Revising the Equator Principles:

Why banks should not become the new sustainability regulators of Emerging Markets

A World Growth Report | February 2013

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Executive Summary

On 13 August 2012 a draft of the updated Equator Principles (EP) was released for stakeholder consultation and public comment. This latest revision of the EP is a marked attempt to dramatically alter the role of financial institutions in emerging markets, from financiers to sustainability regulators.

By writing certain levels of environmental and social performance into Project Finance documentation, which go beyond the levels prescribed by national law, EP lenders (EPFIs) become obligated to monitor, verify and remedy borrower compliance with sustainability standards. This undermines economic growth and sustainable development by imposing a significant burden on borrowers and EPFIs, as well as obstructing the efficient allocation of capital and hampering the advancement of legitimate state institutions.

Under the EP, borrowers must dedicate resources to demonstrate EP compliance, whilst EPFIs must develop the capacity to monitor and verify performance. Such an obligation results in time delays and increased transaction costs in the evaluation of Project Finance transactions. The burden effectively constitutes a tax on legitimate foreign investment and economic growth in emerging markets.

By requiring capital to be allocated on the basis of social and environmental well-being the EP also prevent resources from being allocated to where they will be most productive and yield the highest returns. Such a normative risk management framework inherently ignores the fact that economic trade-offs are fundamental to the maximization of socio-economic welfare.

Furthermore, the EP's contribution to corporate value remains elusive. A cross sectional study of leading financial institutions has found that EPFIs have lower profit margins and failed to add value for their shareholders over the medium term. This proves that the economic justification for values-based investment criteria is weak and that the EP constitute a poor business proposition.

Another important driver of sustainable development is the rule of law by way of legitimate national institutions. Such institutions are vital to establishing a level playing field for commercial entities and laying the foundations of a free and open market. If the development of state institutional capacity does not occur jointly with the development of the market, then it becomes more likely that the weaknesses of the former will jeopardise the latter.

The EP hamper the advancement of such institutions by supplanting the regulatory role of the state. This is a concern for both regulatory and development policy for two reasons. Firstly, bypassing the laws of a sovereign state effectively infringes upon a society's right to govern itself. Thus, the EP governance model inherently lacks democratic legitimacy.

Secondly, the means in which society comes to adhere to a particular set of norms generates a social good that is distinguishable from the overall regulatory outcome. Accordingly, the EP undermine state institutional development by robbing them of the opportunity to learn how to govern.

Nonetheless, many multi-national banks have adopted the EP, on the basis that it constitutes good 'corporate citizenship' and that it acts as a protective eco-badge against the criticism of environmental non-government organizations (ENGO). In reality, both of these propositions have proven to be false.

The manner in which the EP obfuscates the efficient allocation of capital, as well as the heightened level of ENGO scrutiny that becomes afforded to EPFIs, undermine the maximization of shareholder wealth and enhance reputational risks. Thus, adopting the EP has actually undermined corporate value and also failed to quell the threat of negative ENGO campaigns.

Banks have falsely presumed that a reputation for enhancing 'social justice' through their business dealings actually increases company value. Such a notion is derived from modern elements of corporate social responsibility (CSR), which incorrectly perceive the role of business as promoting social and environmental progress; rather than to maximize profit and shareholder interests.

Accordingly, EPFIs should withdraw from the EP process, pursue high yielding investment opportunities in emerging markets and more

actively defend their role in the global economy. Such initiative will maximize returns for EPFI shareholders and enhance economic growth and development in emerging markets; both of which constitute true 'corporate citizenship'.

In the end, the EP's negative impact on the free movement of capital and the rule of law, poses a much greater threat to sustainable economic development and the maximization of welfare than the environmental degradation that the EP supposedly seek to prevent.

1. Introduction

The Equator Principles are a set of voluntary corporate standards that provide an environmental and social risk management framework for evaluating Project Finance transactions. The standards were originally conceived by a small group of global financial institutions and launched on 4 June 2003. The framework strives to make lending socially responsible and follow sound environmental management practices by providing minimum due-diligence standards for Project Finance documentation.[1]

Project Finance is a particular form of corporate lending that is often used to fund the development and construction of major infrastructure projects. Funding is provided through a structured lending agreement that surrounds a Project's operating cash flows and assets.[2] Thus, financing is tailored around the financial and economic viability of an individual Project rather than the guarantee of a single borrower or project sponsor.[3]

History shows that the most reliable way of ensuring capitalism works to improve social welfare is by enabling national economies to become more open and market-oriented.[4] Such efforts improve enterprise performance and create opportunities for the poorest through economic freedom and prosperity. These are the underlying drivers of economic growth, sustainable development and the alleviation of poverty.

Two factors that enhance the benefits of liberal markets are the free movement of capital and the rule of law.[5] Accordingly, this paper seeks to evaluate the EP's impact on the role of multi-national banks in emerging markets, and the consequential impact on sustainable development. In particular, it considers the EP's implication for economically viable Project Finance transactions and the advancement of legitimate state institutions.

