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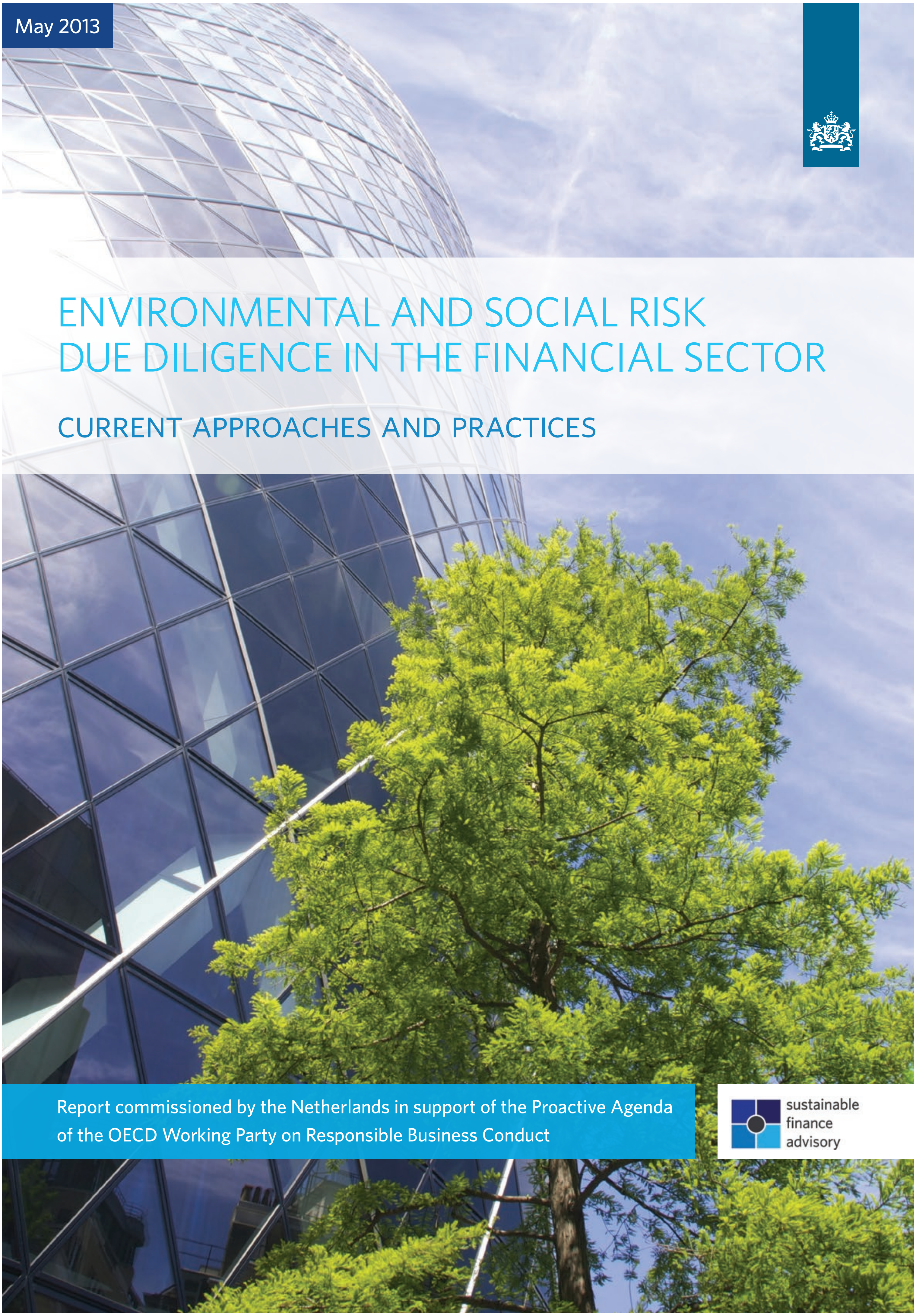

ENVIRONMENTAL AND SOCIAL RISK DUE DILIGENCE IN THE FINANCIAL SECTOR

CURRENT APPROACHES AND PRACTICES

Report commissioned by the Netherlands in support of the Proactive Agenda of the OECD Working Party on Responsible Business Conduct

sustainable finance advisory

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About the report and acknowledgements

The Dutch Ministry of Foreign Affairs commissioned this report on behalf of the OECD Working Party on Responsible Business Conduct as a first step in a dialogue on what the OECD Guidelines for Multinational Enterprises mean for the day-to-day practice of the financial sector. In particular, this project report seeks to identify financial institutions' current environmental and social due diligence practices, perception and application of the concept of supply chain responsibility as embedded in the OECD Guidelines for Multinational Enterprises. The Ministry hopes that this study will help to inform stakeholders and other parties interested in the dialogue on responsible business conduct in the financial sector.

The study started in September 2012. Financial institution surveys were completed in January and interviews in March 2013. The report was finalised in May 2013 and has been made publicly available through various channels in June 2013.

The report draws on primary survey and interview data from global financial institutions supplemented by desktop research. Fifty-two surveys and 29 interviews were completed. To maintain data confidentiality of study participants, all information provided is used anonymously and at the aggregate level in the report.

This report was authored by Sustainable Finance Advisory (SFA) under the supervision of the Dutch Ministry of Foreign Affairs, the project Advisory Group and the OECD Secretariat. The findings are based on research conducted by SFA and should not be interpreted as representing the views of either the Dutch Ministry of Foreign Affairs, individual Advisory Group members or of the OECD.

We would like to thank the Dutch Ministry of Foreign Affairs, the Advisory Group and the OECD Secretariat for their on-going support as well as the financial institutions that participated in the study. Without their valuable contributions this quality and quantity of research would not have been possible.

Sustainable Finance Advisory operates at the interface between finance, business and society to deliver solutions that help its clients make business decisions that are economically profitable, environmentally sound and socially relevant. Our network of consultants provides sustainability services to financial institutions around the globe including training and facilitation, delivering environmental and social risk management systems, sustainability leadership development and driving sector-level interventions. We would like to thank the entire SFA team for their contributions to this project and report (see back page of report).

OECD Guidelines for Multinational Enterprises

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Glossary of terms

Adhering countries
The OECD and non-OECD countries whose governments have adhered to the OECD Declaration on International Investment and Multinational Enterprises and related Decision. As of 23 May 2012 adhering governments are those of all 34 OECD members, as well as Argentina, Brazil, Colombia, Egypt, Latvia, Lithuania, Morocco, Peru, Romania and Tunisia.

Adverse impact
For the purposes of this report, it refers to an environmental and/or social impact where it actually happens, such as pollution of a waterway or displacement of local community members from land.

Advisory Group (AG)
The project Advisory Group (AG) established to provide oversight and guidance throughout this report process. Members consist of representatives from the OECD, OECD countries, financial institutions (FI), Industry Initiatives and NGOs. See **Appendix A**.

Asset
Any resource owned or controlled by an individual, corporation or country that has economic value. It includes physical assets such as facilities, property or equipment as well as accounts receivable.

Asset-Based Finance
For the purposes of this report, a method of funding specific projects typically secured by the project assets, including the revenue-producing contracts (e.g. project finance, structured finance). The lender looks primarily at the revenues generated by the project (accounts receivable) as the source of repayment and as security for the exposure. This type of financing is usually for large, complex and expensive installations (e.g. power plants, mines or transportation infrastructure).

Asset Manager
FI that manages clients' investments. It invests on the clients' behalf and offers them a range of complementary financial services. Its clients are often large funds, such as pension funds, and wealthy individuals.

Business relationship
According to the OECD, the term "business relationship" includes relationships with:

- Business partners;
- Entities in the supply chain; and
- Any other non-State or State entities directly linked to its business operations, products or services.

Capital Markets services
Long-term debt and equity capital transactions (e.g. securities underwriting such as bonds issuance, initial public offerings or IPOs) and related advisory services.

Client
Entity to which a financial institution provides investments, lending or other types of financial services and products.

Commercial bank
An FI which accepts deposits and provides a variety of financial services to companies and individuals such as loans, payment services, investments, insurance and financial planning. The term also includes wholesale banks and corporate banks.

Cooperative bank
Commercial bank that belongs to its members, who are at the same time the owners and the customers of their bank.

Corporate Lending
Lending by FIs to companies (e.g. term loans, working capital facilities, overdraft facilities).

Development bank
A bank owned and directed by member-governments, which lend to regional or national development projects. A development bank located in adhering countries typically lends to financial institutions in developing countries and large-scale development projects.

Risk-based due diligence
In the context of the OECD Guidelines for Multinational Enterprises, the process through which enterprises can identify, prevent, mitigate and account for how they address their actual and potential adverse impacts as an integral part of business decision-making and risk management systems. In the context of an FI's risk management, generally refers to the review and analysis of risks undertaken prior to making a decision relating to lending, investing or the provision of other financial services to a client.

