
## Why should Financial Institutions care about clients' environmental and social risks?

Environmental and social risks related to a client's business can translate into direct monetary losses for a Financial Institution[1] (FI). **FIs thus have not only an ethical but also an economic incentive to fully understand their clients' E&S performance.**

Environmental and social risks related to the financial engagement of a FI can include:

- Direct operational risks leading to potential financial losses;
- Reduced profitability due to higher costs;
- Substantial clean-up costs;
- Delayed construction and completion of projects;
- Penalties / sanctions levied by local authorities;
- Market loss due to boycott of clients;
- Financing risks (lower willingness of financiers to borrow/fund);
- Reputational risks for both the borrower and potentially the financing FI, such as negative headlines or even NGO campaigns.

Even if companies have obtained all necessary permits, it is in the interest of FIs to follow up on potential compliance gaps.

**The number of cases in which FIs have either lost money or reputation due to improper E&S performance of their clients is rising sharply** (for examples, please "click" on or "scan" the bottom of the last page) and is expected to continue to rise (e.g. driven by social media communication).

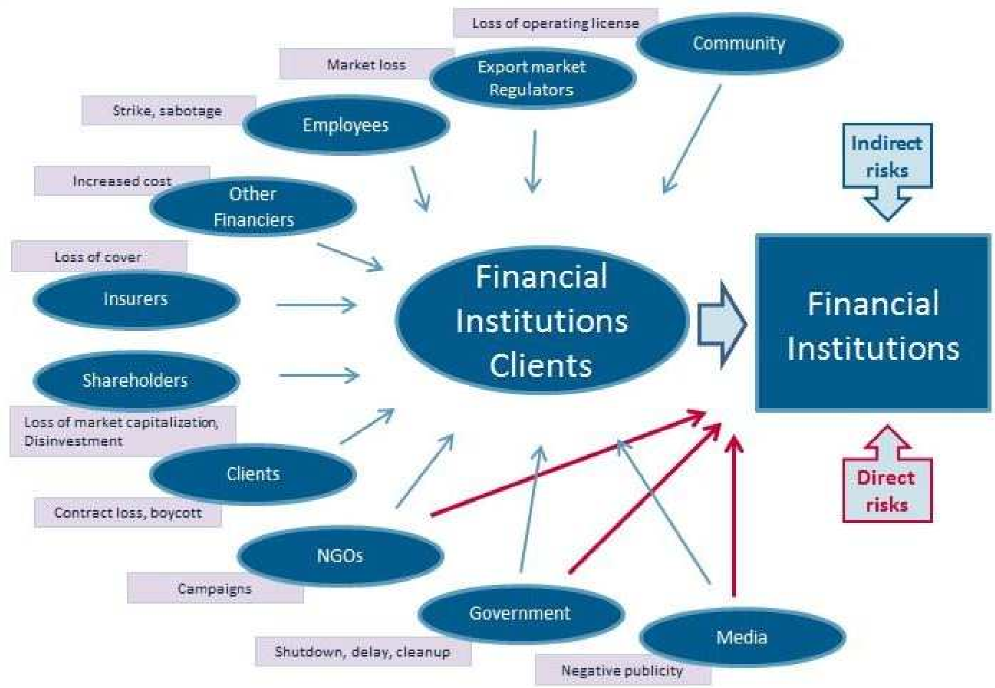
It seems that, in the past, FIs needed to experience such problems at least once before E&S risks begun to be perceived as real business risks that must be identified and mitigated like other business risks. At the same time, E&S opportunities usually remain unexploited (examples see below).

DEG's experience clearly shows that adequate management of E&S issues often correlates with general management capability (e.g. quality, maintenance of equipment). E&S

[1] Financial Institutions are commercial and development banks, mortgage banks, specialised institutions (such as factoring, trade finance, sector specific investment institutions) and insurance companies as well as leasing companies.

management will help banks to get a more comprehensive understanding of their clients and related risks, which are usually not visible when focussing on the balance sheet.

For DEG, E&S management has proved to be a valuable tool in bringing relationships with its customers to a new level as these FI's were able to exploit previously unrealised business opportunities.




**A changing scenario: New regulators are emerging, resulting in direct and indirect risks and opportunities for FIs**

### How can Financial Institutions manage these risks?

In order to increase the opportunities for sustainability and to avoid and minimise risks of related investments, DEG believes that it is necessary to develop, implement and maintain adequate policies and procedures, usually captured in the form of an Environmental & Social Management System (ESMS).

An ESMS is the part of the overall management system of the Financial Institution that includes organisational structure, planning activities, responsibilities, practices, procedures and resources for developing, implementing, achieving, reviewing and maintaining compliance with local environmental and social laws and regulations as well as internationally recognised E&S standards such as the IFC Performance Standards (www.ifc.org). As such, an ESMS aims to identify and manage environmental and social risks and opportunities in the loan and investment appraisal and management processes of FIs.

