Environmental and Social Management Systems & Tools for Financial Institutions Financing SMEs

Presented by Sandra Abiola
Sector Lead Financial Markets
Senior Environmental and Social Development Specialist
IFC Transactional Risk Solutions - Environment, Social & Governance Department

April 9th, 8:30am – 9:30am EDT (Washington DC, USA)
Sandra Abiola is the Sector Lead Financial Markets, in IFC's Transactional Risk Solutions - Environment, Social and Governance Department, based in Johannesburg South Africa. She is responsible for IFC's team of E&S Specialists working with Financial Institutions on E&S risk management globally.

Sandra has a Master in Development Economics and Middle East Studies from SAIS, Johns Hopkins University and a MA in politics, law and economics from the University of Mainz, Germany. She is a social and environmental development specialist with extensive experience on E&S risk management by financial institutions and E&S issue in rural development and agricultural projects.
Sandra’s presentation will have 2 parts:
- Part I – The Business Case for Good E&S Risk Management, (10 min)
- Clarifying Q&A (10min)
- Part II – Review of the Purpose and Components of an ESMS and E&S Due Diligence Procedures and Tools (20 min)
- Q&A for clarification and overall presentation (remaining time)

Please use the chat feature (lower right-side of screen) to type in your questions or comments.
The moderator will relay the questions to the presenter according to the order of their submission.

We will focus on questions related to this presentation only – e.g., we will not answer questions on specific IFC clients or projects.
Please submit your queries in the form of a question and not comments.
Please understand that not every question can likely be answered due to time limit.
Thanks to those who submitted questions ahead of time; Sandra has tried to take them into consideration in her presentation.

As this webinar is being recorded, the moderator will repeat each question before answering.
We appreciate your feedback! Please kindly fill out a quick evaluation survey by clicking on the link after this session. We will also send this link to you as a gentle reminder.

We plan to offer future webinars in this series, please tell us which topics would be of interest to you and we welcome your suggestions 😊

For general inquiries, please contact: AskSustainability@ifc.org
Today’s Agenda

1. The Business Case for Good E&S Risk Management
2. Questions & Answers
3. The Purpose and Components of an ESMS and Review of E&S Due Diligence Procedures and Tools
4. Questions & Answers
PART 1: THE BUSINESS CASE FOR E&S RISK MANAGEMENT
WHAT IS CONSIDERED AN SME?

- SME market consists of a wide range of enterprises of various sizes (as defined by number of employees, working capital, and/or annual revenue) and operating in a variety of sectors.
- SMEs can be slightly larger than microenterprises or almost the size of large corporations.
- Whether based on number of employees, sales, assets or loan size, SME definitions vary by country, market, and financial institution.

**Note on Enterprise Definitions for Micro, Small and Medium Firms**

Global Financial Markets categorizes its clients’ sub-borrowers according to the following definitions:

1. Microenterprise if loan < US$10,000 at origination
2. Small Business if loan < US$100,000 at origination
3. Medium Business if loan < US$1 million at origination (US$2 million for more advanced countries)

Technically, the above definitions are a proxy for the official IFC definition, based on an enterprise qualifying under two of the following three indicators, as follows:

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Micro Enterprise</th>
<th>Small Enterprise</th>
<th>Medium Enterprise</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employees</td>
<td>&lt;10</td>
<td>10&lt;50</td>
<td>50&lt;300</td>
</tr>
<tr>
<td>Total Assets</td>
<td>&lt;$100,000</td>
<td>$100,000&lt;$3 million</td>
<td>$3 million &lt;$15 million</td>
</tr>
<tr>
<td>Total Annual Sales</td>
<td>&lt;$100,000</td>
<td>$100,000&lt;$3 million</td>
<td>$3 million &lt;$15 million</td>
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</tbody>
</table>
**KEY E&S RISKS OF SMEs**

- **Extend of E&S impacts** depends on the **scale and complexity** of the SME’s operation, as well as the **sector and geographic context**
- **Mitigation measures** typically **simple and cost effective**, and help improve bottom line of the SME
- **Only medium/large size companies** need formal ESMS