Part I begins with a discussion of the advantages of Project Finance, focusing on how the lending arrangement manages to overcome unique barriers to economic growth in developing states. Part II then examines the historical development of the EP and provides a summary of the major obligations imposed on complying institutions and borrowers.

Part III analyses the impact of the EP on economic growth, considering the economic costs imposed on borrowers and EPFIs during Project Finance evaluation. This includes a discussion of the EP as a normative risk management tool and the role of markets in the investment decision making process. It then highlights the negative financial consequences for EPFIs, which are inherent in becoming the sustainability regulators of emerging markets.

Part IV outlines the broader negative implications for the advancement of legitimate and effective state institutions, including the consequential impact on free markets and sustainable development. It also highlights the EP's disjointed relationship with the internationally accepted development norms, espoused by the Rio Declaration.

Part V then considers just why, and how, the EP managed to become the global industry standard for environmental and social risk management, highlighting the pivotal role played by ENGOs and modern elements of CSR.

This paper ultimately argues that the EP is a much greater threat to sustainable economic development than the environmental degradation it supposedly seeks to prevent. This is an inevitable consequence of obfuscating the role of markets and imposing a governance role on multi-national

[1] The Equator Principles Association, "The Equator Principle: Preamble," Monday 13 August 2012, <http://www.equator-principles.com/resources/EPIII_PR.pdf>
[2] The International Finance Corporation (IFC), Project Finance in Developing Countries (1999), Public Private Partnership and Private Finance Initiative, <http://www.ppp-pf.ru/docs/1276007352.pdf>
[3] This arrangement is also referred to as non-recourse Project Finance. Project Finance tends to be more relevant in industries where the revenue streams can be easily defined and structured. In the instances where debt financing is provided by more than one bank, the group of lenders is referred to as a syndicate. In loan syndication, the arranger bank is responsible for coordinating and negotiating finance from all of the different lenders.
[4] Henderson, David, "Misguided Virtue: False Notions of Corporate Social Responsibility," June 2001 (Wellington: New Zealand Business Roundtable, 2001), 85.
[5] Kleimeier, Stefanie & Versteeg, Roald, 2010. "Project finance as a driver of economic growth in low-income countries," Review of Financial Economics, Elsevier, vol. 19(2), pages 49-59, April. <http://edocs.ub.unimaas.nl/loader/file.asp?id=1389>

business. The paper thereby concludes with a list of recommendations for EPFIs to remedy the EP's negative impact on economic welfare, sustainable development and the alleviation of poverty.

2. The Role of Project Finance in Stimulating Economic Growth

Developing countries often lack the necessary infrastructure and financial markets to support critical local investment. Project Finance from foreign lenders has thus become one of the fundamental drivers of economic growth in low income nations.

As early as 1911, financial markets were recognised as playing an important role in economic development.[6] Well-developed financial markets contribute to the overall 'quantity' of capital in an economy, but more importantly, the 'quality' of capital makes the greatest contribution to economic growth.[7]

Transaction costs associated with un-developed financial markets are a major impediment to the 'quality' of local capital. This includes the inability to mobilise and pool national savings, the lack of information surrounding local investment opportunities, and the generally insufficient levels of monitoring and corporate governance mechanisms.

Project Finance is inherently able to overcome these transaction costs and substitute un-developed local financial markets, by focusing on the viability of an individual Project rather than the overall financial state of a company. Compared to other forms of foreign capital, it also manages to enhance resource allocation and access to finance for entrepreneurs.[8] Such important benefits stem from allocating Project risks to those parties that are most equipped to bear them.

For example, the use of structured lending agreements lowers the risk associated with processing investment information by allocating it to large foreign lenders. Assessment costs are also limited by only having to evaluate the economic and financial viability of one particular Project, rather than the overall financial state of the Project sponsor.

Secondly, large capital investments in developing countries are usually infeasible, since capital is scarce and local investors are risk averse. Project Financing that is supported by a syndicate of large foreign banks actually enhances the viability of these usually high-risk and high-return investments, which also have the greatest benefits for economic growth. Thus, Project Finance manages to improve the efficiency of capital allocation by targeting existing bottlenecks in the economy.

Thirdly, Project Finance transactions provide foreign banks with the incentive to diligently monitor the construction and development process, because of the high leverage and non-recourse nature of their claim. Since the lending structure hinges on the strength of the project itself, the technical, financial, environmental and economic viability of the project is of paramount concern.[9] Thus, properly screening a project's risks and forecasting future cash flows constitutes prudent risk management and overcomes the usual corporate governance risk in such large investments.

Ultimately, Project Finance ensures that well-structured economically viable Projects are able to attract the necessary long term financing, despite the risks, scale and comparative size of Project sponsors.[10] This mechanism for sharing the costs, risks and rewards of an investment, among a number of unrelated parties, improves the overall 'quality' of capital in an economy and thus enhances economic growth and development.[11]

[6] Schumpter, J., *Theorie der wirtschatlichen Entwicklung*. Leipzig: Duncker & Humbolt (1911).
[7] Kleimeier & Versteeg, "Project Finance as a Driver of Economic Growth," 50.
[8] Ibid., 59.
[9] Ibid., 55.
[10] International Finance Corporation (IFC), Project Finance in Developing Countries (1999).
[11] Kleimeier & Versteeg, "Project Finance as a Driver of Economic Growth," 51.

