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Equator Principles III: setting the standard in environmental and social lender due diligence



The third version of the Equator Principles was released in June 2013. Two years on, we revisit the key changes brought about by them and how they are being applied in practice.

The Equator Principles ('EP'), which have now been adopted by 80 financial institutions ('EPFIs'), are used by commercial banks and other international financial institutions as their main risk management tool for environmental and social risks and impacts in projects and project expansions.

- > The Equator Principles were revised, and Version 3 ('EP III') came into effect in June 2013. An Implementation Note followed in July 2014.
- > The qualitative World Bank Group performance standards, that the EP require projects located in emerging markets to comply with, were themselves rewritten in 2011. The **new IFC Performance Standards** came into effect on 1 January 2012. The principal changes were flagged in our earlier **briefing**.
- > The World Bank Group's quantitative EHS guidelines are currently under review.

Extension to corporate and bridging loans

This change formally extended the EP's application outwith project finance to:

- > 'project-related corporate loans' where:
 - > these relate to a specific project
 - > the loan is for at least two years relating to a single project
 - > it has a value of US\$100m or more
 - > the EP lender's initial exposure is at least US\$50m
 - > the borrower has 'effective operational control' over the project which includes indirect control (the definition of which represented a big step in clarifying the formal application of the EPs and was intended to address sponsor difficulties where the EP had previously been applied absent such control)
- > Bridge loans with a tenor of less than two years that are intended to be refinanced by a project finance or a project-related corporate loan

Having a more transparent and precise scope for EP beyond project finance is helpful. Guidance on EP III now makes clear that the EP should not apply to loans for general corporate purposes.

However, individual EPFIs can choose to apply the EP beyond these parameters. For example, the concept of project finance and project-related corporate loans may be extended to reserve base lending and repo structures. Ultimately, this still remains a matter for each EPFI: EP III simply sets the industry baseline.

Human rights

For the first time the EPs make express reference to the need for human rights due diligence.

Lenders will rely on EP and IFC requirements on stakeholder engagement, and IFC standards on resettlement and indigenous peoples albeit that these do not address human rights expressly.

In practice, we have found lenders and export credit agencies to be more focused on social impacts including the more diffuse human rights risks (for example discrimination, bullying, etc.)

Because it remains a new and often sensitive area, borrowers will need to understand for their particular project:

- > what is expected by way of social and human rights due diligence – when will compliance with general stakeholder consultation requirements be enough, and when will a human rights assessment be necessary
- > expectations as to human rights compliance/reporting obligations – this can be difficult for corporates, who may have very limited ability to influence other actors
- > where the IFC requirement for FPIC (free, prior informed consent of indigenous peoples) is triggered, what action and consent is sufficient to achieve that standard

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EP in High Income OECD countries

EP had previously been relatively invisible where projects are in High Income OECD countries. Local law was treated as being as good as World Bank Group standards, and was generally applied as the relevant benchmark for due diligence.

EP III emphasises that while local law should be sufficient, those national requirements will only satisfy principles 2 (assessments), 4 (management systems and plans), 5 (stakeholder engagement) and 6 (disclosure and grievance mechanisms). The other principles still need to be fulfilled.

Projects categorised as high risk (category A) will require independent environmental review, specific EP III compliant covenants in financing agreements, and independent monitoring and reporting will be required for the term of the loan.

This is still not yet occurring as a matter of course for loans to projects in High Income OECD countries, and both lenders and borrowers will need to accommodate these requirements.

EP III also states expressly that any EPFI can at its discretion benchmark these projects against IFC or other internationally recognised standards.

Projects in High Income OECD countries will want an understanding early on in the project development process of when EPFIs are likely to require both local law and international standards to be satisfied.

Contractual requirements

EP III requires substantially the same borrower covenants as in earlier versions but their application is broader. There is an obligation for all financing agreements, whatever the project categorisation and location, to contain covenants as to:

- > material compliance with applicable environmental and social laws, regulations and permits
- > material compliance with any environmental action plan
- > periodic reporting of the project's compliance with laws, permits and action plan
- > where appropriate, decommission the facilities pursuant to an agreed decommissioning plan

The EP Association has posted draft provisions on EP-related matters on its website for the use of EPFIs and others in financing agreements. These were updated in March 2014. For obvious reasons, it is lender focused. Borrowers will wish to consider independently what contractual protection is reasonable, and to avoid automatic acceptance of these provisions.

Reporting

EPFIs had been roundly criticised by environmental organisations over their limited public reporting on the application of the EP. EP III envisages increased reporting requirements for both lenders and borrowers.

Borrowers are now required to disclose publicly the project's impact assessment and action plan as a matter of course. Principle 10 now requires public disclosure before commencement of construction. Projects generating more than 100,000 tCO₂e during operations must report this from that point onwards.

The EP III also require lenders to provide more information on their application of EP. This envisages disclosure of brief project-specific data after financial close and requires lenders to seek borrower consent to disclosure during the loan documentation process or at financial close. While the information will be quite high level, borrowers should be prepared for growing levels of lender disclosure of project details.

Getting projects EP ready

If you want to discuss the application of EP III or IFC Performance Standards to a project, or how to provide for environmental and social obligations in financing documents, please get in touch with Vanessa Havard-Williams or Rachel Barrett.

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