<table>
<thead>
<tr>
<th>Environmental Impacts</th>
<th>Hazards to Human Health</th>
<th>Social and Labor Issues and Impacts on Local Communities</th>
<th>Regulatory Compliance and Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>- waste and affluent management</td>
<td>- noise levels</td>
<td>- labor and working conditions</td>
<td>- HSE permits and approvals</td>
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<tr>
<td>- toxic/hazardous materials and waste</td>
<td>- smells/irritants</td>
<td>- labor representation relations with local communities</td>
<td>- HSE liabilities due to water/land contamination</td>
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<td>- air emissions</td>
<td>- fire risk</td>
<td>- internal and external grievance mechanism</td>
<td>- Accidents and incidents (oil spills, fires)</td>
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<td></td>
<td>- occupational health and safety</td>
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<td>- Environmental inspections</td>
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</table>
**Risks for Financial Institutions**

- **SME Finance typically includes:** working capital loans (supplies, salaries), terms loans with longer maturity to provide investment capital (equipment, property, other assets) or trade finance

- **Environmental and Social Risks** present themselves to companies and financial institutions as business risks, the main types of risk for banks are:
  
  - **Credit risk (default probability; loss given default):** Client is not able to repay the loan on account of social and environmental issues
  
  - **Liability risk:** The FI faces legal complications, fees, and/or fines in rectifying social and environmental damage by virtue of taking possession of collateral
  
  - **Reputational risk:** Negative aspects of a project harm a financial institution's image in the media, with the public, with the business and financial community, and even with their own staff
## Risks for Financial Institutions

### Type of Risk

<table>
<thead>
<tr>
<th>Type of Risk</th>
<th>Impacts</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Credit Risk</strong></td>
<td>• Escalation of project costs (e.g. delays, additional investments)</td>
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<td>• Fines/penalties due to non-compliance with E&amp;S national requirements</td>
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<td>(OHS, emissions/discharge permits)</td>
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<td></td>
<td>• Loss of production capacity (e.g. closure of business)</td>
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<td>• Poor efficiency leading to low competitiveness/low sales</td>
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<td>• Increased insurance costs</td>
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<tr>
<td><strong>Liability Risk</strong></td>
<td>• Obtaining ownership of contaminated collateral</td>
</tr>
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<td></td>
<td>• Direct liability in the case of strict lender liability</td>
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<td></td>
<td>• Class action suits if made responsible for negative impacts</td>
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<tr>
<td><strong>Reputational Risk</strong></td>
<td>• Media coverage</td>
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<td></td>
<td>• Local resistance /consumer campaigns</td>
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<td></td>
<td>• Governmental investigations</td>
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</tbody>
</table>
## Risks and Opportunities

<table>
<thead>
<tr>
<th>Stakeholder of Portfolio Company</th>
<th>Downside</th>
<th>Upside</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employees</td>
<td>Strike, Sabotage</td>
<td>Retention, Productivity</td>
</tr>
<tr>
<td>Government</td>
<td>Shutdown, Delays</td>
<td>License Renewal, Expansion</td>
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<tr>
<td>Community</td>
<td>Protest, Reputation</td>
<td>Support, Comm. Dev</td>
</tr>
<tr>
<td>Shareholders</td>
<td>Divesting</td>
<td>Long-Term Investors</td>
</tr>
<tr>
<td>Financiers</td>
<td>Increased Cost</td>
<td>Reduced Cost</td>
</tr>
<tr>
<td>Media</td>
<td>Negative Publicity</td>
<td>Reputational Benefits</td>
</tr>
<tr>
<td>Clients</td>
<td>Contract Boycotts</td>
<td>Stable Market</td>
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<tr>
<td>NGOs</td>
<td>Campaigns</td>
<td>Cooperation</td>
</tr>
<tr>
<td>Insurers</td>
<td>Loss of Coverage</td>
<td>Reduced Premiums</td>
</tr>
<tr>
<td>Export Market</td>
<td>Market Loss</td>
<td>Open Markets</td>
</tr>
</tbody>
</table>
SUSTAINABILITY ADDS VALUE

The Client

- SME Cardboard packaging manufacturer in Madagascar
- 242 employees, 460 clients
- Improvements cost US$220,000

The Result

- Savings achieved: US$539,000 in first 2 years
- Attracted new export clients

- Improved waste, wastewater mgt and fire protection (a fire had occurred)
- Enhanced occupational, health & safety -- no work-related accidents, fatalities
- Began staff bonuses based on company’s improved financial performance
- Implemented E&S management system
QUESTIONS & ANSWERS
(10 MIN)
PART 2: ENVIRONMENTAL AND SOCIAL MANAGEMENT SYSTEM (ESMS) AND E&S DUE DILIGENCE TOOLS
Background: FI provided a NGN 7.9 billion (USD 50 million) bridge finance loan to a Nigerian power company building an electricity transmission line.