3. The Core Elements of the Equator Principles

Since its official launch in 2003, the EP has been revised once in 2006 (EP II) and is now undergoing a second revisionary process (EP III).[12] The number of EP signatories (EPFIs) has grown dramatically to include 75 lending institutions and 3 associates from 32 countries. Together, they constitute over 70 percent of international Project Finance transactions to developing nations and approximately 85 percent of the global Project Finance market.

The EP is overseen by the EP Association, an unincorporated group of EPFIs and Associates. The Association is tasked with the management, administration and development of the EP. It fulfils this mandate according to a set of governance rules, which provide guidance to EPFIs, as well as procedures for appointing the EP Association Steering Committee.[13]

EP III is based on the discussions and analysis of specialist working groups, which have been tasked with updating the framework to reflect current best practice; as well as recent changes to the International Finance Corporation's Performance Standards and Environmental, Health and Safety Guidelines (IFC Guidelines).[14] The IFC Guidelines are technical reference documents that outline a raft of measures and procedures for environmentally and socially sustainable performance.

The EP applies to four types of financial services relating to Project Finance transactions with capital costs of $US 10 million or more. EPFIs are prohibited from providing such financial services to any Projects that do not conform with the EP.
EPFIs must first categorize all prospective Projects based on the magnitude of their potential environmental and social risks (Principle 1).[15] For Projects with potential significant or limited adverse environmental and social risks, EPFIs must then require that borrowers undertake an Environmental and Social Impact Assessment (Assessment), which addresses all the relevant environmental and social concerns (Principle 2).

For Projects in developing countries, the Assessment must evaluate compliance with the IFC Guidelines (Principle 3). Alternatively, for Projects in developed nations, the Assessment must evaluate compliance with relevant host country laws, regulations and permits.

EPFIs will also require borrowers to develop an Environmental and Social Management System (ESMS), and an Environmental and Social Management Plan (ESMP), to addresses the various issues raised in the Assessment (Principle 4). The relevant parties must then agree on an Action Plan (AP) to address those instances of non-compliance (Principle 4).

EPFIs are further required to make borrowers demonstrate effective stakeholder engagement and ensure that all Assessment and ESMP documentation is readily available to the public (Principles 5&10). Independent review of the Assessment, ESMS and ESMP by an Environmental and Social Consultant, including ongoing assessments of EP compliance, must be required by the EPFI over the entire life of the loan (Principles 7&9).

Finally, borrowers must establish a grievance mechanism for resolving concerns about a Project's environmental and social performance (Principle 6) and submit periodic reports to the EPFIs satisfaction on Project compliance with the ESMP and AP (Principle 8). In those instances where borrowers fail to establish compliance within a period determined by the EPFI, the lender reserves the right to exercise remedies; as considered appropriate (Principle 8).

Notably, the various obligations are not imposed or overseen by an independent regulatory authority. Rather, EPFIs are obligated to ensure that all performance standards are written into

[12] The update (EP III) is scheduled for release sometime between now and the beginning of 2013

[13] The EP Association Steering Committee is comprised of 13 EPFIs and is responsible for coordinating all of the Association's management responsibilities.

[14] IFC Performance Standards on Environmental and Social Sustainability - Effective January 1, 2012 <http://www1.ifc.org/wps/wcm/connect/c8f524004a73daeca09afdf998895a12/IFC_Performance_Standards.pdf?MOD=AJPERES> and the World Bank Group Environmental, Health, and Safety Guidelines (known as the "EHS Guidelines") <http://www1.ifc.org/wps/wcm/connect/554e8d80488658e4b76af76a6515bb18/Final%2B-%2BGeneral%2BEHS%2BGuidelines.pdf?MOD=AJPERES>

[15] Category A Projects are those with "*potential significant adverse environmental and social risks*", whilst Category B maintain "*potential limited adverse environmental and social risks*" and finally, Category C possess "*minimal or no adverse environmental and social risks*".

Project Finance documentation. As such, EPFIs themselves become the regulatory and oversight authority for the social and environmental performance of borrowers.

4. The Equator Principles as a Barrier to Economic Growth

4.1 The Cost of Compliance

The true economic and financial impact of the EP is derived from Principle 3. All of the remaining obligations are derived from the level of environmental and social performance that is prescribed by this provision. Principle 3 states that all Project Finance transactions to developing nations must satisfy the environmental and social standards prescribed by the IFC guidelines.

In effect, Projects must meet a level of environmental and social performance that goes well beyond what is prescribed by the rules and regulations of developing states. On the other hand, Project Finance to developed countries must only meet the levels prescribed by national law.

