How SEA can inform lenders

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Abstract

SEA can be a powerful tool to improve decision-making for plans, policies and programmes, but it can also be useful for banks. SEA can help lenders address the reputational risks they are exposed to through financing projects that may have a negative impact on the environment and it can also help with identifying the financial incentives that ‘green’ projects attract. Although bank lending decisions apply to projects, examination of the lending practices of an Australian and a Hungarian bank have shown that decisions about the type of projects to target or avoid are also made at strategic level, such as in the credit policies. It was also found that in some cases lenders become involved in project planning at a very early stage, when projects are conceptualized, and certainly before formal approval is sought from relevant authorities and an EIA is conducted. This suggests that SEA can be a useful tool to inform bank lending decisions.

Introduction

Strategic environmental assessment (SEA) is a relatively new environmental assessment tool aimed at assisting decision-makers with achieving better developmental outcomes; in other words it is meant to facilitate the transition to a green economy. SEA applies to developments at the level of plans, policies and programmes and is viewed mainly as a tool for policy-makers, land-use planners, and other strategic-level decision-makers in government. However, we believe that SEA could also benefit lenders when they make decisions about which projects to finance. We propose that SEA can be a valuable tool for lenders because it can alert them to the potential risks associated with financing projects and inform them about the nature of those risks. In addition, we suggest that SEA can also help lenders identifying the business opportunities represented by ‘sustainable’ or ‘green’ projects as these often attract financial incentives and which can enhance the lenders’ reputation.

Rationale and methodology

The idea that SEA could provide useful information to lenders arose from an in-depth qualitative study exploring the lending practices of a European and an Australian mid-size commercial bank, to determine whether the environmental impacts of project influenced lending decisions. This study involved semi-structured interviews with twenty-two individuals, all of whom were directly involved in the project lending practices. Participants represented staff with decision-making capacity over the majority of the projects the banks financed. In addition, a host of documents, including policies and guidelines that governed lending practices, and various forms and reports that bankers used or produced during the lending process were reviewed. This data was collected in 2006 from the European bank and 2007 from the Australian bank.

Information about the type of projects the two banks financed was collected and it was determined that they financed a wide range of activities including those would likely have impacts on the environment and would likely require approval from relevant development and/or environmental authorities. Both banks’ portfolio included projects in the energy sector (such as the construction and upgrade of gas- and coal-fired power plants, the construction of wind farms), large-scale commercial and residential real estate developments (such as the construction of shopping centers, estates, apartment complexes and land subdivisions) as well as transport and social infrastructure (construction of motorways, ports and tunnels, sewerage treatment plants, hospitals and landfills).
Part of this study involved investigating the operative processes of lending to find out when and how lenders became involved with projects, in other words when do proponents approach the banks seeking financing and the extent to which banks become engaged in project planning. The results indicated that in some cases, bankers become involved in projects in the very early planning phase, even before an EIA is conducted ((Banhalmi-Zakar 2011). This suggested that SEA may be better timed than EIA to provide information about environmental and social impacts to lenders.

The results of the study also revealed that lenders were interested in the environment in terms of the financial risks and opportunities that it represented (to the banks) through lending (Banhalmi-Zakar 2011). In fact, for the most part, bankers did not talk or think about the environment in terms of project-related environmental impacts, but “environmental risks” and “opportunities” (Banhalmi-Zakar 2011). The results of this study also revealed that the majority of bankers have never read an EIA; few had seen one, although more than half of the informants indicated that they were aware that these “environmental reports” or “impact studies” were linked to the project approval process. This prompted us to look at whether SEA can provide the type of information that lenders can use to identify and assess the risks and opportunities presented by the environment.

Potential links between lenders’ information needs about the financial risks and opportunities of the environment and SEA were explored using desktop research on SEA practice, including illustrative examples from a Danish context. Apart from the examples the desktop research has focussed on a generic framework for SEA rather than any specific system or legislation.

**SEA: Purpose and process**

SEA is a tool to integrate environmental issues into decision-making as a part of the overall pursuit of sustainable development. SEA contributes to this through assessment of potential environmental impacts of proposed policies, plans and programmes (PPPs) and using this to continuously make PPPs more sustainable. (Therivel 2004; Kørnøv and Christensen 2007) An important element in this regard is the intention that SEA should ‘get in early’. That is early in the planning process and before the project level where environmental impact assessment (EIA) is used. This intention is based on the fact that earlier in the planning process, overall and important decisions are open and thus can be influenced by an assessment. (Therivel 2004, 14-8; Kørnøv and Christensen 2007) For example an SEA of a national energy plan may influence the choice of energy source, for instance coal or biomass, while an EIA will come in at the project level where this decision has been made, and focus is on environmental optimisation of for example a coal-fired power plant. Thus both tools have important roles and they supplement each other.