Failure to identify the following E&S issues:
- Displacement of local residents from their homes as well as farmlands without compensation,
- Potential health and safety hazards from increased noise, pollution, dust, traffic and road accidents,
- Low hanging wires resulting in risks of electrocution.

Result:
- Court injunction, suspension and delays of 18 Months.
- Significant additional costs to remedy issues.
COMPONENTS OF AN ESMS

POLICY
Financial institution's environmental and social commitment and standards

E&S CAPACITY
Roles and responsibilities
Training

PROCEDURES
Evaluating E&S Risk
- Transaction screening
- Risk categorization
- E&S due diligence
- Conditions of financing

Monitoring E&S Risk
- Reviewing client/investee E&S performance
- Managing non-compliance

REPORTING
E&S performance of financial institution and clients/investees
System consisting of procedures, management commitment, delineation of roles and responsibilities and guidance to review and manage the E&S issues and risks associated with its lending/investments.

1. Brief E&S Policy
2. Outline Applicable Criteria (XL, HC, PS)
3. Activities covered by the ESDD
4. Detailed Step-by-Step ESDD Process (integrated)
5. Responsibilities of the E&S Staff
6. E&S Covenants for Legal Agreements
7. Monitoring and Reporting (internal, external)
8. Internal Training and Communication of E&S procedures
9. Tools:
   - Categorization Guidance
   - ESDD Questionnaires/Forms to be used
A Financial Institution’s commitment to its goals and efforts to manage social and environmental risk across its operations:

- Written statement, approved by Senior Management
- Communicated to all employees, in particular operational staff of the FI
- Communicated to all stakeholders including clients

Example: XXX continually endeavors to ensure effective social & environmental management practices in all its activities, products and services with a special focus on the following:

- Ensuring that all activities undertaken by the Company are consistent with the Applicable Requirements outlined later in this document
- Ensuring that all projects are reviewed against the Applicable Requirements
- Financing projects only when they are expected to be designed, built operated and maintained in a manner consistent with the Applicable Requirements
- Making best efforts to ensure that all projects are operated in compliance with the Applicable requirements on an ongoing basis, during the currency of the Company’s financing
- Ensuring transparency in its activities
- Ensuring that the management and the shareholders of the client companies understand the policy commitments made by the Company in this area.
## SELECTION OF APPLICABLE PERFORMANCE CRITERIA

<table>
<thead>
<tr>
<th>Applicable S&amp;E Performance Criteria</th>
<th>Portfolio Risk Level</th>
<th>Lending Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFC Exclusion list</td>
<td>Low-risk</td>
<td>Micro-finance, Trade Finance</td>
</tr>
<tr>
<td>IFC Exclusion list</td>
<td>Moderate-risk</td>
<td>SMEs, Leasing</td>
</tr>
<tr>
<td>+ National E&amp;S regulations and laws</td>
<td>High-risk</td>
<td>Corporate/ project finance (above USD1 million)</td>
</tr>
<tr>
<td>+ National E&amp;S regulations and laws</td>
<td></td>
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</tr>
</tbody>
</table>

- **Low-risk**
  - Micro-finance, Trade Finance

- **Moderate-risk**
  - SMEs, Leasing

- **High-risk**
  - Corporate/ project finance (above USD1 million)
The IFC Exclusion List defines the types of projects that IFC does not finance:

- Production or trade in any product or activity deemed illegal under host country laws or regulations or international conventions and agreements, or subject to international bans, such as pharmaceuticals, pesticides/herbicides, ozone depleting substances, PCB’s, wildlife or products regulated under CITES.
- Production or trade in weapons and munitions.
- Production or trade in alcoholic beverages (excluding beer and wine)¹
- Production or trade in tobacco¹.
- Gambling, casinos and equivalent enterprises¹.
- Production or trade in radioactive materials.
- Production or trade in unbonded asbestos fibers.
- Drift net fishing in the marine environment using nets in excess of 2.5 km. in length.
- Production or activities involving harmful or exploitative forms of forced labor/harmful child labor.
- Commercial logging operations for use in primary tropical moist forest.
- Production or trade in wood or other forestry products other than from sustainably managed forests.
APPLICABLE REQUIREMENTS – NATIONAL LAWS (EXAMPLES)

- Environment protection legislation
- Waste management and effluent criteria
- Social Laws – Labor Act, Land Act
- Natural resource protection
- Biodiversity protection
- International treaties
E&S DUE DILIGENCE PROCESS