Equity
The amount that shareholders own, in the form of common or preferred stock, in a publicly quoted or privately owned company.

E&S issues
For the purposes of this report, it refers to the environmental and social matters covered by the OECD Guidelines in the chapters on Human Rights, Employment and Industrial Relations and on Environment, which are within the scope of this report.

Additionally, it is used in this report to refer to any potential or actual impact to the physical, natural or cultural environment, or on the surrounding community and/or e.g. workers of a company.

Export Credit Agency (ECA)
Export Credit Agencies (ECAs) provide financing services such as guarantees, loans and insurance to domestic companies to promote international trade. The primary objective of ECAs is to remove the risk and uncertainty of payments to exporters.

Exposure
The amount that an FI may lose in an investment or loan.

Financial Institution (FI)
Banking, investment and insurance institutions that provide lending, investment, insurance or other financial products and services.

Financial services
Products and services offered by FIs such as loans, payment services, asset management and insurance.

OECD Guidelines
The OECD Guidelines for Multinational Enterprises, 2011 edition. They provide voluntary principles and standards for responsible business conduct consistent with applicable laws and internationally recognised standards. However, the countries adhering to the OECD Guidelines make a binding commitment to implement them. They contain recommendations made to multinational enterprises operating in or from adhering countries.

Initial Public Offering (IPO)
The first sale of a company's shares to the public, leading to a stock market listing (known as a flotation in the UK).

Investee company
Listed and/or private entities in which FIs hold shares.

Investment services
For the purposes of this report, managing funds and making investments (listed and private equity, fixed income and other non-listed assets) on FIs' own behalf or on behalf of institutional investors (e.g. asset management on behalf of pension funds).

Investment bank
An FI that focuses on raising capital for clients and on investment services to individual and institutional investors. An investment bank does not accept deposits.

Leverage
In the context of the OECD Guidelines, leverage is considered to exist where the enterprise has the ability to effect change in the wrongful practices of the entity that causes the adverse impacts.

Multinational Enterprise (MNE)
We use the term in the sense of the OECD Guidelines. The OECD Guidelines find that a precise definition of multinational enterprises is not required. These enterprises operate in all sectors of the economy and usually comprise companies or other entities established in more than one country. Ownership may be private, State or mixed. The OECD Guidelines are addressed to all the entities within the multinational enterprise (parent companies and/or local entities).

National Contact Point (NCP)
OECD National Contact Points (NCPs) are agencies established by adhering governments to promote and implement the OECD Guidelines. The NCPs assist enterprises and their stakeholders to take appropriate measures to further the implementation of the OECD Guidelines. They also provide a mediation and conciliation platform for resolving practical issues that may arise.

Pension Fund
A fund established to facilitate and organise the investment of employees' retirement funds. They are meant to generate stable growth over the long term and control relatively large amounts of capital.

Private equity
Stock in a privately held company.

Private equity company
FI that specialises in investments in companies that are not publicly traded. Private equity companies acquire a controlling or substantial minority position in a company and then seek to maximise the value of that investment.

Reinsurance
The insurance that is purchased by an insurance company from one or more other insurance companies, as a means of risk management.

UNGPs
The United Nations Guiding Principles on Business and Human Rights.

Syndication
A method of financing where several FIs finance or underwrite together a particular transaction or project, to limit their exposure. The financing is structured, arranged, and administered by one or several commercial banks or investment banks known as lead arrangers.

Working capital facilities
Lending to provide operational liquidity to a company.

Executive Summary

Context

At the OECD 50th Anniversary Ministerial Meeting held in May 2011, in Paris, former US Secretary of State, Ms. Hillary Rodham Clinton presided over the 2011 OECD Ministerial Council Meeting during which the update of the OECD Guidelines for Multinational Enterprises (the OECD Guidelines) by the 34 OECD and 10[1] non-OECD adhering governments was agreed upon.

The OECD Guidelines are recommendations addressed to enterprises operating in a global context covering all major areas of business ethics, notably labour, human rights, anti-corruption, the environment, tax and competition. The OECD Guidelines are supported by a unique implementation mechanism where adhering governments agree to establish National Contact Points (NCPs) for the promotion of the OECD Guidelines and the provision of assistance to parties when questions arise with respect to the observance of the OECD Guidelines in "specific instances" (or complaints).

The update included a new human rights chapter consistent with the UN Guiding Principles for Business and Human Rights and the expectation that enterprises should undertake due diligence in order to avoid being involved in adverse impacts on matters covered by the OECD Guidelines, including in their supply chains and business relationships, and to address such impacts when they occur.

As the 2011 update confirmed that the OECD Guidelines apply to all sectors, including the financial sector, they do not provide more detailed guidance on the application of the OECD Guidelines to financial institutions (FIs) or any other specific sector. However, specifically the extended OECD Guidelines' recommendation to

> *"Seek to prevent or mitigate an adverse impact where they have not contributed to that impact, when the impact is nevertheless directly linked to their operations, products or services by a business relationship"*

raises specific challenges regarding the proper observance of the OECD Guidelines by the financial sector.

Discussions between FIs and their stakeholders including from civil society revealed different understandings and interpretations of how the OECD Guidelines can be and are being observed by the financial sector, particularly the new provisions on due diligence and human rights. A sense of urgency to tackle this divergence of views is expressed by the NCPs, dealing with specific instances raised against FIs by stakeholders for allegations of non-observance of the OECD Guidelines. Where a company and its stakeholders fail to reach agreement on the issues raised, NCPs can make statements about what would constitute proper observance of the OECD Guidelines in the specific instance.

The 2011 update established a "proactive agenda" of the OECD Investment Committee to foster multi-stakeholder discussion on emerging issues of responsible business conduct as covered by the OECD Guidelines and develop additional tools or guidance as appropriate. One of the first Proactive Agenda items raised was the need to better understand what proper observance of the OECD Guidelines by the financial

1 Argentina, Brazil, Colombia, Egypt, Latvia, Lithuania, Morocco, Peru, Romania and Tunisia. Together these 43 adhering countries account for around 85 per cent of world foreign direct investment (FDI) outflows [see FDI in Figures: **www.oecd.org/investment/statistics**.

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sector entails and determine whether the development of practical tools for implementing the existing recommendations would be a useful next step.

In order to take a first step towards meeting this objective, the Dutch Ministry of Foreign Affairs on behalf of the OECD Working Party on Responsible Business Conduct commissioned this study to map the current approaches and practices of FIs on risk-based environmental and social (E&S) due diligence.

This study surveyed over 50 FIs globally and interviewed 30 FIs in order to map:

- The different approaches to risk-based E&S due diligence in the context of providing different financial services; and
- The level of leverage of an FI, perceived or otherwise, to prevent or mitigate adverse E&S impacts of business partners to which they may be linked through the provision of financial services.

Key findings from the FIs' surveys and interviews

Based on the survey and interview information, this study identified the following key findings:

1. Different business models of FIs and the specific mix of financial products and services they provide drive different E&S due diligence approaches.
2. FIs systematically prioritise E&S due diligence for transactions and investments according to the level of potential E&S risk involved.
3. Awareness and implementation of the UN Guiding Principles for Business and Human Rights are variable both in adhering and non-adhering countries, with many FIs at the early stages of understanding the implications for their institutions.
4. Some FIs refer to the OECD Guidelines in their E&S policies, but few use them in their implementation of E&S due diligence as they are seen as too "generic". Many cite a lack of clarity on:
   a. Terminology which is open to interpretation; and
   b. The role and process of the NCPs.
5. FIs' perceived level of leverage or influence over client/investee company behaviour on E&S issues varies, even within same product or service group.

1. Background

1.1. Context

The OECD Guidelines for Multinational Enterprises

The OECD Guidelines are far-reaching recommendations for responsible business conduct that are binding for governments of adhering countries and provide non-binding (voluntary) principles and standards for multinational enterprises (e.g. enterprises operating in a global context).[2] The OECD Guidelines require adhering governments to establish National Contact Points (NCPs) that promote the OECD Guidelines and provide a mediation and conciliation platform for resolving practical issues that may arise in "specific instances".[3] Where parties are unable to resolve their issues, NCPs can make public statements on the (non-) observance of the OECD Guidelines in the specific instance. This unique grievance mechanism distinguishes the OECD Guidelines from other similar standards.

Adhering countries comprise of 34 OECD members as well as 10 non-OECD countries: Argentina, Brazil, Colombia, Egypt, Latvia, Lithuania, Morocco, Peru, Romania and Tunisia[4] (Adhering Countries).