An ESMS typically has the following components:

- Environmental & Social Policy: The E&S Policy is a commitment of the FI to promote environmental and social sustainability in its business operations, approved by top-management and communicated to stakeholders;
- Exclusion List[2]: Adherence to a list of activities excluded from financing by the FI;
- ESMS Manual: The Manual is the core of the ESMS. It defines the organisational structure, key responsibilities and procedures necessary to achieve the E&S Policy commitment. This requires integration of key processes into core

[2] e.g. DEG/EDFI Exclusion list: https://www.deginvest.de/DEG-Englische-Dokumente/About-DEG/Our-Mandate/EDFI_DEG_Exclusion-List_en.pdf

operations applicable in all phases of the credit process, with firm and visible support by top management. Required documentation includes:

- E&S responsibilities and job specifications;
- E&S questionnaires for borrowers to assess E&S, labour and health and safety risks associated with the borrowers activities;
- Standardised E&S contract language;
- Risk categorisation and screening model;
- E&S guidelines for specific sectors and special regions;
- E&S due diligence procedures, including standard Terms of Reference for commissioning of external E&S experts and ideally a pool of qualified experts;
- Specific action plans to mitigate E&S risks and aimed at reaching compliance with E&S requirements; and
- E&S monitoring procedures.

Sufficient capacities (depending on size of loan book, at least one suitable trained E&S officer is required) and resources to enable implementation of a functional ESMS need to be provided.

The E&S officer will primarily need to ensure that FI clients manage their operational E&S risks appropriately (resources, procedures, responsibilities, etc.).

Further references, additional guidance, and good practice materials are made available by IFC through its website and FI client support portal: http://firstforsustainability.ifc.org

**Key resistance – and how to overcome**

1. *"Other banks don't require this"* – Maybe true. But they will sooner than later as it makes business sense
2. *"We are not the environmental authorities"* – Sure, but you better rely on your own risk assessment as you do with other risks
3. *"IFC what Standards?"* – IFC Performance Standards are based on common sense, present good business practices and are full of valuable benchmark information
4. *"I am a banker and not an environmentalist"* – Just know when to involve experts.

**Situation today:**

- IFC Performance Standards are THE benchmark for E&S risks management by a FI;
- Adherence to IFC Performance Standards is international good banking practice and contributes to overall risk management;
- An estimated 80% of total project finance debt in emerging market economies is based on IFC Performance Standards ;
- In many emerging countries an estimated 20% of FIs have an ESMS in place;
- In many emerging countries an estimated 50% of FIs are on the way to implement an ESMS;
- Central banks and regulators are starting to demand E&S management from their FIs.

***A high risk client is by no means a "bad client"; it is just a client where management of E&S risks and opportunities makes business sense – not to please DEG but to improve your client's performance and to avoid financial losses of your own institution.***

**What exactly does DEG require from its FI customers?**

DEG's Environmental and Social Policy and the following requirements are based entirely on international standards and are in line with the environmental and social standards set by many development finance institutions such as IFC, EBRD, Proparco, FMO and other European Development Finance Institutions (EDFI):

- Development, implementation and continuous improvement of an adequate ESMS for the entire non-retail portfolio, potentially through an action plan agreed with DEG;
- Assignment of E&S responsibilities to a suitably trained officer and a representative of senior management and/or board member;
- Contractual obligation of all non-retail clients to comply with the minimum E&S requirements;
- Annual Environmental and Social Monitoring Report and on an ad-hoc basis in case of unusual events.

### What support does DEG offer?

DEG supports its FI costumers in the process of developing and implementing an adequate ESMS.
For this purpose, DEG has entered into framework agreements with highly qualified international experts in order to provide guidance and advice to Financial Institutions in a five-phased approach:

- Phase 1: Assessing the status quo;
- Phase 2: Supporting the development of policies, procedures, tailor-made tools, checklists;
- Phase 3: Review of policies and procedures, on-site training of key staff;
- Phase 4: Evaluation of the implementation of E&S policies and procedures;
- Phase 5: Provision of on-going off-site support and final evaluation.

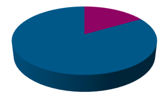
**DEG can cover up to 100% of the expert's costs out of its Technical Assistance programme.**

Travel costs and expenses are usually covered by DEG FI clients.

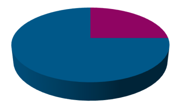
DEG furthermore assists central banks or banking associations levelling the playing field for all FIs in selected countries. Examples of such industry-wide efforts currently underway include Nigeria, Kenya, Bangladesh, Uruguay and China. FIs in these countries have been invited to participate in the design of national banking principles, an experience that has been described by all as highly beneficial.

### What are FI's experiences with E&S risk management so far? (Source: IFC)

86 % of the FIs report positive changes from integrating E&S into business



75% of FIs observe reduced risk from integration of E&S into strategic decision making & lending



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### Proving the business case: Examples for the necessity to properly manage E&S risk in FIs