Further SEA can be said to have a democratic purpose. One of the benefits of SEA is that it can help “facilitate transparency and democracy” relates to environmental information, and in systems of decision-making that are not always otherwise transparent. This purpose is pursued through requiring to varied degrees documentation, communication and participation, through which SEA can open up for discussions of different interests. (Kørnøv and Christensen 2007, 400-1; Therivel 2007, 17)

SEA follows a process as illustrated in figure 1. The process described in figure 1 is generic and streamlined. The actual
process can look different within different contexts and based on different legislation (Kørnøv and Christensen 2007).

Another aspect of relevance for this paper is that SEA is inherently about the future, since it attempts to predict and evaluate future impacts of PPPs. Thus although SEA does not have an explicit traditional risk framework, it can be viewed as an assessment of environmental risk.

The suitable timing of SEA

The investigation into banks’ internal lending operations revealed when and how lenders become involved with projects. It was found that there two types of approaches to processing applications for project loans. One approach was processing incoming loan applications that were submitted by the clients, which were usually prepared according to the banks’ expectations (Banhalmi-Zakar 2011). The bankers explained that this approach did not leave much chance for the bank to provide input into the planning, approval or feasibility assessment processes (Banhalmi-Zakar 2011). They described this as being “handed” an application document for a concrete, planned project, which was then assessed and decided upon (Banhalmi-Zakar 2011). If a project was subject to an EIA this was often conducted prior to the client approaching the bank and would be attached to the application (Banhalmi-Zakar 2011).

The other approach of processing loan applications was much more involved on the lenders’ part. In this case, the lenders actively sought out proposed projects that could potentially be lucrative to finance early on, then work the feasibility and financing options through with the client (Banhalmi-Zakar 2011). This occurred at the very early project planning phase and the bankers described their involvement in such projects as “extensive” and indicated that “setting up” such loans would take “several months to years”. This is where we believe SEA could be a useful resource for lenders as SEA is available early on in the conceptualization phase of projects and has prompted us to look at whether SEA can provide the type of information that can be useful for banks.

The risks and opportunities represented by the environment

A substantial body of work has been published on the nature of the risks that the environment represents in lending, since the 1990s. Today, ‘environmental risk’, as it is often referred to by bankers, sector it generally seen as representing three distinct type of risks, as advocated by Thompson (1998a,b) and Case (1999): direct, indirect and reputational risks. Direct risks refer to direct liability of banks as a result of environmental damage to a site a bank takes control over, in the event that of loan default (Case 1999; Cowton and Thompson 2000; Jeucken 2001). Indirect risks arise when a borrower's ability to repay a loan is hindered as a result of environmental issues and can also arise from the contamination of a property held as collateral (Thompson 1998; Case 1999; Jeucken 2001; Thompson and Cowton 2004). According to Case (1999), this form of risk was responsible for the severe financial losses that banks incurred, giving rise to due diligence and valuation practices.

In fact several authors have attributed greater significance to the environmental affect of the indirect impacts of PFSs (Barannik 2001).

The third type of of risk is reputational risk. Authors agree that among the three types of risks, the financial implication of reputational risk is the most difficult to quantify (Thompson 1998; Case 1999; Cowton and Thompson 2000). It is of particular concern when a lender is looking to finance large-scale projects, as these attract more public attention and banks are keen to protect their reputation (Case 1999). It has been pointed out, that unlike direct and indirect risks, reputational risk does not
necessarily depend on compliance with environmental regulation of the owners of operators of project and can impact lenders even if their involvement in a project is minimal (Thompson 1998a; Case 1999; Jeucken 2001). Even an advisory role can damage a lender’s reputation through “guilt by association” (Case 1999). Reputational risk is also cumulative in nature, meaning that while a banks’ involvement in one ‘bad project’ may be forgiven, a series of bad decisions can have a detrimental effect on a its reputation (Case 1999 p148).

The perceived nature and potentially major effects of reputational risk all add to the difficulty in assessing reputational risk. And the study of the two banks’ lending practices also revealed that reputational risk was a serious concern. For example, a number of bankers from the Australian bank, particularly those involved with financing large-scale projects, flagged reputational risks, as the environmental risk that they would be most concerned about. Direct and indirect risks were more “manageable” through their standard risk management processes, they could be handled by including environmental impact management or environmental fines in the projects’ cashflow. But reputational risk was impossible to cost and manage. Consequently, when presented with reputational risks that were too high, the banks “stepped away” from financing the project. In one example, the Australian bank eventually refused to finance the construction of a shopping centre because of public discontent over environmental issues.

However, lenders’ reputation has two sides and on the brighter side, banks know that financing ‘green projects’ is good for their image. ‘Green projects’ were projects which the bankers considered to benefit the environment. They included the construction of wind farms, sewage networks treatment plants, power plant upgrades and retrofitting apartment buildings to make them more energy efficient. Both banks included a description of the ‘green projects’ they financed (although these were relatively few in comparison to their entire project lending portfolios), highlighting their benefit to the environment in the ‘environment’ section of the Annual Reports and Corporate Social Responsibility Reports. Somewhat surprisingly however, the majority of the bankers that were interviewed were unaware of their banks’ green’ endeavours’, suggesting that this information is meant to improve the banks’ image externally and has no real drive within the organisation.