The OECD Guidelines provide non-binding (voluntary) principles and standards for responsible business conduct for enterprises in a global context consistent with applicable laws and internationally recognised standards. The OECD Guidelines are the only multilaterally agreed and comprehensive code of responsible business conduct that governments have committed to promoting.[5] The OECD Guidelines comprise of 11 chapters covering a broad range of issues related to:

- Concepts and Principles;
- General Policies;
- Disclosure;
- Human Rights;
- Employment and Industrial Relations;
- Environment;
- Combating Bribery, Bribe Solicitation and Extortion;
- Consumer Interests;
- Science and Technology;
- Competition; and
- Taxation.

Enterprises are recommended to conduct due diligence as described in the OECD Guidelines' chapter on General Policies to ensure that they meet the recommendations of the substantive chapters. It should be noted that this recommendation does not, however, apply to the OECD Guidelines' chapters on Science and Technology, Competition and Taxation.[6]

The 2011 update of the OECD Guidelines

To ensure that the OECD Guidelines continue to be a "leading international instrument for promoting responsible business conduct", the OECD Guidelines were last updated in 2011 to reflect, inter alia, the latest developments relating to human rights as embodied by the United Nations Guiding Principles on Business and Human Rights (UNGPs).[7] The update included a new human rights chapter which consistent with the UNGPs, recommends enterprises to undertake due diligence in order to avoid being involved in adverse impacts on matters covered by the OECD Guidelines, including in their supply chains and business relationships. To address such impacts when they occur, the improvement of the NCP process and the adoption of a proactive agenda was discussed.

The OECD Guidelines reflect the overarching principle of the UNGPs that:

> *"The responsibility of business enterprises to respect human rights applies to all enterprises regardless of their size, sector, operational context, ownership and structure. Nevertheless, the scale and complexity of the means through which enterprises meet that responsibility may vary according to these factors and with the severity of the enterprise's adverse human rights impacts."*[8]

2 The OECD Guidelines, Part 1, Preface, Paragraph 1, page 13.
3 The OECD Guidelines, Foreword, Paragraph 3, page 3.
4 **http://www.oecd.org/daf/inv/investment-policy/oecddeclarationanddecisions.htm**
5 The OECD Guidelines, Foreword, Paragraph 1, page 3.
6 The OECD Guidelines, Part 1, Chapter II, Commentary 14, page 24.
7 The United Nations Human Rights Council endorsed the UNGPs in June 2011.
8 Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework, principle 14. Page 15.

The proactive agenda

Under the 2011 OECD Guidelines, the OECD Investment Committee should pursue "a proactive agenda that promotes the effective observance by enterprises of the principles and standards contained in the OECD Guidelines".[9] The OECD Working Party on Responsible Business Conduct, a subsidiary of the OECD Investment Committee, carries out the practical work of the Proactive Agenda. For that reason, this report will refer to the Working Party on Responsible Business Conduct throughout. NCPs should:

- Consider new developments and emerging practices concerning responsible business conduct;
- Support the positive contributions enterprises can make to economic, social and environmental progress; and
- Participate where appropriate in collaborative initiatives to identify and respond to risks of adverse impacts associated with particular products, regions, sectors or industries.[10]

Challenges related to the application of the OECD Guidelines

The 2011 Update confirmed that the OECD Guidelines apply to all sectors, including the financial sector. However, due to time constraints, further guidance on the application of the OECD Guidelines to FIs was not included in the update.

As a result of the "generic" nature of the OECD Guidelines and the recent update, discussions between various stakeholder groups including adhering countries, NCPs, FIs and civil society revealed conflicting views as to how the OECD Guidelines apply to the financial sector. Furthermore, given the complexity of the financial sector itself, as well as the complexity of responsible business conduct in relation to issues such as human rights, varying levels of understanding and various views exist amongst these stakeholders with regard to:

- Different types of FIs;
- Different types of financial services;
- Current risk-based E&S due diligence conducted by different FIs;
- The perceived level of influence an FI could have on its clients/investee companies to prevent or mitigate adverse impacts to which they are linked through the provision of financial services; and
- How specific instances raised by stakeholders against FIs and/or their clients/investee companies should be handled by NCP processes.

Divergences in understanding and opinions amongst stakeholders are further compounded by a "definitional divide" found in the differences in terminology used by the: (1) OECD Guidelines; (2) UNGPs; and (3) the financial sector.

Within this context, specific challenges exist as to the interpretation of how the OECD Guidelines' provision to

> *"seek to prevent or mitigate an adverse impact where they have not contributed to that impact, when the impact is nevertheless directly linked to their operations, products or services by a business relationship"*[11]

applies to FIs and the financial products and services they provide.

In addition, the areas characterised by the least clarity and greatest differences in opinions between stakeholders are related to the chapters on Human Rights, Employment and Industrial Relations and Environment. In summary, there is a potential disconnect between the principles of responsible business conduct as set out in the OECD Guidelines and their interpretation by different stakeholders, as well as in terms of how they apply to the actual practices of the financial sector.

Why this mapping exercise was undertaken

In order to inform discussions on how the OECD Guidelines apply to the financial sector, this mapping exercise was undertaken to better understand the actual practices of FIs in the area of risk-based E&S due diligence including:

- The nature of various financial services and products and how that relates to the recommendation under the OECD Guidelines that enterprises should seek to prevent or mitigate adverse impacts which are linked to their operations, products or services by a business relationship;
- Existing practices of FIs on risk-based E&S due diligence; and

9 The OECD Guidelines, Part 2, Chapter II, Commentary 8, page 69.
10 The OECD Guidelines, Part 2, Commentary on the Implementation Procedures, Commentary 18, page 81.
11 The OECD Guidelines, Part 1, Chapter II, Commentary 12, page 20.

- The perceived level of leverage/influence over a client or investee company to prevent or mitigate the adverse impacts to which an FI may be linked through the provision of particular financial services.

Subsequently, this mapping exercise may be used by the OECD Working Party on Responsible Business Conduct as a basis for future discussions and actions to promote the OECD Guidelines within the financial sector.

1.2. Elements in scope of this project

This project maps the ways in which the financial sector perceives and manages E&S risks associated with their activities and relationships beyond legal requirements, **within but not limited to** the context of the OECD Guidelines. The research contemplates the approach of FIs to identify and manage E&S risks associated with activities of clients or investee companies, to which FIs are directly linked[12] via the provision of financial services and products, as set out in the OECD Guidelines.[13]

The scope of the research was limited to the following chapters of the OECD Guidelines:

- Chapter IV. Human Rights;
- Chapter V. Employment and Industrial Relations; and
- Chapter VI. Environment.

Consistent with current practice of the majority of FI participants in this study, we will refer to these three issues as environmental and social (E&S) issues. We use the term **E&S issues** to refer to any potential or actual impact to the physical, natural or cultural environment, or on the surrounding community and/or, for example, workers.. It should be noted that while human rights can fall under either environmental or social issues, depending on the circumstances, employment and industrial relations issues always falls under the umbrella of "social" issues.

INCLUDED IN THE SCOPE OF THIS RESEARCH IS A MAPPING OF:

- **Different types of FIs;**
- **Different types of financial services;**
- **Relevant industry initiatives and standards that have emerged (e.g. UN Guiding Principles on Business and Human Rights, UN-backed Principles for Responsible Investment, IFC Performance Standards, Equator Principles);**
- **Existing risk-based E&S due diligence processes and implementation in relation to different financial services;**
- **Human rights risk due diligence processes and implementation; and**
- **The perceived level of leverage or influence of an FI to prevent or mitigate adverse impacts to which they are linked through the provision of financial services.**

Case studies and practical examples are included throughout the report where appropriate to support the analysis.

1.3. Elements out of scope of this project

This project is not intended to provide a normative overview of the ways in which the OECD Guidelines apply to the financial sector, nor does it aim to create any new recommendations additional to those contained in the OECD Guidelines. Rather, the approach is to explore and map how FIs manage E&S risks whether in application of the OECD Guidelines and/or other internationally agreed standards and/or local laws. Furthermore, issues of compliance with national anti-money laundering or consumer protection laws, while within the purview of the OECD Guidelines, are beyond the scope of this research.[14]

Lastly, the research does not cover the recommendation in the OECD Guidelines that multinational enterprises including FIs avoid causing or contributing to adverse impacts through their own operations (e.g. activities involving facilities, branches, assets or employees).

12 The OECD Guidelines, Part 1, Chapter II, Commentary 12, page 20.

13 The study makes reference to the General Policies chapter of the OECD Guidelines, which sets out general principles. See the OECD Guidelines, Part 1, Chapter II, page 19–26.

14 Nonetheless, the focus of this research should not be seen as a stand-alone exercise as all chapters are interlinked. Further studies could explore such dependencies not only among the chapters but also between different OECD working groups.

2. Mapping exercise: approach

2.1. Methodology

2.1.1 Information gathering

A project Advisory Group (AG) was established to provide oversight and guidance throughout the process. The AG's multi-stakeholder membership consisted of representatives from NCPs, adhering countries, FIs, relevant industry initiatives[15], business, labour and NGOs (see **Appendix A**).