This disparity between developed and developing nations is concerning because it imposes an additional burden on the approval and development of Projects to developing states. Complying with such heightened standards requires the use of resources that would otherwise not be necessary under local regulations.

The extent of this burden includes the various reporting and assessment requirements, which borrowers are obligated by EPFIs to complete. These requirements place an economic and financial burden on both borrowers and EPFIs. Firstly, the obligation to categorise prospective Projects according to their potential environmental impact, forces EPFIs to develop such an internal assessment capacity or to engage the relevant services of external consultants.

The obligation imposed on borrowers to undertake an Assessment, and then to submit ongoing reports demonstrating Project compliance, also demands further strengthening of EPFI sustainability capacity and expertise. It ultimately requires extra inputs, time and resources so that EPFIs may effectively monitor and then verify borrower compliance with the IFC Guidelines.

As for borrowers, the above obligations, as well as the requirements for stakeholder engagement and independent environmental consultants, not only slow the Project evaluation process, it also renders some Projects totally infeasible. Similar sustainability standards are not required by developing nation laws for the simple fact that many Project sponsors do not have the necessary technical skills, resources and time to meet such obligations.

Ultimately, by holding borrowers to a certain level of environmental and social performance, both EPFIs and borrowers must incur a significant financial burden. Borrowers undertake the necessary action to demonstrate compliance, whilst EPFIs must develop the capacity to monitor and verify satisfactory performance. This imposes a significant economic cost, in terms of time delays and additional transaction costs, in evaluating Project Finance transactions.

Considering the significant advantages of Project Finance as a foreign source of capital, the additional compliance burdens constitute a tax on foreign investment. Accordingly, the EP is an effective barrier to economic growth in developing nations, which do not impose environmental and social standards that are commensurate to the IFC guidelines.

4.2 The Misallocation of Capital

Notwithstanding this compliance burden, the EP also place a further impediment to economic growth by encouraging EPFIs to invest in low yielding Projects. The stricter sustainability standards do not necessarily guarantee that the most economically viable Projects will receive Project Financing. Instead, the EP require capital to be allocated on the basis of social and environmental well-being.[16]

By imposing a sustainable lending perspective, the EP prevent resources from being allocated to where they will be most productive and thus maximize local wealth and prosperity. This consequence of economic altruism illustrates the true failure of using a normative risk management tool to evaluate Project Finance transactions.

[16] Henderson, "Misguided Virtue," 31.

Such low yielding investments decisions are a further impediment to economic growth and constitute a secondary tax on foreign investment.[17] These taxes are borne by EPFI shareholders and the poor; who ultimately stand to benefit the most from Project Finance.

Such practical implications are an inevitable consequence of requiring EPFIs to allocate capital according to social justice norms, rather than on the basis of costs and gains at the margin.[18] The EP ignores the fact that economic trade-offs are fundamental to the maximisation of socio-economic welfare. This assertion is supported by notable economist David Henderson, who stated that:

"Neither the greater stringency of [environmental] norms and standards, nor their wider diffusion necessarily represents an improvement. To the contrary, both are liable to give rise to reductions in welfare that may be substantial."[19]

The pursuit of a pre-determined and universal environmental goal, irrespective of local conditions, can thus be done in a manner that causes more harm than good. The maximization of social welfare can only be achieved by allocating resources in response to changing prices afforded by the market; not by way of a global normative risk management tool. Markets more accurately reflect costs and gains at the margin, as well as the impact of local regulatory conditions on the economic, social and environmental viability of Projects.[20]

It should therefore be the responsibility of financial institutions, not the EP, to consider the extent that relevant environmental and social risks constitute a credit risk. Such a due diligence process ensures that capital is allocated to where it will be most productive, maximizes social welfare and abides by the local regulatory benchmarks for environmental and social performance.

[17] Wilson, Tim, "No, Really – what are the 'Equator Principles'," *The IPA Review* (2007), 7. <http://www.ipa.org.au/library/59_2_WILSON_EquatorPrinciples.pdf>
[18] Henderson, "Misguided Virtue," 65.
[19] Ibid., 66.
[20] Ibid., 65.

4.3 Repercussions for Signatory Banks

Despite the growing interest in sustainability matters, their contribution to value remains elusive. A recent cross sectional study of leading financial institutions has found that, compared to their non-signatory rivals, EPFIs have different risk strategies, significantly lower profit margins, lower price to book ratios, and have failed to add value for their shareholders over the medium term.[21]
Accordingly, EPFIs have actually worsened their financial performance against several criteria. This is no surprise considering the financial implications of becoming surrogate sustainability regulators, as well as the inherent limitations imposed on the allocation of capital.

