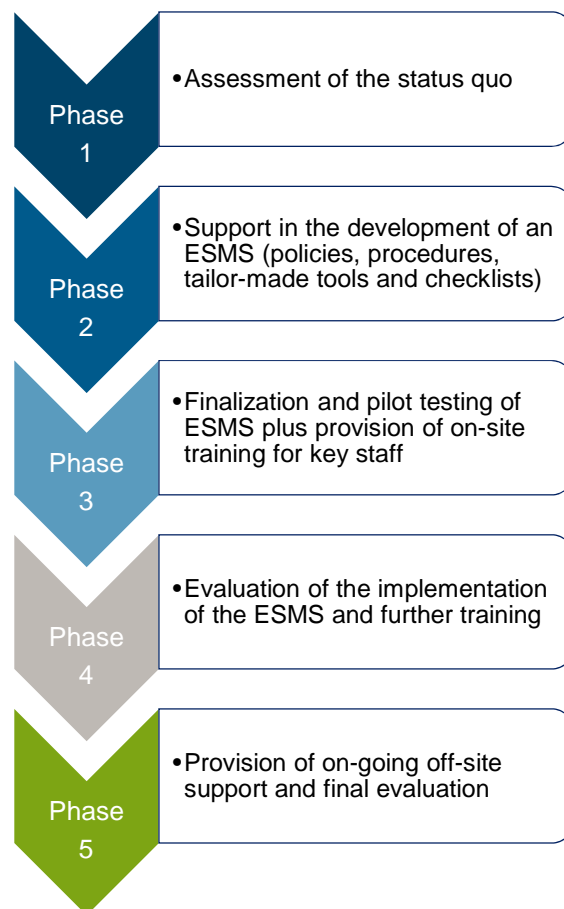
- › Advice on specific sector E&S risks and investment opportunities;
- › Referral to online training courses;
- › Direct access to tools, materials and webinars on risk screening and categorisation;
- › Refresher E&S training for staff;
- › Advice on specific sub-projects;
- › Advice on recruiting E&S staff;
- › Support in contracting external E&S experts to support your staff;
- › Case studies for FIs;
- › Organizing regional exchange;

“DEG has been very supportive and the TA support provided was invaluable. Support received from the DEG Business Support Services department for a client has also proved very useful.”

(African PEF)

BUSINESS SUPPORT SERVICES

DEG assists its clients with advisory services directed at ESMS design and implementation via its Business Support Services (BSS) programme. These advisory projects follow a five phases approach adapted to the needs of each FI or PEF.



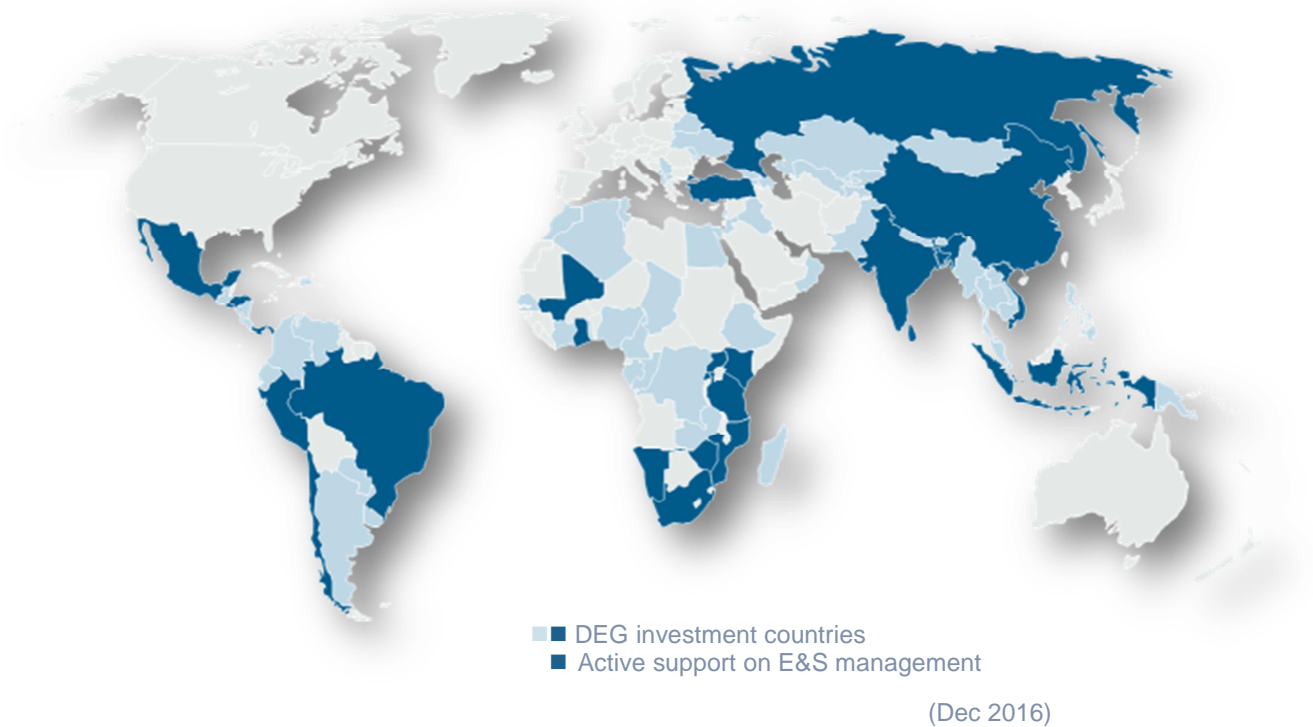
DEG will cover up to 100% of the professional fees for independent experts with international E&S expertise, who can assist DEG’s clients in the process of ESMS design and implementation. Travel costs and expenses of the experts will be met by the client.

Development and implementation of a simple ESMS generally takes from 6 to 12 months, although a more complex ESMS can take longer. The experts accompany and support DEG’s clients throughout the whole process and assist in developing a tailor-made ESMS meeting the specific needs of each client.

“The advantages of implementing an effective ESMS from the corporate point of view are strengthening the value of individual investments and the fund’s reputation.”

(Latin American PEF)

DEG – YOUR PARTNER FOR LONG-TERM BUSINESS SUCCESS



WORLD-WIDE EXPERIENCE WITH SUPPORTING CLIENTS AND PROMOTING ESMS

The mission of DEG, a subsidiary of KfW, is to promote business initiative in developing and emerging market countries as a contribution to sustainable growth and improved living conditions of the local population. To this end, we make long-term financing and advice available to private enterprises investing in these countries.

Founded in 1962, DEG now has a portfolio of EUR 8.6 billion in 79 countries (2016) and new commitments exceeded EUR 1.5 billion in 2016.

CONTACTS

In case of further questions, please contact us via: info@deginvest.de.