The methodology for gathering data consisted of:

- Desktop review;
- Surveys; and
- Interviews.

Desktop review was conducted to:

- Define the types of FIs and financial services to be included in the scope of the study;
- Gather initial data on E&S due diligence and sector initiatives; and
- Gather initial data on the nature and characteristics of the different types of financial services and related E&S risk due diligence.

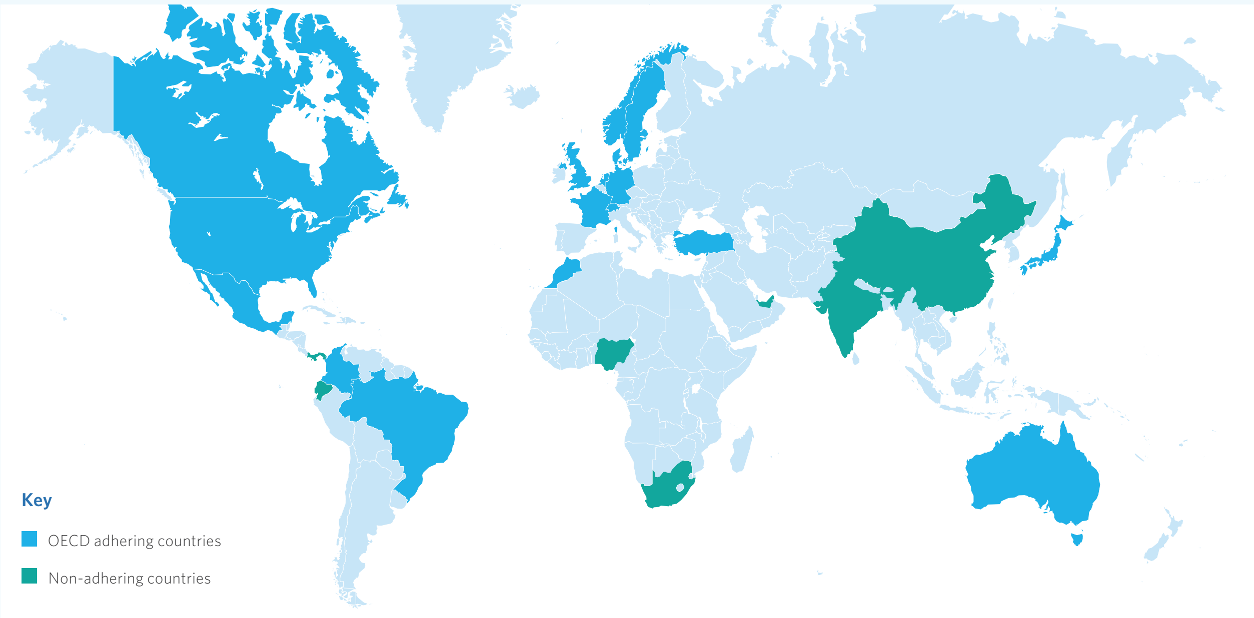
An online survey[16] was designed to gather information from FIs on:

- E&S risk due diligence including human rights due diligence; and
- Potential influence to prevent or mitigate adverse impacts of clients or investee companies in practice.

Survey responses from over 50 FIs globally were received, 83% from adhering countries and 17% from non-adhering countries. FIs from 24 countries were represented in the study (see map below); roughly half of the survey responses were from European FIs (see **Appendix B** for a more detailed breakdown).

Map showing geographical cover of the study

FIs from 24 countries represented in the study. Surveys completed: 52. Interviews completed: 29.



15 These include, for example, the Equator Principles, United Nations Environment Programme-Finance Initiative (UNEP-FI), United Nations-backed Principles for Responsible Investment (UN PRI), Business and Advisory Committee to the OECD, and the Trade Union Advisory Committee to the OECD (TUAC).

16 A link to the survey questionnaire completed by FI study participants can be found at: **http://www.oecdguidelines.nl/ncp/ncpconference/environmental-and-social-due-diligence-in-the-financial-sector-survey**.

Interviews were conducted to gather qualitative information to supplement quantitative survey data. The 29 FIs interviewed are from adhering and non-adhering countries and representative of the different types of FIs identified as relevant for the purposes of this study. Where possible we attempted to quantify findings from interviews, however due to the nature of the interview process, we were not able to do this in all cases. Although we used a standard interview question template to guide the interviews (see **Appendix C** for representative interview questions), the discussions varied considerably depending on the FI, their business model, their survey responses, or where the FI had further understanding/ experience or specific implementation examples to share. In some cases, we have used terms such as "most", "some" and "a few" to describe anecdotally interview data where it was not possible to specify the exact number of FIs which provided particular views or information. A more flexible, tailored approach yielded better information as compared to limiting our interview process to asking the same set of questions of each FI.

In most cases, FI study participants were from the Environment and Social Risk, Responsible Investment, Sustainability teams or other equivalent function within their respective organisations. Approximately 50% of survey respondents held senior level positions such as the head of the department/function, directors or assistant directors, whilst the others comprised of mid-management or environmental/ social specialists. Where an FI participated in both the survey and the interview processes responses were typically provided by the same individual(s).

2.1.2 Clarifications on terminology

In this section we clarify the key terms we use in this report. These should not be interpreted as normative, but rather to ensure a consistent use of terms which otherwise may be readily subject to interpretation in different ways by different stakeholders. The report is intended to be accessible to a wide range of readers beyond FIs; a glossary of terms has been included for ease of reference (see **Glossary of Terms**).

- Risk-based **due diligence** in the context of the OECD Guidelines is:
  "the process through which enterprises can identify, prevent, mitigate and account for how they address their actual and potential adverse impacts as an integral part of business decision-making and risk management systems."
- For FIs the approach to risk-based **due diligence** generally refers to the review and analysis of E&S risks undertaken prior to making a decision relating to lending, investing or the provision of other financial services to a client. However, this does not exclude per se processes in place to address adverse impacts, which arise after a decision has been approved to provide specific products or services. Throughout the report we will refer specifically to **E&S risk due diligence**.
- Investment and insurance companies tend to refer to environmental, social and governance ("ESG") practices. However, for ease of reference and consistency, we will use the same "E&S" terminology for all FIs (i.e. "E&S due diligence" would also include ESG due diligence).
- For the purposes of this study, **adverse impacts** refer to environmental and/or social impacts where it actually happens. These are not to be confused with other types of adverse/negative impacts that might occur as a **consequence** of the adverse impacts on the ground, such as financial or reputation impacts on the client/investee company or the FIs.[17]
- It should be noted that E&S issues as they have been defined for the purposes of this report (i.e. any potential or actual impact to the physical, natural or cultural environment, or on the surrounding community and/or e.g. workers) vary in the degree of severity, as defined for example, in the categorisation approach under the Equator Principles.
- We will use the term **client** to mean the entity to which the FI is providing financial services; and **investee company** to mean the entity in which an FI is making an investment. We will use the term **client or investee company** throughout to refer to both situations.
- We use the term **business/commercial teams** to refer to the front office teams, client relationship managers, fund managers and other commercial deal teams in an FI.
- For the purposes of this project, five types of financial services are defined as per Table 1 below:

17 The OECD Guidelines refer to "Avoid causing or contributing to adverse impacts on matters covered by the OECD Guidelines" of which environmental and social matters are in the scope of this report. They do not however define in detail the term "adverse impacts" and hence a definition is provided for clarity on the use of the term throughout this report.

Table 1: Definition of financial services

Type of financial service
Asset-Based Finance A method of funding specific projects typically secured by the project assets, including the revenue-producing contracts (e.g. project finance, structured finance). The lender looks primarily at the revenues generated by the project (accounts receivable) as the source of repayment and as security for the exposure. This type of financing is usually for large, complex and expensive installations (e.g. power plants, mines or transportation infrastructure).
Capital Markets Debt and equity capital transactions [i.e. securities underwriting (bonds issuance, initial public offerings (IPOs)] and related advisory services.
Corporate Lending Lending to companies (e.g. term loans, working capital facilities, overdraft facilities), other than Asset-Based Finance.
Insurance For the purposes of this project, Insurance services cover only insurance services for companies and not for private individuals.
Investment Investments (listed and private equity, fixed income and other non-listed assets) on an FI's own behalf or on behalf of institutional investors (e.g. asset management on behalf of pension funds).

It is recognised that the financial services described above are high level and the nature and complexity of services within each group can vary significantly. Furthermore, there are other financial services out of scope of this project, that cannot be clustered under the above groups but which could be subject to E&S due diligence.

- We will use the term "**financial institutions**" (each, an **FI**, or collectively, **FIs**). The types of financial institutions listed in Table 2 below participated in, and were the agreed subject of, the study.