The interesting result about the ‘green’ projects, that both banks financed, was they all attracted some form of financial incentive and it was these financial incentives that the bankers capitalised on. Usually these bankers were at the senior level, who, after a few successful projects, sought to create a niche for the bank for these projects. This was seen in both banks; the Australian bank had a real ‘appetite’ for projects in the energy sector and financed a number of gas-fired power plants, wind farms and other alternative energy generators. The European bank financed a high volume of wastewater treatment projects and apartment retrofits, creating for the latter “a portfolio-based financing scheme” to be able to keep up with the great number of small scale loans. Obviously the realisation of these projects depended on the banks taking advantage of the business opportunities presented by the financial incentives, some of which served to decrease market risk and others, to provide security for the bank against borrower default. Recognition of the business opportunities associated with these projects is another area where SEA can possible help.

**Drawing a parallel between the SEA content and lenders’ information needs**

Overall it appears that SEA holds two types of information which can be of relevance to lenders, in accordance with their needs.

I. Facts about possible environmental risks
II. Fact about possible controversy (related to environmental risks)

These will be elaborated on in the following paragraphs.

**Facts about possible environmental risks**

SEA in establishing possible and significant environmental impacts likely to result from a PPP, can provide facts about the environmental risks connected to it. SEA can cover different types of PPPs, for example: sectoral ppp’s, ppp’s for managing a resource, development plans, land use plans and conservation plans (Therivel 2004, 9). The PPPs can also cover a range of sectors, for example industry, transport, waste, water management and energy (Therivel 2004, 9, Kørnøv and Christensen 2007). The diversity in what SEA covers, means that it can be a tool for lenders to assess environmental risk at different levels. For example:

A. In 2007 the Danish Energy Agency published an SEA of a programme for future off-shore wind turbines in Denmark (Danish Energy Agency 2007). The SEA provides insights into the environmental risks for the sector as such and also for specific geographical placements and thus future projects.

B. In 2011 the Municipality of Copenhagen published a draft SEA of a plan for urban development in an area, Nordhavn, located on the harbour front (Municipality of Copenhagen 2011). The SEA provides insight into the environmental risk connected to the specific projects that will result from the implementation of the plan, for example building a new metro line, office and residential buildings.

Regarding example A, it is interesting that this is an SEA related to what could be defined as ‘green’ projects; installation of wind turbines. However, an SEA of such projects can help shed light on environmental risks in a broader and more holistic concept of the environment. For instance wind turbines have positive impacts on CO$_2$-emissions, but may be problematic for marine life. So also for these projects there are possible risks that should be considered and can be pointed out early on by an SEA.

**Facts about possible controversy**

Through the different instruments mentioned above; documentation, communication and participation, SEA can provide insight into whether the PPP covers content that is environmentally controversial. Even if PPPs appear not to have significant environmental risks, in terms of ‘objective’ environmental impacts, they may still not be acceptable to the public. For example:

C. In 2009 the Danish Government decided to start working on planning for a national test center for large wind turbines to be placed in Northern Jutland (Danish Nature Agency). However, the project has been met with widespread protests (see for example National Association for Better Environment). An SEA prepared in connection to choosing the site between other alternatives could have revealed this risk.

Depending on the specific SEA system, many different actors can participate. If involved public authorities take part in a form of hearing this can provide preliminary insight into whether future permissions are likely to be given by these authorities later on in the implementation process.

To sum up, the different parts of the SEA process can contribute with different information as illustrated in figure 2.
It can be seen from figure 2, that information about controversy primarily stems from documentation and hearings. These can also take place at other steps in the process than that illustrated in the figure. Information about the environmental risks can be derived from the screening, where some PPPs are deemed low-risk. Further the scoping and evaluation stages provide information on specific environmental risks. Last the monitoring programme set up for the PPP can be a source of information of any changes in the level of environmental risk.

SEA exhibits many similarities to EIA in terms of its process and the issues it aims to address, but it differs in terms of its scope, timing and some of the challenges it faces with implementation. Compared to environmental impact assessment (EIA), SEA operates at a different level; it applies to plans, policies and programs, while EIA is conducted at the project-level.

**Conclusion**

Based on an understanding of the processes behind bank lending decisions in two commercial banks, it was proposed that SEA could be an effective tool for lenders. We have shown that SEA documents become available to stakeholders and the wider public at a time when lenders contemplate whether to finance large-scale projects where environmental and social impacts inherently arise. We have shown how SEA can provide information about how the public would react to certain types of developments and which we believe, lenders could use to address the reputational risks they would be exposed to if they decided to finance them. This is especially important considering that reputational risk are the most difficult to manage for lenders. We have shown how SEA can provide information to banks about project approvals, thus help forecast any regulatory issues. And overall SEA we suggest that SEA can be of assistance for banks when making strategic decisions about which sectors they wish to target or avoid, and help them identify the risks and opportunities represented by the environment.
References

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