Screening against XL

Collect E&S information and initial categorization

Site Visit

Prepare ESDD and Categorize

Investment Committee review including E&S

E&S covenants in LA
RESPONSIBILITIES OF E&S STAFF

**E&S Manager:**
- Overseeing E&S risk management and implementation of ESMS
- Managing resources (budget and staff) for E&S risk management and training

**E&S Officer/Loan Officer:**
- Evaluating the environmental compliance of a target client company with the Applicable Requirements; including through site visits, collection of necessary E&S documentation (e.g., information, certificates, authorizations), and preparation of E&S due diligence reports (or E&S section of the credit application)
- Ensuring that all investment decisions are supported by appropriate due diligence documentation, including, but not limited to, an E&S section in each final Investment Memorandum
- Ensuring that the procedures are implemented for each project, and that records of environmental reviews are maintained
- Ensuring appropriate environmental representations, warranties, and covenants are incorporated into all legal agreements
- Supervising projects in the portfolio against on-going compliance with the Applicable Requirements on a regular basis including site visits, annual monitoring
- Reporting any major E&S issues to senior management and annual reporting to external parties
E&S Covenants: All loan agreements should contain covenants requiring that clients are in compliance with the Applicable Requirements (negative, positive, CODs)

Records to Maintain: Environnemental and Social Due Diligence (ESDD) E&S Supervision records including site visit reports Reports to be provided to management and to IFC

Internal Reporting: E&S due diligence findings, proposed Action-Plans and E&S covenants Updates on E&S performance once in portfolio Any major events (accidents, incidents, media coverage)

External Reporting: Immediately if clients experience major accidents or incidents High-Risk (Cat. A) projects prior to making a loan decision Annual E&S report to shareholders and other lenders
## Tools: Categorization Guidance

<table>
<thead>
<tr>
<th>Category</th>
<th>Definition</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>A – High Risk</td>
<td>The project is likely to have significant adverse environmental impacts that are sensitive, diverse or unprecedented.</td>
<td>• Mining (opencast and pit)</td>
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<td>• Oil and gas developments, including pipeline construction</td>
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<td>• Forestry operations</td>
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<td>• Projects which pose serious occupational or health risks</td>
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<td>• Construction of dams and reservoirs</td>
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<td></td>
<td>• Pesticides and herbicides: production or commercial use</td>
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<td></td>
<td>• Domestic or hazardous waste disposal operations</td>
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<td></td>
<td>• Hazardous chemicals: manufacture, storage or transportation above a threshold volume</td>
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<td>• Large infrastructure projects, including development of ports and harbors, airports, road, rail and mass transit systems</td>
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<tr>
<td>B – Medium Risk</td>
<td>The project may result in specific environmental impacts, but these impacts are site specific and few if any of them are irreversible. In most cases mitigation measures are predetermined Performance Standards, Guidelines, or design criteria.</td>
<td>• Dairy operations</td>
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<td>• Textile Plants</td>
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<td></td>
<td></td>
<td>• Cement manufacture</td>
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<td></td>
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<td>• Food Processing</td>
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<td></td>
<td>• Modernization of existing plants</td>
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<tr>
<td>C – Low Risk</td>
<td>The project is likely to have minimal or no adverse environmental impacts. No further environmental assessment is required.</td>
<td>• Software development</td>
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<td>• Service industries</td>
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<td></td>
<td>• Consulting firms</td>
</tr>
</tbody>
</table>
### Social and Environmental Screening Checklist