Table 2: Clarifications of types of financial institutions

Type of financial institution
Asset Managers Asset Managers provide investment services on behalf of institutional funds, such as endowments and pension schemes or wealthy individuals. Pension funds use Asset Managers to manage their funds. Some of the largest pension funds are worth several hundred billion dollars.
Banks The different types of banks included in this study are: commercial, investment, development and co-operative.
Insurance companies The insurance business model includes provision of insurance policies for clients (private individuals as well as companies) and also investments (e.g. from insurance premiums). This study covers only insurance services for companies and not for private individuals. In addition to the typical insurance providers, export credit agencies (ECAs) also provide insurance to companies to remove export risk, for example, alongside the lending that banks might provide for large projects.
Private equity Private equity institutions specialise in investments in companies that are not publicly traded. Private equity firms acquire a controlling or substantial minority position in a company and then look to maximise the value of that investment. They characteristically make longer-term investments and take on operational roles in the investee companies to manage risks and achieve growth.

2.1.3 Limitations of the study

The following limitations of the study should be noted:

- **Types of FI**: It was agreed that the study would not be able to cover the entire spectrum of FIs that exist. It was also recognised that given their size, number and geographic spread, banks would likely form the largest group, and that smaller sample sizes would be possible for other FI types (e.g. asset managers, private equity companies, etc.);
- **Sample Size**: the sample size of FI types other than banks was small meaning that the findings for these FIs are illustrative, rather than representative;
- **Retail banks**: retail banks were excluded due to the decision to focus on financial services provided to corporate clients or investee companies;
- **Market leaders**: in order to identify emerging good practice the sample largely included market "leaders" in the area of risk-based E&S due diligence and E&S risk management more generally. They may therefore not necessarily be representative of their peer group;
- **Constituency**: the scope of the study did not provide for opportunity to conduct surveys and/or interviews with other relevant actors, hence the survey and interview findings reflect information from, and the views of, FIs only. The report does reflect feedback from the multi-stakeholder project Advisory Group comprising of NCPs, labour, NGOs and industry associations; and
- **Geographical representativeness**: While over 150 FIs from all regions of the world were invited to participate in the survey, approximately 50% of respondents were FIs headquartered in Europe, hence the findings are not representative of all geographies.[18]

18 It is worth considering the feedback from some FIs that they have experienced a proliferation in survey and interview requests over the past few years. Whilst this indicates a positive trend toward engaging the financial sector on these issues, for future work it is important to bear in mind FIs' feedback on "survey fatigue".

2.2. Financial institutions and services

This section of the report presents the following:

- An overview of the types of FIs included in the study; and
- An overview of the financial services and products provided by these FIs.

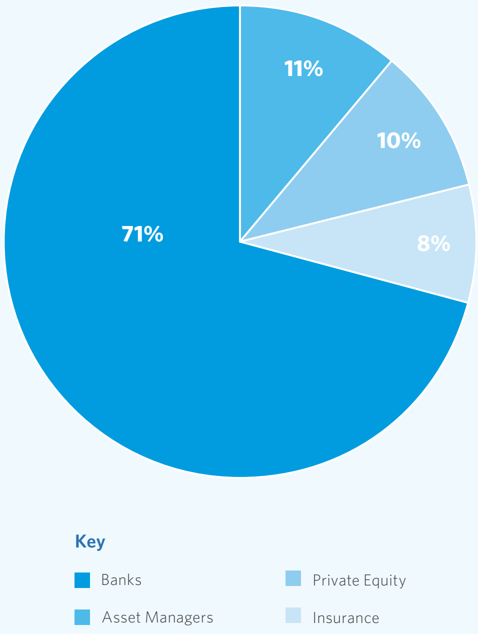
2.2.1 Types of Financial Institutions

There are broadly four different types of FIs included in this study:

1. Asset Managers;
2. Banks;
3. Insurance companies; and
4. Private equity institutions.

Given the large number of banks targeted for this survey, the number of survey responses from this group was the highest, accounting for 71% of total responses. As previously mentioned, survey samples for other FI types are smaller and related information should generally be seen as illustrative.

Diagram 1: Survey responses by type of financial institution



Financial institutions have different business models, and these different business models can determine different approaches to E&S due diligence. The different types of financial services offered by different types of financial institutions also influences approaches to E&S due diligence. In general, the business models of large global banks can be some of the most complex, as they typically offer many types of financial services. In the case of insurance, certain companies are standalone companies, with insurance as their sole or main business, while others are part of larger groups, which provide also other types of financial products and services, such as banking services.

Other factors which influence E&S due diligence approaches include geography and sector focus. E&S due diligence approaches vary depending on whether clients or investee companies are located in developed or emerging markets. For example, in developed markets, legislation and enforcement of E&S laws are considered stronger than in emerging markets, thus a higher level of E&S due diligence is sometimes deemed necessary for the latter. Many large FIs, including participants of this study, have clients across a wide range of major sectors (e.g. metals and mining, oil and gas, agriculture); the mix of clients in their portfolios based on size of exposure and geography varies significantly.

In short, variances in business models between and within different types of FIs, including the mix of financial services offered, size, geography and sector focus, result in different understandings and approaches to E&S issues and due diligence, and perceived levels of responsibility for negative impacts and leverage.

2.2.2 Types of financial products and services

There are five different types of financial services included in this study:

1. Asset-Based Finance;
2. Capital Markets;
3. Corporate Lending;
4. Insurance; and
5. Investment.

This research has focused on uncovering E&S due diligence approaches for the five financial services provided by one or more of the FIs discussed in the section above. Table 3 below provides an overview of the mix of financial services provided by different types of FI study participants:

Table 3: Mix of financial services provided by financial institutions as part of "core business"

	Asset-Based Finance	Capital Markets	Corporate Lending	Insurance	Investment
Asset Manager					✓
Bank	✓	✓	✓	✓	✓
Insurance company				✓	✓
Private equity	✓				✓

Table 3 is indicative of the core business activities of these types of FIs, relevant for the purposes of this project. It does not provide an exhaustive list of all services that may be provided by a particular type of FI. For example, there are some instances where an Asset Manager may provide debt-based finance (including Asset-Based Finance). The nature and characteristics of each financial service are important as they determine the type of E&S due diligence to be carried out as well as the potential for leverage over a client/investee company.

Informed by desktop research, Table 4 below provides a general overview of those characteristics (see **Appendix D** for references).

Table 4: General characteristics of financial services

	Asset-Based Finance	Capital Markets	Corporate Lending	Insurance	Investment
Duration (typical range)	Wide variation (e.g. between 1–25 years although average is around 9 years[i])	Variable including short-term transactions (e.g. Initial Public Offerings (IPO) typically require 3–9 months[ii])	Weeks to over 10 years (e.g. working capital loans can be less than 1 year; term loans between 1 to 10 years)	Annual policy renewal cycle; shorter term for ECAs (e.g. credit terms typically less than 1 year[iii])	Wide variation (e.g. average equity holding is around 1 year,[iv] bonds typically from 1–10 years[v])
Industry sectors financed	Typically large & high risk infrastructure and industrial projects[vi]	All sectors (largest sectors are financial, energy & power & industrial[vii])	All sectors	All sectors	All sectors
Typical amount of funds involved	Large (e.g. average fund size was USD 128 million in 2000[viii])	Large (e.g. average IPO was USD 204.8 million in 2010[ix])	Highly variable; probably smaller on average relative to other financial service types.	Highly variable	Highly variable[x]
Amount of E&S information available (on client or portfolio company, or asset/project in the case of asset finance)	Variable (Higher than for other financial services e.g. project finance where Equator Principles are applied)	Relatively high, as a larger proportion of clients are multi-national companies	Variable (Higher for larger and listed companies, lower for small-medium enterprises)	Highly variable	High for public equities (due to disclosure requirements), MNCs, lower for other asset classes e.g. property, private equity
Use of syndication (groups of FIs working together on a temporary basis to finance a particular transaction)	Syndicates normally required, from 3 to over 50 FIs in largest projects[xi]	Syndicates are common for largest underwriting projects[xii]	Syndicates (of 3 or more of FIs) may be used for term loans[xiii]	Syndicates may be used for high risk/unusual risks[xiv]	Assets are typically owned by a large and diverse group of managers
Tiers between client and the FI	Borrower is a special project vehicle (SPV)[xv], creating tiered relationship. Syndicates create additional tiers, e.g. between lead arranger/other participants.	Typically direct client to FI relationship Syndicates (e.g. underwriting syndicates) will create tiers.	Typically direct client to FI relationship. Syndicates will create tiers, e.g. between lead arranger/others.	Typically direct client to FI relationship, except in reinsurance.	Typically direct client to FI relationship. Structured investment vehicles, "funds of funds" etc. will create tiers.