By requiring EPFIs to adopt a sustainable perspective, the EP forces banks to alter their investment strategy and risk propensity, so as to allow for sustainable objectives. Accordingly, EPFIs must adjust their strategic objectives to place greater value on less quantifiable future costs and benefits.[22] This broadening of stewardship also introduces greater uncertainty into decision making, which in turn imposes a need for more comprehensive risk management.[23]

Such a reordering of internal investment and risk strategies eventually affects revenues and expenses through a realignment of products, services and process.[24] The consequential adjustments to the supply chain, inputs, outputs and mix of assets and liabilities, evidently lowers corporate profitability, by imposing higher current expenses and larger opportunity costs.[25]

Ultimately, despite the normative benefits of sustainability initiatives, there is no sound business case to support the EP's values-based investment criteria. As outlined by Les Coleman of Melbourne University:

"The economic justification for exceeding mandated requirements in relation to

[21] Coleman, Les, "Sustainability May Cost the Earth: Examining the Strategic and Financial Consequences of Banks' Sustainable Corporate Strategy" (August, 24 2008), *21st Australasian Finance and Banking Conference 2008 Paper*. Available at: <http://ssrn.com/abstract=1252523> or <http://dx.doi.org/10.2139/ssrn.1252523>
[22] Coleman, "Sustainability May Cost the Earth," 26.
[23] Ibid., 12.
[24] Ibid., 12.
[25] Ibid., 12.

environmental protection, social responsibility, sustainability and so on has proven weak at best."[26]

Any attempts to leverage the supposed reputational gains from becoming an EPFI are evidently outweighed by the financial cost of foregoing lucrative business opportunities and becoming surrogate regulators. The interests of shareholders and the world's poor would undoubtedly be better served by low cost and quality financial services, rather than the EP's normative risk management framework.

5. The Broader Negative Implications for Sustainable Development

5.3 Banks as Regulators: The Democratic Deficit

An important driver of sustainable development is the rule of law by way of legitimate and effective national institutions. In this sense, 'institutions' refers to state authorities that have been vested with regulatory powers, as well as the mechanisms for enforcing such powers. Such institutions encompass the executive, legislative and judicial arms of government.

The importance of effective national institutions is soundly based on the premise that the nation-state is the underlying: "*locus of governance in a galaxy of increasingly interlinked institutions of governance above and below*".[27] Institutions are vital in establishing a level playing field for commercial entities and laying the foundations of a free and open market.

If the development of state institutional capacity does not occur jointly with the development of the market, then it becomes more likely that the weaknesses of the former will jeopardise the latter.[28] From this perspective, functioning state institutions are an important catalyst for economic growth and sustainable development.

As mentioned above, the EP impose environmental and social standards that go well beyond the levels prescribed by the law of many developing states. Thus, the lender, rather than the state, is responsible for monitoring, verifying and penalizing non-compliance with the EP benchmarks.

The EP thereby amounts to an 'outsourcing' of regulatory and enforcement responsibilities to a supranational governance arrangement.[29] This centralized system of governance is a major concern for regulatory and development policy in low income states for two reasons.

Firstly, such an arrangement lacks democratic legitimacy and fails to recognize that the state is the most effective regulator of corporate activity. Since the Peace of Westphalia in 1648, nation states have been the ultimate representatives of civil society in the international community.[30] The sovereign state is vested with the power of its people and thereby forms the foundation of the international political order.[31]

Accordingly, any regulation of sustainability within the jurisdiction of a sovereign state, which actually bypasses the law of that state, is inherently infringing upon a society's right to govern itself.[32] The regulation of Project Finance transactions must instead occur through the premeditated democratic processes of the host nation.

In such instances, national institutions have the intimate knowledge of the local regulatory framework and are thus able to regulate comprehensively with a higher degree of coverage than voluntary corporate standards.[33] Furthermore, states have the necessary knowledge and capacity to regulate industries according to their own local norms and in line with the unique environmental, social and economic needs of the community.

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[26] Ibid., 26.
[27] Paul Hirst & Grahame Thompson, *Globalization in Question: The International Economy and the Possibilities of Governance* (1996), 190-191.
[28] McInerney, Thomas F., "Putting Regulation Before Responsibility: The Limits of Voluntary Corporate Social Responsibility" (October 10, 2005), *Cornell International Law Journal*, Vol. 40, p. 171, 2007. Available at: <http://ssrn.com/abstract=658081> or <http://dx.doi.org/10.2139/ssrn.658081191>
[29] Wilson, T. "What are the 'Equator Principles'," 8.
[30] Hall, Stephen. *Public International Law* (Lexis Nexis Butterworths: 2003).
[31] Hall, *Public International Law* (2003).
[32] Ibid.,
[33] McInerney, T. "Putting Regulation before Responsibility," 190.

