

# Can we have a Global Standard on Environmental, and Social Governance?

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## Preamble

Environmental and Social Governance (ESG) is critical for sustainable development. National Governments, Business and Communities are working in partnership to realize its best implementation. The extent of ESG is however uneven as national priorities are different and so are the implementation capacities.

Understanding the gravity of environmental problems in impacting regional or global scale has led to drafting Multilateral Environmental Agreements. A number of national governments have committed to achieving specific environmental goals through these since the 1970's.

Financial institutions around the world have realized the impacts of their investments on environment, communities & workers; and that these can affect the value of their investments. Development Financing Institutions and Private Sector Banking Institutions (PSBIs) have assumed a center stage in fostering linkage between economic development and environmental protection. These institutions have their own ESG that are applied across their business operations around the globe. DFIs such as the World Bank, Asian Development Bank, Inter American Development Bank etc have set up processes towards harmonization.

At operational level, many PSBIs have come together and signed up Equator Principles (EP), UNEP Finance Initiative (UNEP FI) and subscribed to Principles for Responsible Investment (PRI). In this process, ESGs at National Governments and Local Financing Institutions are influenced and are moving towards a "global standard". DFIs particularly have been influencing ESG at national governments.

This paper investigates the existing situation on ESGs around the world, examines the role of financing institutions in harmonization, raises issues and attempts to answer the question whether a global standard on ESG is realistic and achievable. Examples on ESG in India have been used for the purpose of illustration.

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## Global Environmental Governance through Multilateral Environmental Agreements

Global environmental governance can be defined as "the sum of organizations, policy instruments, financing mechanisms, rules, procedures and norms that regulate the processes of global environmental protection"<sup>2</sup>. This process is being regulated by MEAs that are legal instruments with binding effects on countries that have agreed to become parties to a particular

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<sup>2</sup> Quoted from 'Auditing the Implementation of Multilateral Environmental Agreements (MEAs): A Primer for Auditors' prepared by UNEP in cooperation with INTOSAI-WGEA, 2010

agreement through ratification or accession. There are a number of international agreements governing some aspects of environment that have been negotiated at bilateral, regional and global levels. UNEP identified over 280 MEAs which are wholly directed to environmental protection as of December 2009.

Every MEA addresses a specific environmental issue defining specific goals to contain the ongoing environmental damage. Thus, the Convention on International Trade in Endangered Species seeks to ensure that no wildlife species becomes or remains subject to unsustainable exploitation through international trade, but it also allows legitimate trade and scientific research; the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal seeks to protect human health and the environment from illegal transboundary movements and disposal of hazardous waste; and so forth.

Every nation has its own development priorities, institutional capabilities, economic capacities, geographical sensitivities, environmental and social sensitivities. Developed nations have highly developed economies and advanced technological infrastructure relative to other nations. So, how can particular MEA objectives be met by these nations at different economic and technology levels? To bridge this gap, MEAs include the components on technology transfer and financial assistance. For example, multilateral fund in Montreal Protocol or use of market instruments like Clean Development Mechanism in Kyoto Protocol.

Environmental concerns are generally viewed as “secondary priorities,” and nations do not want to put domestic businesses at a competitive disadvantage. MEAs have played the role of elevating the importance of an environmental problem at an international level providing additional motivation at the domestic level to address the problem. The MEA provides a basic framework for the nation to follow in developing measures, which also ameliorates concerns of competitive disadvantage, and thereby facilitates domestic legislative development. National laws, standards, and institutions have to be created or modified to reflect the new commitments.

For example in India, The Hazardous Wastes (Management & Handling) Rules, 1989 were framed based on framework of the Basel Convention. These Rules were again modified in 2008 to include restrictions on transboundary movement. Similarly The Biological Diversity Act, 2002 was framed in consonance to the Convention on Biological Diversity.

In the above discussion, we see that MEAs improve the environmental governance, especially of the developing nations, thus ensuring harmonization at the global level.

### **Global Environmental Governance through Development Financing Institutions**

Multilateral, regional and bilateral DFIs work across various regions of the world fostering economic growth and sustainable development. DFIs are backed by the developed nations with a mission to service the investment shortfalls in developing nations by bridging or supporting the gap between capital markets. They provide a broad range of financial services such as loans or guarantees to investors and entrepreneurs, taking equity participation in firms or setting investment funds for financing public infrastructure projects.