As seen from Table 4 above, each financial service type is unique, and wide variances exist in the characteristics between and within each type (e.g. the duration of Corporate Lending transactions can last from just a few weeks to over 10 years). Nonetheless, some broad generalisations can be made:

- **Asset-Based Finance** (particularly project finance) and **Capital Markets** are the types of financial services which most typically involve large volumes of funds, and relatedly, both are areas where syndication is most common;
- **Asset-Based Finance** is unique in its **orientation towards particular sectors** associated with a large E&S footprint, including greenfield developments (e.g. on sites which were not altered by previous developments) such as infrastructure and industrial projects;
- **Insurance**, **Corporate Lending** and **Investment**, while each has unique characteristics (e.g. duration), they are alike in serving a wide range of client/investee companies, of various sizes and in various sectors. They are also similar in typically (although not exclusively) involving a direct relationship between one client or investee company and one FI.

These types of characterisations or factors will be important later in the analysis when considering E&S due diligence practices and potential for leverage or influence over clients/investee companies.

2.3. International frameworks, principles, standards and guidelines

2.3.1 Introduction

There are numerous frameworks, principles, standards and guidelines, which the financial sector already uses to identify and/or assess E&S risks. In our survey we grouped:

- International **frameworks and principles** that FIs can **refer to** in their E&S due diligence policies or position statements; and
- Practical **standards and guidelines** that FIs can **embed** in their policies and/or implement in their E&S due diligence processes.

This grouping is useful in assessing a range of different external initiatives which are commonly referenced by FIs and, in particular, helps to understand how they relate to E&S due diligence approaches. Table 5 below maps international frameworks, principles, frameworks and standards used by the surveyed FIs in relation to different types of financial services.

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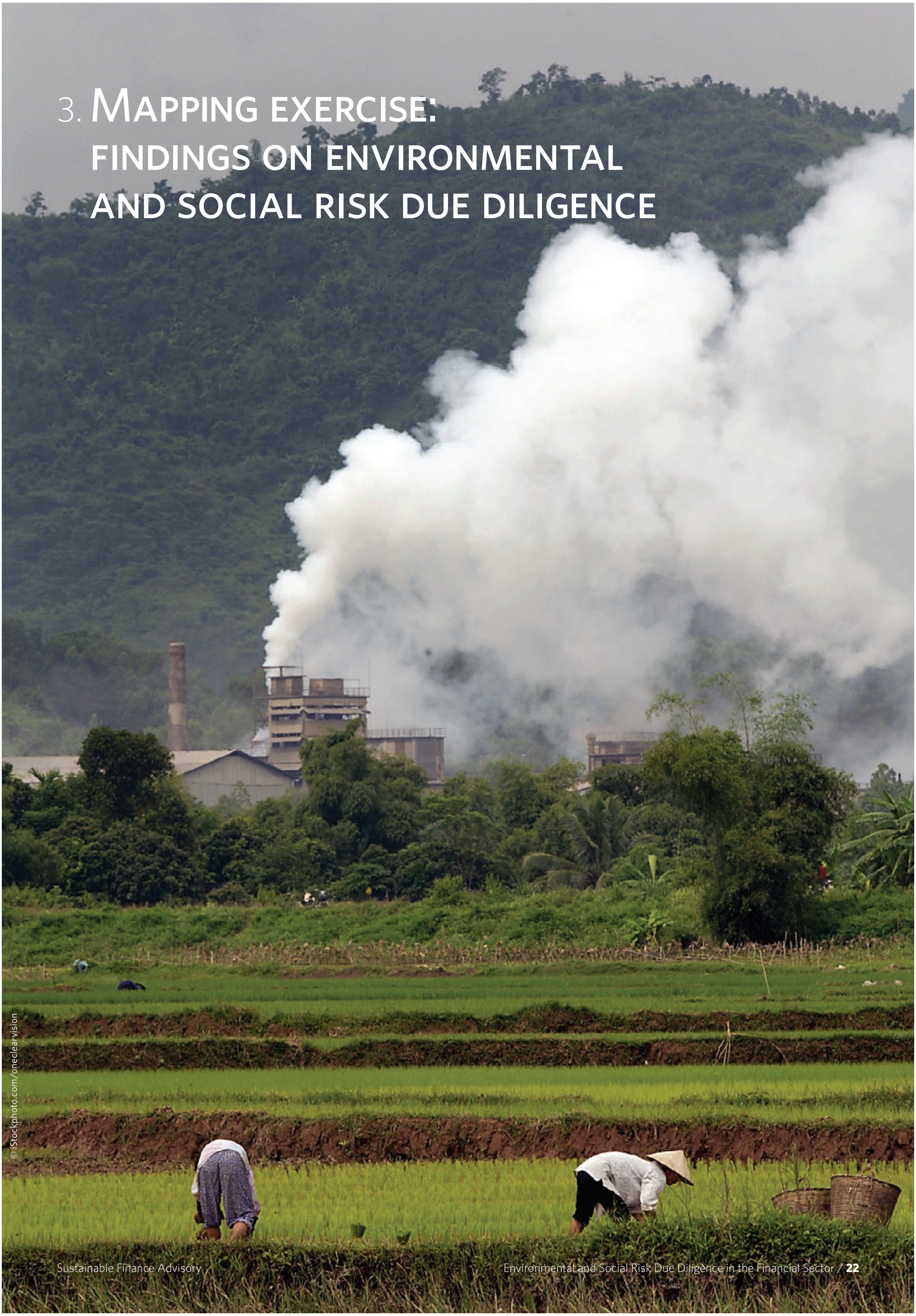
Table 5: Mapping of international frameworks, principles, standards and guidelines applied by study participants by types of financial institutions and services

	E&S Issue Type			Type of financial institution					Type of financial service				
	Human Rights	Employment & Industrial Relations	Environment	Asset Managers	Banks	Insurance Companies	Pension Funds	Private equity	Corporate Lending	Asset-Based Finance	Investment	Capital Markets	Insurance
International Frameworks and Principles													
Banking Environment Initiative			✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Millennium Development Goals	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
OECD Guidelines for Multinational Enterprises	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
United Nations Guiding Principles for Business and Human Rights	✓	✓		✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
UNEP FI Principles for Sustainable Insurance (PSI)	✓	✓	✓	✓		✓	✓						✓
United Nations backed Principles for Responsible Investment (UN PRI)	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
United Nations Environment Programme – Finance Initiative (UNEP FI)	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
United Nations Global Compact	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Universal Declaration of Human Rights	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
International Standards and Guidelines													
Certification standards for commodities (e.g. Forest Stewardship Council (FSC), Roundtable on Sustainable Palm Oil (RSPO), etc.)		✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
General or industry specific, environment, health and safety guidelines		✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Global Reporting Initiative (Financial Sector Supplement)		✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Industry or sector specific standards (e.g. International Hydropower Association, International Council on Mining and Metals)	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
International Finance Corporation (IFC) Performance Standards	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
International labour standards of the International Labour Organisation (ILO) conventions	✓	✓		✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
OECD Due Diligence Guidance for Responsible Mining of Minerals in Conflict-Affected Areas	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
World Bank Group Environmental, Health, and Safety Guidelines	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
The Equator Principles	✓	✓	✓		✓				✓	✓	✓		



3. Mapping exercise: findings on environmental and social risk due diligence

3.1. Findings on Frameworks and Principles

According to survey data, the frameworks and principles which FIs **refer to** the most in their E&S policies or position statements are:

- UNEP Finance Initiative (UNEP FI);
- United Nations Global Compact (UNGC);
- Universal Declaration of Human Rights (UNDHR);
- United Nations backed Principles for Responsible Investment (UNPRI)[20]; and
- United Nations Guiding Principles for Business and Human Rights (UNGPs).

3.1.2 Findings on the United Nations Guiding Principles on Business and Human Rights

Whilst 60% of survey respondents are "aware"[21] of the UNGPs, during interviews there was a very mixed response in relation to their understanding and use of the UNGPs to identify and/or assess human rights issues. A further discussion on this topic is included in **Section 3.4.** Those FIs that indicated they were not familiar with the UNGPs are located in countries that adhere to the OECD Guidelines as well as countries that do not:

- **Adhering countries:** Australia, Denmark, France, Germany, Japan, Mexico, Netherlands, Turkey, UK, USA, Brazil; and
- **Non-adhering countries:** Ecuador, Nigeria, South Africa and UAE.

This finding suggests that awareness-raising activities on the UNGPs have not yet reached a number of FIs both in adhering and non-adhering countries. It is worth noting that a few FIs did not have specific plans to take specific action pursuant to the UNGPs, as for example, they already covered human rights aspects within existing due diligence processes.

"We deal with human rights issues through our policy on corporate responsibility. There are no plans, in the near future, to adopt the mentioned frameworks [UNGP]. Brazil has several laws on human rights and we follow all procedures to guarantee their enforcement."