This is important for development policy because every country differs widely in their geography, productivity, income and in the cultural preferences of their people. The balance between costs and gains at the margin, as well as the socially acceptable degree of externalities, vary according to these local conditions.[34]

Thus, in the situation where a "*decreases in pollutants may involve extremely high costs but only a small improvement in air quality*", what constitutes best environmental and social practice, and thus the appropriate regulatory standard, should be determined by the state.[35] The resultant regulatory standard then allows market prices to present opportunities for mutually beneficial cross border trade and investment.[36]

These notions align with the principles espoused by the Rio Declaration on Environment and Development (1992), which was able to secure a global consensus on the manner in which states should pursue their development agendas. Specifically, states have: *"the sovereign right to exploit their own resources pursuant to their own environmental and developmental policies."*[37]

5.4 Barrier to the Advancement of State Institutions

The second issue with supplanting the regulatory and enforcement role of the state is that it then loses the inherent social gains that are to be derived from learning how to govern.[38] In other words, the means in which society comes to adhere to a particular set of norms generates a social good that is distinguishable from the overall regulatory outcome.[39] Such a process is particularly important for struggling democracies and emerging market economies.[40]

[34] McInerney, Thomas F., "Reframing the Mandatory Versus Voluntary Debate in Advancing Labor, Environmental and Human Rights Protection" (November 21, 2007), 4, Available at: <http://ssrn.com/abstract=1480646> or <http://dx.doi.org/10.2139/ssrn.1480646>
[35] Henderson, "Misguided Virtue," 65.
[36] Ibid., 69.
[37] Rio Declaration on Environment and Development, 14 June 1992, Rio de Janeiro, Brazil, UN Doc. A/CONF.151/26 (vol. I) / 31 ILM 874 (1992). <http://www.unep.org/Documents.Multilingual/Default.asp?DocumentID=78&ArticleID=1163>
[38] McInerney, T. "Putting Regulation before Responsibility,"192.
[39] Ibid., 191.
[40] Ibid., 190.

For example, regulating economic activity helps state institutions to develop the necessary legislative and policy knowledge to establish competitive and liberal markets. National debates can then ensue on the appropriate policy responses to environmental degradation or socially responsible performance. Courts can also explore the distinction between nuisance and environmental harm, thereby developing doctrine and case law that ensures environmental performance and economic development objectives are pursued according to the public interest.[41]

Furthermore, enforcing regulation enables institutions to develop the specific technical capacity to safeguard legitimate commercial activity. Enforcement authorities then see that effective regulation is possible and also learn how to hold commercial entities accountable for their actions.

Successful enforcement efforts can also help to garner public support and enhance regulatory legitimacy.[42] This in turn strengthens civil society, in so far as state institutions are perceived as safeguarding the legitimate public interest, protecting their citizens and promoting economic freedom and prosperity.[43] Thus, developing the regulatory capacity and effectiveness of national institutions strengthens both the state and the market.

The EP effectively rob national institutions of this opportunity and in turn hamper the advancement of legitimate institutions and the rule of law. This undermines sustainable development since competent regulatory authorities and free market forces drive greater regulatory compliance and thus enhanced environmental and social performance.

In other words, economic growth and effective institutions actually fosters improved environmental and social responsibility. This argument is supported by the Environmental Kuznets' Curve (EKC), which maintains that environmental quality follows a U-shaped relationship with development; first deteriorating

[41] Ibid., 192.
[42] Baldwin, Robert. and Cave, Martin. *Understanding Regulation: Theory Strategy and Practice* (1999).
[43] McInerney, T. "Putting Regulation before Responsibility," 192.

but then improving as economies generate more wealth for their people.[44]

Accordingly, the regulation of Project Finance transactions should occur through the premeditated democratic processes of host nations, whilst universal sustainability standards should be pursued through bilateral and multilateral agreements. Such a governance framework aligns with the principles espoused by the Rio Declaration on Environment and Development (1992), and the fact that nation-states are the underlying locus of governance in our global economy.

6. The Rise of a Global Industry Standard

The dissemination of the EP has made the IFC guidelines the global industry benchmark for environmental and social performance. History suggests that the IFC guidelines were never actually intended to be used as global rules for multi-national banks on sustainability matters.[45] Rather, they were originally conceived as internal policy guidelines for World Bank staff.[46]

Ironically, many EPFIs have previously indicated that they would prefer a completely different framework for quantifying social and environmental risk. They only opted for the IFC standards as a default solution, because of a lack of alternatives.[47] This ultimately begs the question of how and why the EP came to be so widely accepted by the global financial community. The answer lays in the strategic public relations efforts of ENGOs and the ideas of global 'corporate citizenship'.

6.1 The ENGO Campaign to Transform Markets

Environmental activists have traditionally sought to influence the production and consumption of products by lobbying governments and international organizations to impose strict sustainability standards. This has partly been a response to the changing demand of a small portion of developed world consumers, who have broadened their concept of value to include the environmental and social impact of their consumption.[48] It also forms part of a broader ENGO mission to transform markets according to a particular set of economic, environmental and social values.[49]

Globalisation, the rise of multinational corporations (MNCs) and the integration of global supply chains have prompted a shift in the productive capacity of many commodity based industries to the developing world. At the same time, ENGOs have been unsuccessful in their efforts to convince developing countries to adopt the same sustainability standards as the Western world.[50]

ENGOs have thus shifted their concern towards persuading major corporates in the global supply chain to uphold more sustainable and socially responsible business practices.[51] Targeting these large firms is much easier than the alternative task of convincing international organizations, developing states and even billions of consumers, that producers should become more sustainable.