The financial support and social development that DFIs bring, especially for high risk projects serves as a catalyst enabling mobilization of private capital. The DFIs also often engage in

cooperation with the national governments and provide funds for preparatory works such as management consultancies and technical assistance. DFIs act as channels for policy implementation in areas such as governance, compliance with environmental regulations, good business practices and sustainability of the investments.

As part of their mandate, DFIs require that their financing activities are conducted in conformance to their environmental and social safeguards. For example Asian Development Bank (ADB), requires its borrowers to comply with its Safeguard Policy Statement (SPS); The World Bank, a multilateral development bank, requires its borrowers to comply with its ten policies on environmental and social safeguards; Inter-American Development Bank (IDB) which operates in the regions of Latin America and the Caribbean, requires all financing activities to comply with their Sustainability Standards and so forth.

Bilateral DFIs such as FMO, a Netherlands based entrepreneurial development bank requires its borrowers to comply with their Environmental, Social and Corporate Governance Policy; CDC United Kingdom's DFI requires their fund managers to adhere to their Environmental and Social Governance mechanism, DEG,, Germany's DFI and PROPARCO, France's DFI subscribe to International Finance Corporation's (IFC) Performance Standards and Environmental, Health & Safety Guidelines.

When Multilateral and Bilateral DFIs initiate a dialogue with national governments, private entrepreneurs or financial intermediaries, an Environmental and Social Management System (ESMS) is stipulated. The system is so designed that the host country environmental and social regulations as well as lending agency's environmental and social safeguards are addressed in parallel. A monitoring and reporting mechanism is established to review the conformance to the ESMS. For situations where the financial institution enters the project cycle at a later stage such as refinancing transactions, and environmental and social due diligence is conducted by an Independent Reviewer to establish the conformance of borrower to the lending agency's environmental and social safeguards. The disbursement conditions to be implemented during the life of the projects are drawn based on the level of conformance.

Majority of the bilateral DFIs subscribe to IFC Performance Standards (PS) for the implementation of their environmental and social safeguards. Almost all DFIs refer to Environmental, Health& Safety Guidelines for general application as well as sector specific for implementation in the borrower's projects. The aspects on environmental assessment, involuntary displacement, indigenous peoples, natural habitats and physical cultural resources are common across ADB's SPS, World Bank's Safeguard Policies and IFC PS. ADB SPS and IFC PS also have a list of prohibited investment activities. On similar lines, FMO has an exclusion list which includes activities more than ADB and IFC lists such as destruction of high conservation value areas; pornography or prostitution; and racist and anti-democratic media. World Bank also has additional issue and sector specific Safeguard Policies such as international waterways, safety of dams and disputed areas. ADB and IFC additionally look at community and occupational health & safety through their SPS and PS respectively. These financial institutions identify and classify the environmental and social risks of their investment as Category A, B and C<sup>3</sup> on similar parameters. In addition to this three-tiered classification, Inter-

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<sup>3</sup> Category A is assigned to projects with adverse, diverse, unprecedented and irreversible environmental impacts mostly on natural resources. Category B is assigned to projects with adverse environmental and social impacts that

American Development Bank also takes into account other risk factors such as such as governance capacity of executing agencies or borrower, sector-related risks, vulnerability to disasters, and risks associated with highly sensitive environmental and social concerns.

The DFIs through their environmental and social safeguards have been successful in setting up systems in the borrower institutions and nations wherein environmental and social issues are addressed formally in addition to legal compliance. They have influenced practices in these institutions that get reflected in other transactions as well. Generally the ESMS required as a mandate by DFIs is applied only to projects where the specific line of fund is disbursed. However there have been cases where financial intermediaries have realized the value of such ESMS and broadened the framework to their entire business operations. Infrastructure Leasing and Financial Services (IL&FS) of India is one such example of a financial intermediary which developed its Environmental and Social Policy Framework (ESPF) in response to the requirements of the World Bank. The ESPF at IL&FS is mandated to the entire business canvas. The ESPF has been structured such that it is harmonious with Government of India, World Bank, ADB and KfW requirements.

While it is possible to harmonize ESG across national governments and financial institutions on the count of guiding and operational principles, when it comes to the process and procedures, deviations are seen due to local interests, constraints and priorities.

The environmental assessment process at DFIs requires public consultation to be conducted early in and throughout the project cycle for every project. However, in India the environmental impact assessment process requires a public consultation after preparation of draft Environmental Management Plan. Also the consultation is in the form of a public hearing and certain projects and activities are excluded for conduct of this process. The public consultation aspect generally features as a point of deviation especially when the DFIs enter late in the project cycle in the refinance mode or end of the project development cycle.