Bank

Of the FIs that are familiar with the UNGPs, in general, most are at the early stages of understanding the implications for their institutions. FIs familiar with the framework are:

- Developing their own institutional approach (e.g. policy);
- Developing a policy approach in collaboration with other partners; or
- Already covering aspects of the framework within existing policies and processes.

"For us the recent developments in human rights [UNGPs] will mean significant changes, particularly as our [EU] home country is taking a leading role to include them in the financial sector. It does not mean much change for our policies, communications of these and what we aspire to do. However, it does mean significant changes for implementation and consistency of implementation across geographies and sectors."

Bank

The Thun Group is an example of a recent initiative amongst banks to support implementation of the UNGPs and better understand how they can be applied to banking business.[22]

20 The UN PRI convenes working groups and facilitates debate on investment-related financial services provided by FIs such as private equity companies and Asset Managers. Its membership has grown, from a few dozen since it was launched in 2006 to over a thousand in 2012. Some FIs indicated it would be a good platform to build on existing discussions on E&S due diligence related to Investment services.

21 Information presented is related to a separate survey question that specifically asked FIs whether they were "aware" of the UNGPs.

22 The Group is currently completing its work on a discussion document that focuses on Guiding Principles 16–21 (relating to the corporate responsibility to respect human rights) and suggests an approach to the assessment and the scope and depth of due diligence which may be undertaken." Thun Group of Banks Response to a question at the UN Forum on Business and Human Rights, December 2012.

A number of FIs interviewed identified benefits of the UNGPs including:

- **Client engagement:** The UNGPs are perceived as a useful tool for engaging clients as they provide concepts and a framework for discussion.
- **Provides a common framework for the human rights policy of individual FIs:** The UNGPs are viewed as helpful in providing internationally endorsed/recognised principles for a human rights policy of an individual FI. For FIs that already have a human rights policy, the framework provides a useful reference.
- **Provides clear guidance for FI clients or investee companies:** The UNGPs are seen as providing a clear framework for client or investee companies to manage human rights issues in, for example, their supply chains.

Many of the FIs interviewed are reviewing the UNGPs in relation to existing E&S policies and due diligence processes, for example, by conducting a "gap analysis".

> "For us it is important to have an internationally agreed framework and authority such as the UNGPs, particularly in discussions with client/investee companies in developing countries where human rights may not be incorporated into law."
>
> **Asset Manager**

3.2. Findings on standards and guidelines

The standards and guidelines most commonly **embedded** in policies and/or implemented in E&S due diligence processes as identified by survey respondents are:

- General or client's/investee's industry-specific environment, health and safety guidelines (73%);
- IFC Performance Standards (71%);
- Equator Principles (EP) (54%);
- International labour standards of the International Labour Organisation (ILO) conventions (52%); and
- World Bank Group Environmental, Health, and Safety Guidelines (50%).

3.2.1 The Equator Principles and IFC Performance Standards

Since the launch of the Equator Principles for project finance 10 years ago, they have become widely accepted as good practice for project finance transactions over USD 10 million. Adopters use the EPs in their E&S due diligence processes. Whilst the EPs are designed for project finance transactions, some FIs also use them as reference for other financial services such as structured finance. A number of FIs interviewed cited the Equator Principles and IFC Performance Standards as very useful to their E&S risk due diligence processes.

SURVEY SAYS...

FIs view the IFC Performance Standards as:

- Internationally recognised and accepted both in adhering and non-adhering countries;
- Practical;
- Easier to implement within E&S due diligence processes; and
- More straightforward to compare to national laws especially in non-adhering countries in relation to implementation of E&S due diligence.

The Equator Principles have recently been updated to reflect emerging good practice and the latest updates to the IFC Performance Standards. One of the key changes is to extend the coverage of the principles to include, inter alia, project-related corporate loans that meet criteria including, for example, a total aggregate loan amount of at least USD100 million and a loan tenor of at least two years.[23]

23 Equator Principles: Frequently asked questions on the EPIII update (**http://www.equator-principles.com/resources/EPIII_FAQs.pdf**).

3.2.2 Sector-Specific Guidelines

FIs interviewed mentioned the use of sector-specific guidelines (e.g. Forestry Stewardship Council, Roundtable on Sustainable Palm Oil, International Hydropower Association Sustainability Assessment Protocol) as a useful benchmark for assessing the E&S performance of their clients or investee companies.

Some interviewed FIs have sector-specific position statements, which refer to these sector-specific guidelines, and some also engage directly with industry associations to understand best practice, and consider it good practice for their clients to do the same.

SURVEY SAYS...

26 out of 52 FIs embed sector-specific guidelines or standards in their policies and/or implement them in their E&S due diligence processes

29 out of 52 FIs have sector or industry-specific policies and/or position statements (e.g. Energy, Defence, Pharmaceuticals, Consumer Products, etc.).

3.2.3 The OECD Guidelines

The findings of the survey show that the awareness and use of the OECD Guidelines by FIs was low: only 13 out of 52 survey respondents apply or refer to the OECD Guidelines in the context of E&S risk due diligence. The findings are discussed in-depth in **Section 4.1.**

3.2.4 Comments on the findings

Overall, whilst FIs may refer to many frameworks, principles, guidelines and standards in practice very few can be/are directly applied in the **implementation** of E&S risk due diligence across different types of financial services. Unless such standards are directly relevant to the financial sector and provide a framework which assists FIs in assessing underlying E&S risks, their uptake by the sector is low.

3.3. Findings on environmental and social risk due diligence processes and implementation

3.3.1 Introduction

E&S due diligence is an important tool for FIs to identify, assess, categorise and manage potential E&S risks or issues associated with a project, transaction, client or investee company, ideally before such risks or issues become adverse impacts. For the purposes of this study, it is important to understand when and how FIs undertake E&S due diligence, so that it potentially gives an indication of whether FIs can subsequently manage any identified E&S risks by influencing client or investee company behaviour. The sections below map in detail E&S due diligence approaches and their implementation by FIs for different financial services. These findings combine data obtained from the surveys and information acquired from the interviews conducted with the FIs.

3.3.2 Findings on approaches to risk-based E&S due diligence

FIs have different approaches to addressing the E&S risks to which they may potentially be linked through the provision of financial products and services.

KEY POINT

One of the most important drivers for conducting E&S due diligence is the FIs' aim of having a risk management approach that is suited to the risk profile of their engagements.

Factors which influence the approach to E&S risk due diligence

According to FI study participants, a number of factors influence the way an FI approaches E&S risks, including , but not limited to, the:

- FI's business model;
- Types of financial services offered (including their typical duration, amounts involved and number of tiers between the FI and the client/investee company);
- Industry sectors of the client/investment portfolio;
- Types of E&S issues related to the FI's portfolio and the potential to cause adverse impacts;
- Geographic scope of the FI's business;
- Applicable industry initiatives and legal frameworks;
- Cultural aspects (internal and external); and
- External pressures from civil society.

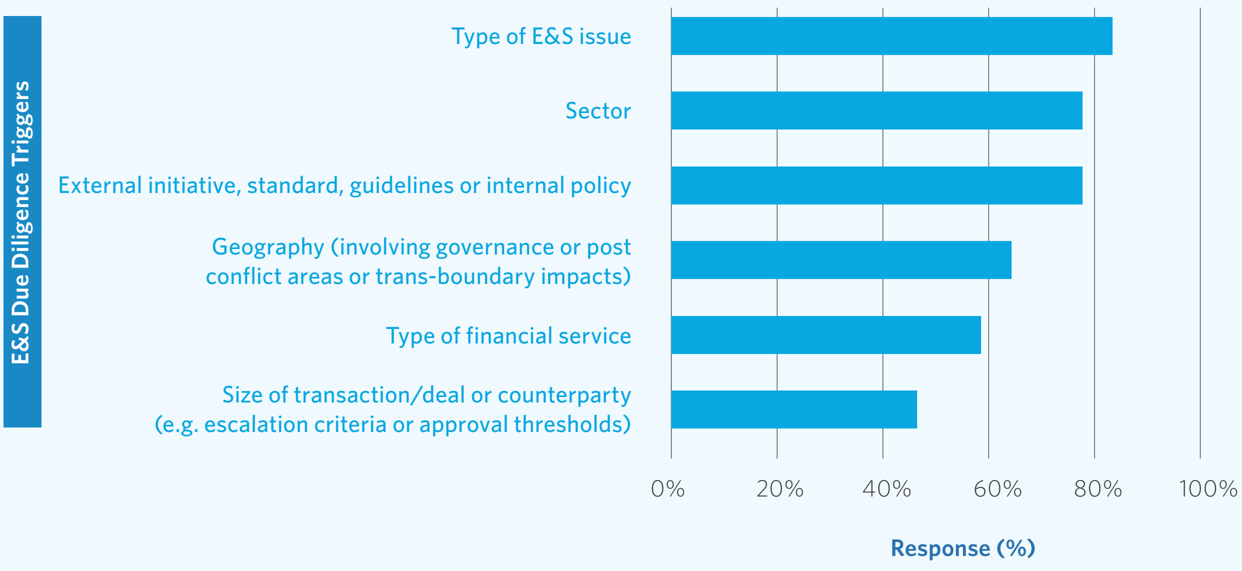
As mentioned in **Section 2.2.1** the business models of FIs are very different, varying not only from one type of FI to another, but also within the same category of FIs. They differ in:

- Nature of the FIs' businesses (e.g. business strategy);
- Scope (e.g. development FIs, commercial FIs);
- Size (e.g. number of clients/investments, of employees, of group entities);
- Shareholders' structures (e.g. state owned, privately owned, cooperative FIs); and
- Organisational structures.