<table>
<thead>
<tr>
<th>Environmental issues—check all that apply:</th>
<th>Waste water</th>
<th>Hazardous chemicals, fuels, and pesticides</th>
<th>Nuisance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Air emissions</strong></td>
<td></td>
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</tr>
<tr>
<td>□ Boilers</td>
<td>□ Waste water discharged to __________</td>
<td>□ On-site chemicals or fuels storage</td>
<td>□ Dust</td>
</tr>
<tr>
<td>□ Generators</td>
<td>□ Drains and grates</td>
<td>□ Protective measures against leaks/spills</td>
<td>□ Noise</td>
</tr>
<tr>
<td>□ Vehicles and equipment</td>
<td>□ Oil separators</td>
<td>□ Signs of leaks/spills</td>
<td>□ Odours</td>
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<tr>
<td>□ Furnaces and incinerators</td>
<td>□ Separation tanks or filters</td>
<td>□ On-site spill clean up equipment</td>
<td>□ Fumes</td>
</tr>
<tr>
<td>□ Welding and soldering</td>
<td>□ Reed beds</td>
<td>□ Protective measures against rain</td>
<td>□ Vibrations</td>
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<tr>
<td>□ On-site burning</td>
<td>□ Cut-off valves</td>
<td>□ Signs of corrosion on tanks/containers</td>
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<tr>
<td>□ Use of solvents</td>
<td>□ Foul sewers and septic tanks</td>
<td>□ Secured storage areas against theft</td>
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<tr>
<td>□ Use of fumigation</td>
<td>□ Water treatment units</td>
<td>□ Training on proper handling of chemicals and fuels</td>
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<tr>
<td>□ Evaporation of chemicals</td>
<td>□ Cleaning operations</td>
<td>□ Pesticide use and management</td>
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<td>□ Refrigeration plant</td>
<td>□ Spraying operations</td>
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<td>□ Use of exhaust ventilation</td>
<td>□ De-watering/water pump out</td>
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<td><strong>Solid and hazardous wastes</strong></td>
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<td>□ Waste generated</td>
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<tr>
<td>□ Types of waste:</td>
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<tr>
<td>□ Hazardous waste (e.g., waste oils, pesticide washings, solvents, clinical waste, asbestos)</td>
<td>□ Training on proper handling of chemicals and fuels</td>
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<tr>
<td>□ Waste disposed to ______________________</td>
<td>□ Pesticide use and management</td>
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<td><strong>Resource consumption</strong></td>
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<td>□ Materials used:</td>
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<td>□ Use of renewable natural resources</td>
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<td>□ Use of tools and equipment</td>
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<td>□ Water source:</td>
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<td>□ Energy source:</td>
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</tbody>
</table>
## Social and Environmental Screening Checklist

### Community interactions—check all that apply:
- No designated person in charge of responding to questions from the community
- No procedures for managing community complaints
- Use of security personnel

### Social issues—check all that apply:
- Land acquisition required
- Displacement/resettlement of local settlements
- Impact on local settlements/livelihood
- Impact on indigenous peoples
- Complaints from neighbours/communities
- On or adjacent to site of cultural/archaeological importance

### Labour issues—check all that apply:
- No Personal Protective Equipment provided (e.g., safety goggle/hard hat/protective glove)
- Inadequate employee health and safety measures (e.g., fall prevention/ventilation)
- Inadequate working conditions (e.g., air quality/lighting/confined spaces/on-site hygiene)
- Inadequate terms of employment (e.g., working hours/rest breaks/time off/overtime pay)
- Unequal employment opportunities (e.g., discrimination against gender/ethnic group/age)
- Payment below minimum wage
- Employees below minimum age
- Child or forced labour
- No process for employees to voice complaints
- No recognition of employee organizations/labour unions
Cement
- Chemicals
- Construction
- Crops
- Electronics
- Energy
- Fishing
- Food
- Forestry
- Garages
- Glass
- Health
- Iron
- Laundry
- Leather
- Livestock
- Low
- Machinery
- Mining
- Oil&Gas
- Paper
- Pharmaceuticals
- Precision
- Printing
- Textiles
- Tourism
- Transport
- Waste
- Water
- Wood

http://firstforsustainability.org/media/factsheet_cement.pdf
KEY ESMS AND ESDD IMPLEMENTATION CHALLENGES

Top Challenges FIs face:

1. Business Case (cost versus benefits) unclear
2. Lack of buy-in from bank’s senior management
3. Lack of understanding of how to set up an ESMS
4. Inadequate incorporation of E&S due diligence steps into the loan review process (separate processes, lengthy questionnaires, perceived long DD process)
5. Lack of in house capacity to undertake E&S due diligence
6. Lack of knowledge on sector specific risks and mitigation measures
7. Clients unwilling to acknowledge and address E&S issues
8. Local E&S permits etc are issued without appropriate E&S management
9. Local E&S laws and regulations are not enforced
1. First for Sustainability website, including guidance materials on ESMS, ESDD, Categorization and reporting: [www.firstforsustainability.org](http://www.firstforsustainability.org)


4. EHS Guidelines, Guidance Notes, Best Practice Examples for 60 sectors: [http://www.ifc.org/ehsguidelines](http://www.ifc.org/ehsguidelines)


6. UNEP-FI: ESRA Course (3 week in depth online ESMS course): [http://www.unepfi.org/training/esra-training-programme/online-course/](http://www.unepfi.org/training/esra-training-programme/online-course/)

QUESTIONS & ANSWERS
THANK YOU &

WE LOOK FORWARD TO YOUR FEEDBACK