

ENVIRONMENTAL ASSESSMENT FOR FINANCIAL INTERMEDIATION LOANS AND EQUITY INVESTMENTS

Introduction

Financial intermediary projects involve the provision of capital by ADB to financial intermediaries, which in turn finances specific investments through loans or equity. Frequently, ADB funds will be channeled through a large financial institution such as a national development bank, which on-lends to smaller commercial banks and other financial intermediaries. Sometimes, a borrowing country's central bank acts as the intermediary between ADB and smaller financial intermediaries. Demand in the marketplace dictates the types of investments that are eventually made and the pace of borrowing, although the ADB and the borrowing government normally agree on a set of broad criteria. For example, some loans may be assigned to rural or industrial investments, whereas others may have a specialized focus, such as investments for rural agriculture, pollution prevention and abatement or urban development.

ADB's loans involving financial intermediaries are usually in the form of credit lines and equity investments. A financial intermediary could be a government, public corporation, or private institution. ADB's financing of subprojects through financial institutions may take on different forms. Private equity investments may finance companies with diverse operations or specific projects. Investment may flow directly through the financial institution to a specific subproject, as in credit lines. In other cases, such as an equity investment in a commercial bank, ADB's investments are not targeted to specific subprojects but support an institution whose investments may have environmental and/or social impacts.

Under ADB's environmental assessment requirements financial intermediary projects are subject to the same rigor of assessment by ADB and the same expectations of environmental performance in design and implementation as regular investment projects. However, the nature of financial intermediary projects requires differing roles and responsibilities of the party or parties involved. The ultimate project sponsor (the company or individual carrying out a project financed) is responsible for the project environment assessment. This is consistent with ADB policy for regular investment projects and with environmental assessment regulations in most countries: the entity that wants to undertake a project must also carry out any required environmental assessment. In most cases, project sponsors conduct any required environmental assessment and hire professional consultants to undertake the environmental assessment. The financial intermediaries must verify that subprojects in which they invest meet the environmental regulations or other requirements of the country (or, as appropriate, state, provincial or local authorities), and are consistent with ADB's environmental policies. This essentially means that financial intermediaries must screen projects and ensure that any legally required environmental report has been prepared and approved by the appropriate authorities, before approving any loan or investment. In the absence of such regulations, the financial intermediaries should verify that the environmental assessment meets the ADB's requirements as set out in OM 20.

Microfinance projects are usually executed through financial intermediaries. Loan amounts are small and projects normally have little potential for environmental impacts. To minimize loan transactions costs, environmental assessment procedures for microfinance projects may be streamlined.

Conducting Environmental Due Diligence

For financial intermediation loans and equity investments projects, ADB is seldom directly involved in environmental assessment of subloans. As a result, ADB's environmental assessment focuses on due diligence assessment of the financial intermediary (Table 1). Environmental due diligence should concentrate on; (i) evaluation of the financial intermediary's EMS ¹; and (ii) if the project involves credit lines or other forms of on-lending, an evaluation the financial intermediary's procedures for environmental assessment and review of loans.

1. Evaluation of the EMS

The evaluation begins overall description of the organization, its Board of Directors, its senior management, its business activities and its environmental and social track record. The adequacy of financial intermediary's EMS should be reviewed to determine whether it has the capability to ensure that ADB's environmental and social safeguards will be met. Key officers and staff responsible for environmental management should be identified and evaluated in terms of their training and experience. A key element of an EMS is an environmental policy as approved by a Board of Directors or senior management. The policy should be scrutinized to ensure that it provides for necessary mandate for integration on environmental and social considerations into the financial intermediary operations and provide development of procedures to ensure compliance with environmental laws and regulations. Procedures that are used for monitoring and review of environmental performance should be carefully assessed.

2. Evaluation of Environmental Assessment and Review Procedures

When the project involves credit lines or other on-lending arrangements, environmental due diligence also requires an evaluation of the environmental assessment and review procedures for subprojects (see Appendix 6). These procedures are equivalent to those that are required for sector loans. The evaluate should assess the adequacy of the environmental assessment and review procedures in the context of ADB's environmental assessment requirements

3. Recommended Improvements to meet ADB Safeguard Policies

The final aspect of environmental due diligence is the preparation of recommendations and action plan for any needed improvements to the financial intermediary's EMS. Recommendations should concentrate on those needed to meet ADB's Safeguard Policies.

¹ Here the term "environmental management system" is defined as a system for planning, implementing, reviewing and improving the processes and actions that an organization undertakes to meet its environmental goals. The major components of an EMS are: (i) environment policy, (ii) environmental management capability, (iii) environmental assessment and review procedures for subprojects (credit lines), and (iv) environmental monitoring and reporting. Many EMSs are built on the "Plan, Do, Check, Act" model. This model leads to continual improvement based upon:

- planning, including identifying environmental aspects and establishing goals [plan];
- implementing, including training and operational controls [do];
- checking, including monitoring and corrective action [check]; and
- reviewing, including progress reviews and acting to make needed changes to EMS [act].

4. Reporting

A report on environmental assessment of the financial intermediation loan or equity investment should be prepared following the recommended format in Appendix 7.

Table 1: Evaluating a Financial Intermediary - Environmental Due Diligence

This questionnaire is designed to guide the collection of information for evaluating the environmental procedures and performance of the financial intermediary. The questions may be discussed with financial intermediary staff having responsibility for environmental issues, a senior manager, or a credit officer.

1. *Current environmental procedures*

- Does the financial intermediary have any formal environmental policy or procedures? If yes, please describe them and provide appropriate documentation.
- Are there any types of projects in which the financial intermediary will not take part due to the environmental risks? (e.g., projects involving handling of hazardous wastes or endangered plants or animals).
- Who is responsible for environmental issues? (name/role and title).
- How are environmental considerations taken into account in the credit review and approval process for project loans or equity investments?
- How are environmental issues taken into account in deciding whether to offer or extend commercial credit, working capital finance, trade finance, payment services and other financial services to a company?
- In the view of the financial intermediary, to what extent is the nature of its investments in projects likely to be subject to environmental risks, and how are potential environmental risks taken into account?

2. *Staff environmental capabilities*

- Are there staff with environmental training in the financial intermediary? If so, describe.
- Are there technical staff with an engineering/industry background responsible for technical analysis of credit proposals?
- What experience, if any, does the financial intermediary have of hiring or dealing with environmental consultants?

3. *Environmental aspects of existing portfolio*

- To the financial intermediaries knowledge, are any of its investment/loans subject to environmental liabilities of any kind?
- To the financial intermediary's knowledge, have any of its commercial customers been the subject of environmental criticism? If so, describe.

4. *Environmental services*

- Does the financial intermediary, as part of its advisory services, have the capability to advise corporate clients on the environmental risks associated with project finance?
- Does the financial intermediary offer a service of investment in "environmental funds"?

5. *Other issues and plans for the future*

- Has the financial intermediary signed any national or international agreements or declarations concerning environmental issues?
 - Has the financial intermediary ever received any criticism of its environmental record? If so, what was the criticism?
 - Does the financial intermediary carry out environmental audits of its properties to
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- analyze health and safety issues, waste disposal, etc.?
- Does the financial intermediary have plans to develop environmental procedures in the future? If so, what are these?

Source: As adapted from Conducting Environmental Due Diligence on FI Projects, EBRD in Financial Intermediary Lending and Environmental Assessment, World Bank Source Book Update Number 27: June 2002.