In India, involuntary displacement caused by a project in public interest is covered under the Land Acquisition Act or 1894 subsequently amended in 1984. Under the Act, only title holders are compensated. The compensation is awarded for loss of land and structure which constitutes physical loss and displacement. Also in a number of cases, especially roads & highway projects, the land acquisition falls within the purview of the Execution Agency such as National Highway Authority of India (NHAI). However, loans are borrowed from DFIs by the Concessionaire who has been awarded the project for designing, building, financing and operating the project during the concession period ranging from 25 to 30 years and then transferring the asset back to NHAI. Since loans are borrowed by the Concessionaire, the environmental and social safeguards of DFI are applicable to them. DFI safeguards additionally require compensation for economic loss as well as displacement of non-titleholders such as squatters. The information on squatters in most cases is not recorded and available when the DFI has entered later in the project cycle. Hence this aspect remains as a point of non-compliance throughout lifetime of the loan. Similarly economic loss does not get recorded during socio-economic surveys. Some road companies have now started taking some social

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are local and short-term for which effective mitigation measures are readily available. Category C is assigned to projects that are likely to cause minimal or no negative environmental and social impacts.

initiatives through the mechanism of Corporate Social Responsibility. But these measures still do not meet DFIs specific requirements on social safeguards

Cognizant of these issues, IFC Performance Standard updated in 2012 on Land Acquisition and Involuntary Resettlement (Performance Standard 5), has included an exception for private sector responsibilities under government managed resettlement. It states that “Where land acquisition and resettlement are the responsibility of the government, the client will collaborate with the responsible government agency, to the extent permitted by the agency, to achieve outcomes that are consistent with this Performance Standard”. Other DFIs are yet to stipulate e such modes of collaboration.

The EHS Guidelines of IFC state specific standards for emissions and effluents. National standards for permissible environmental quality of various media are also available. The EHS Guidelines safeguards require the borrower to apply the more stringent standards of the two. Hence the borrower may be in compliance to host country regulations and still be non-compliant to DFI safeguards. Adherence to DFI standards may need significant technology or process modifications which could affect feasibility of the project. Here DFI often come up with arrangements for technical assistance, longer tenure with moratorium. Leveling up or harmonization is the principal idea.

### **Partnerships by Financial Institutions for Global Environmental Governance**

Since the early 90’s, a group of financial institutions have been coming together to understand and incorporate environmental and social risks in investment decisions. UNEP FI in 1991 was among the early initiatives. It is a global partnership between UNEP and the financial sector. Over 200 institutions, including banks, insurers and fund managers, work with UNEP to understand the impacts of environmental and social considerations on financial performance. UNEP FI conducts periodic training through electronic media for their signatories on environmental and social risk assessment in various languages.

Equator Principles formulated in 2002 and subsequently revised in 2006 for addressing environmental and social risks in project finance transactions is another example of such global partnerships. The principles are based on the IFC Performance Standards and EHS Guidelines and signatories are termed as Equator Principles Financial Institutions (EPFI).

The United Nations-supported Principles for Responsible Investment (PRI) initiative is another international network of investors who are trying to understand the implications of sustainability for them and support signatories to incorporate these issues into their investment decision making and ownership practices. In implementing these various initiatives, the financial sector has contributed to the development of a more sustainable global financial system by incorporating environmental and social factors in decision making. UNEP FI and PRI are yet at the level of prescribing overarching principles while providing the signatories room for developing their own operational mechanisms. However, Equator Principles has a more mature and robust framework as they are based on systems developed at IFC.

Implementation of these principles by signatories in different regions across the globe shows that harmonization of environmental and social governance at financial institutions is possible.

## Can we have a Global Standard on Environmental & Social Governance?

Environmental, social and governance involves different tiers - (i) Policy Principles; (ii) Acts, Rules, Standards, Exclusions; (iii) Procedures; (iv) Monitoring and Reporting; and (v) Practices. A global standard requires harmonization at all levels.

Summarizing from the above discussions, we can conclude that a global standard on environmental and social governance can be achieved only up to a limited extent. Coherence and alignment are possible at the level of Policy Principles and Regulations. Procedures, monitoring and reporting in terms of scope, timing and intensity; and stipulation of best practices will vary depending on national context, readiness and priorities.

Efforts towards harmonization by MEAs and financial institutions will however play a dominant role. The national governments, especially from developing economies, should partner to harmonize ESG at least at the level of policy principles and regulations to create a level playing field to global economy and to move collectively towards sustainable development.

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