As identified by the World Wildlife Fund (WWF), between 300 and 500 multi-national corporations (MNCs) control at least 70 percent of the trade in 15 commodities, which they believe have the greatest negative environmental impact. Furthermore, 100 of these MNCs control 25 percent of the total trade in all commodities.[52] ENGOs have thus waged a series of negative

[44] Pfaff, A. and Walker, R. 2010. Regional Interdepdence and Forest "Transitions": Substitute Deforestation Limits the Relevance of Local Reversals, *Land Use Policy*, 27 (2010) 199-129.
[45] Affolder, Natasha, "Cachet Not Cash: Another Sort of World Bank Group Borrowing" (January 15, 2006). *Michigan State Journal of International Law*, Vol. 14, Nos. 2-3, p. 141, 2006. Available at SSRN: <http://ssrn.com/abstract=1307807>
[46] Affolder, Natasha, "Cachet Not Cash," 142.
[47] Richard Everett & Andrew Gilboy, Associates for Global Change, "Impact of the World Bank Group's Social and Environmental Policies on Extractive Companies and Financial Institutions," (June 2003) (Submission to World Bank Extractive Industries Review Secretariat), <http://bankwatch.ecn.cz/oldbw/eir/reports/vol6_2.pdf>
[48] Wilson, Tim, "Naked Extortion? Environmental NGOs imposing [in]voluntary regulations on consumers and business," Institute of Public Affairs, (September 2011) <http://www.ipa.org.au/library/publication/1315452023_document_110906_-_report_-_naked_extortion.pdf>
[49] WWF Market Transformation Initiative, "Better Production for a Living Planet," World Wildlife Fund, 2012 <http://assets.worldwildlife.org/publications/357/files/original/wwf___better_production_for_a_living_planet___2012_web.pdf?1345735175>
[50] Wilson, T. "Naked Extortion,"5.
[51] Ibid., 9.
[52] WWF Market Transformation Initiative, "Better Production for a Living Planet," 2.

public relation campaigns against these companies, based on their respective environmental and social records.[53]

In response, and sometimes in collaboration with the same ENGOs, these companies have established voluntary environmental and social standards in exchange for more favorable public treatment. Reputation is a particularly sensitive area for such large and highly visible MNCs. For them, voluntary environmental standards are seen as a protective eco-badge to defend against ENGO criticism and costly reputational damage.[54]

Similarly, the origins of the EP can be traced back to a meeting that was held in October 2002, between a number of commercial banks and the IFC. It was here that the original EPFIs decided to form a common environmental and social risk management framework based on the IFC guidelines. The collective effort was driven by negative ENGO campaigns over the funding of some environmentally and socially sensitive energy projects.

The ultimate success of the ENGO market transformation strategy was captured by Jules Peck, WWF's Global Policy Advisor, when she said: *"The Equator Principles are proof that banks are feeling the heat from environmental groups worldwide."*[55]

After cornering supply chain companies into these seemingly voluntary standards, ENGOs have then sought to gradually tighten or 'ratchet up' those benchmarks.[56] This is evident in EP III, which has made a distinct effort to broaden the scope of financial products, increase the compliance burden on borrowers, and expand the regulatory role of EPFIs.[57]

6.2 Global Corporate Citizenship

Nonetheless, the 'ratcheting up' and dissemination of the EP cannot solely be attributed to the campaign efforts of ENGOs. It also stems from a willingness on the part of big business to appease ENGOs efforts on the basis that it constitutes good 'corporate citizenship' and that not complying would ultimately increase reputational risks associated with renewed ENGO campaigns.

As highlighted in Part III, the theory that maintaining a reputation for 'social justice' actually enhances company value, does not exist in reality. Rather, sustainable lending practices and the promotion of social well-being actually erode company value.[58] This misconception is derived from the modern notions of CSR, which have pervaded corporate thinking.

Traditional notions of CSR are soundly grounded in the idea that a firm's success partly depends on its reputation for fair dealing, good treatment of its employees, and explicit account of the public interest.[59] Corporate decision making has thus traditionally been reliant upon what is most cost effective at the margin, even in cases of socially responsible initiatives.

This is starkly different from modern CSR, which perceives multi-national business as commanding a leading role in social, environmental and economic progress; also known as the 'triple bottom line'.[60] Corporate actions should thereby consider the wellbeing of society, rather than profitability and shareholder interests.

This prioritization of company objectives encourages appeasement of ENGOs and thus the dissemination of the EP. Therefore, despite its competitive burden, EPFIs have been advocating in favor of the EP, so as to depict themselves as acting in the public interest and their non-signatory rivals as having gained an unfair competitive advantage.

Such a corollary of the ENGO market transformation strategy was previously highlighted by Hugh Morgan, former CEO of an Australian mining company, who spoke of a conversation he had with another CEO of a "very large resource-based corporation":

"*Hugh, don't you understand? My organization is run by Greenpeace today, and it is my job to ensure that Greenpeace is running yours tomorrow.*"[61]

[53] Wilson, T. "Naked Extortion,"5.
[54] Affolder, Natasha, "Cachet Not Cash," 142.
[55] WWF-UK, Banks Adopt Environmental Guidelines – But Are They Enough? (June 5, 2003), <http://www.wwf.org.uk/news_feed.cfm>
[56] Wilson, T. "Naked Extortion," 13.
[57] See Annex

[58] Coleman, "Sustainability May Cost the Earth," 26.
[59] Henderson, "Misguided Virtue," 28.
[60] Ibid., 24.
[61] Ibid., 79.

It has also become clear that adopting the EP not only makes no business sense, it even fails to quell the threat of ENGO campaigns. If anything, appeasement actually increases reputational risks due to the more intense level of ENGO scrutiny that becomes afforded to EPFI business practices. As was recently highlighted by the Rainforest Action Network (RAN):

"*all voluntary CSR initiatives bring with it heightened spotlight from the NGO community, and thus participating institutions risk reputational damage if they are seen to be hypocritical or shirking their responsibilities.*"[62]

Since becoming EPFIs, two financial institutions have been subjected to such heightened scrutiny and negative campaigns, despite not having breached any of the standards. Firstly, after supporting a $2.18 billion initial public offering of Malaysian timber company Samling, HSBC came under fire from the NGO Bank Track, for simply being associated with a forestry business.[63]

Likewise, ANZ were subjected to a negative campaign by the Australian Conservation Foundation (ACF) in response to the provision of banking services to another Malaysian based forestry business. This was despite the fact that ACF was actually benefiting from an ANZ donation facility, by way of the bank's community giving programme.[64] The head of Greenpeace International has even indicated ENGO intentions to increase the number and severity of these attacks:

"*Our aim is to get all banks to say we won't make loans to oil, coal, gas and deforestation related activity. We want to shut off the flow of capital. The time is right because the banks are at their most vulnerable in terms of public legitimacy*".[65]

This statement truly captures the underlying activist nature of ENGOs, as well as their irrational approach towards sustainable development issues. Accordingly, global lending institutions must realize the fallacies of the 'corporate citizenship' business proposition and recognize that the underlying agenda of ENGOs is hostile towards big business, free trade and the ideas of a market economy.[66]

7. Conclusion and recommendations

The latest revision of the EP is a marked attempt to dramatically alter the role of financial institutions in emerging markets, namely from financiers to sustainability regulators. By writing certain levels of environmental and social performance into Project Finance documentation, which go well beyond the levels prescribed by national laws, EPFIs become obligated to monitor, verify and remedy borrower compliance with sustainability standards.

The arguments that support adoption and compliance with the EP are heavily misguided and ultimately based on false presumptions surrounding the economic justification for exceeding mandated sustainability requirements. In reality, such 'corporate citizenship' actually undermines the maximization of social welfare, destroys corporate value, and fails to quell the reputational risks associated with ENGO campaigns.

The ENGO strategy to transform markets should therefore be recognized for its true negative impact on the developing world, as well as its underlying goal to redefine markets according to the values of ENGOs. EPFIs should thereby withdraw from the EP and resume investing in the most economically viable Projects in emerging markets.

Such a championing of profits will drive greater economic freedom and prosperity for the poor, enhance environmental and social sustainability, and thereby constitute legitimate 'corporate citizenship'. As Milton Friedman so importantly highlighted:

"*There is only one social responsibility of business – to use resources and engage in activities designed to increase its profits so long as it stays within the*

[62] Rainforest Action Newtork et al., NGO Collective Analysis of the Equator Principles at 4, Available at: <http://www.banktrack.org/show/pages/publications>
[63] Wilson, T. "What are the 'Equator Principles'," 8.
[64] Ibid., 8.
[65] Confino, Jo, "Rio+20: Greenpeace declares was on the finance sector," *The Guardian*, 19 June 2012, <http://www.guardian.co.uk/sustainable-business/rio-20-greenpeace-war-finance-sector>

[66] Henderson, "Misguided Virtue," 35.

rules of the game, which is to say, engages in open and free competition without deception or fraud."[67]

EPFIs should also start actively responding to the unfounded claims and allegations of ENGOs. This rebuttal should articulate the crucial role played by financiers in stimulating economic growth in emerging markets and also highlight the fact that the EP not only undermine shareholders returns, but also hamper the alleviation of world poverty.

In conclusion, the regulatory role assigned to multi-national banks under the latest revision of the EP, and its consequential impact on the free movement of capital and rule of law, are a much greater threat to sustainable economic development, than the environmental degradation that the EP seeks to prevent.

History shows that sustainable development is best achieved through the liberalization of markets and the advancement of legitimate state institutions. Accordingly, any effort to establish international sustainability requirements for Project Finance transactions should be done through bilateral and multilateral agreements among nation states; not arbitrary corporate social responsibility standards.

[67] Friedman, Milton, "The Social Responsibility of Business is to Increase its Profits," *The New York Times Magazine*, September 13, 1970, <http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html>

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