Each of the foregoing influence the way E&S risk management is structured.

At the transaction level, a number of factors determine or "trigger" whether, or what level of, E&S due diligence is undertaken as illustrated in Diagram 2 below:

Diagram 2: Survey responses on factors that trigger E&S Due Diligence



The types of E&S issues emerge as the factor with most influence (selected by 85% of the FIs surveyed), followed by the industry sectors of the client/investee company and the applicable industry initiatives (both selected by 77% of the FIs).

Based on the survey results, the main environmental and social issues that "trigger" and/or influence the type or level of E&S due diligence undertaken by the FIs are outlined below.

ENVIRONMENTAL ISSUES:

- **Pollution (e.g. contamination of air, land or water);**
- **Deforestation;**
- **Loss of biodiversity and natural habitats;**
- **Greenhouse gas emissions and climate change impacts; and**
- **Depletion of natural resources.**

SOCIAL ISSUES:

- **Child labour;**
- **Occupational health and safety;**
- **Working conditions;**
- **Forced and compulsory labour; and**
- **Community health, safety and security.**

Based on our research, E&S due diligence practices also vary according to the commercial importance of specific industry sectors to an FI. For example, banks which lend extensively to certain sectors (e.g. agriculture) will focus more on E&S issues pertinent to this sector and E&S due diligence approaches will be tailored accordingly.

The interviews with the FIs showed that cultural aspects, both external [in relation to the country where the FI operates (e.g. different perceptions of the importance of economic priorities versus E&S issues can potentially lead to differing E&S due diligence practices between developed and emerging economies)] and internal (within an FI's own organisation), also influence E&S due diligence approaches.

"A fundamental shift in the mind-set of Indian financial institutions is needed to re-balance the focus from commercial growth only, towards environmental and social issues. This is an issue commonly found in other emerging economies."

Bank

Another factor that may influence an FI's E&S due diligence approach is external pressure from civil society. In some cases such pressure from civil society has triggered or facilitated the development of certain E&S risk practices or policies, such as human rights policies.

During the interviews some of the FIs recognised that after an initial "reactive" approach to E&S due diligence, FIs should ideally progress their E&S due diligence practices and approach in a more "proactive" manner over time. It was also observed by a few FIs that after committing to various external initiatives/standards, the focus of some companies (not only FIs) can be on external reporting to appease and react to stakeholder demands, rather than focusing on actual E&S risk management.

"Currently too many companies drive E&S due diligence and report on E&S issues and impacts from the perspective of the external stakeholders rather than using the data collected to drive internal improvements in E&S areas."

Private equity company

Types of approaches to E&S risk due diligence

Some FI study participants have established a centralised approach to E&S due diligence, where the E&S risk policies, experts and decision-making authorities are situated at the central/head office level of the organisation. In such cases there is one point of contact for E&S issues, usually an independent E&S risk management team that reviews all relevant financing/investing proposals.

Other FI study participants have adopted a decentralised approach, where the various business divisions bear the responsibility for conducting the E&S due diligence for their portfolios. In these cases, E&S risk policies are developed at business division level and the E&S risk experts are located in the business/commercial teams.

There are also FIs that have a more limited approach to E&S due diligence, where E&S issues are dealt with on a case-by-case basis, within the regular credit/investment decision processes. In these cases, E&S issues will typically only be considered in the larger transactions or deals.

A number of FI study participants have adopted a systematic approach to E&S risk due diligence, as reflected in the implementation example below.

IMPLEMENTATION EXAMPLE 1:
Systematic approach to E&S risk due diligence

Characteristics of a systematic approach to E&S risk due diligence:

- E&S risk aspects are embedded into existing risk frameworks and are an integral part of determining the FI's risk profile or appetite;
- An integrated, mainstreamed approach is in place (e.g. E&S risks are considered across the whole range of financial services and by a number of different functions);
- A framework of policies, processes, systems and tools is used for consistent implementation; and
- Where relevant, E&S risk due diligence takes place not only at the transaction level, but also outside the deal flows (e.g. some FIs screen for potential E&S issues before engaging with new clients, during Know Your Customer (KYC) processes) and at portfolio level.

Some of the FI study participants with well-established E&S due diligence and risk management practices are increasingly of the view that engaging on E&S issues is also an opportunity to "create value" and deepen client relationships.

IMPLEMENTATION EXAMPLE 2:
E&S risk management framework

One FI's E&S risk management framework is structured in a three level pyramid:

Level 1 – **Strategic level** involvement in certain E&S initiatives, where the FI is able to make strategic interventions (e.g. participation in extractive industries initiatives, supporting academic research, participation in industry-led presentations and workshops on specific E&S topics);

Level 2 – **Tactical level**, where the FI conducts portfolio reviews and engages with clients outside the transaction flow; and

Level 3 – **Operational transactional level**, where the FI conducts transaction and client level reviews and engages with clients within the context of a specific transaction or business engagement.

On-going top-down and bottom-up communication among the levels provides the basis for well-established and implemented E&S risk management strategies.

E&S risk management framework pyramid

E&S risk policies

All the FIs surveyed confirmed having an **official policy or position statement on E&S issues**.

86% of the surveyed FIs have a general sustainability/reputation risk/responsible investing policy that covers all business activities, accompanied by policies that cover specific industry sectors and E&S issues.

E&S risk policies can be categorised according to their scope into:

- **Sector-based policies,** which provide the framework for E&S due diligence when engaging with companies in specific industry sectors (e.g. energy/oil & gas, metals & mining or agriculture); and
- **Issue-based policies,** which provide the framework for E&S due diligence on specific environmental or social topics across industries (e.g. human rights, climate change, water, biodiversity, or country "no go" zones).

Sector-based policies range from straightforward exclusion lists, which identify certain industry sectors as outside the business scope of the FI (e.g. defence industry), to comprehensive policies that articulate the circumstances in which financial services and/or products can be provided to companies in industries deemed to be sensitive for E&S reasons.

69% of the surveyed FIs also have a process, tool or methodology for categorising industry sectors by the level of E&S risk (e.g. high, medium, low). The sectors most frequently associated with the highest level of E&S risk and thus most likely to be subject to specific E&S policies are energy/oil and gas, metals and mining, and aerospace/defence services. Industry-based policies typically cover both the E&S aspects relevant to that specific sector.

Issue-based policies are often applicable outside of an E&S risk management or investment framework, given that they also can define the rules applicable to the FI's direct operations (e.g. policies dealing with the FI's direct environmental impacts or with supply chain issues). Nineteen of the 52 surveyed FIs have a standalone issue-specific policy or position statement on human rights, 18 have a geography/country specific policy or position statement including "No Go" zones, and 25 have other issue-specific policies and/or statements (e.g. on climate change, biodiversity, water).

E&S risk due diligence processes/implementation

In most cases (83% of the FIs surveyed), E&S due diligence processes are aligned with credit/investment approval processes.

KEY POINT

FIs see prioritisation as necessary when conducting E&S due diligence, due to the complexity of their business models (e.g. the universal banks) and also due to the high volumes of transactions/clients.

FIs find that the assessment of E&S issues at the very early stage in a potential new transaction/investment is essential to successfully managing E&S risks.

Where needed, specific procedures, governance structures, processes and tools are developed for conducting E&S due diligence (e.g. applicable decision-making processes and escalation criteria/procedures, E&S issue screening templates/questionnaires).

During the interviews it was determined that some FIs identify upfront, certain sectors, countries and/or companies that have significant E&S issues that the FIs would not finance/invest in due to E&S considerations. These may be specified in separate exclusion lists, or can be part of E&S sector/issue based policies, credit/reputation risk policies (such as risk appetite policies) or compliance/KYC policies. The restrictions can include, for example, companies in sectors such as defence, gambling, tobacco, nuclear power or transactions involving countries under United Nations and/or European Union sanctions or embargoes (e.g. Iran and North Korea are under UN arms embargoes).

SURVEY SAYS...

50% have E&S due diligence processes integrated into **all** systems

6% do **not** have E&S due diligence processes integrated into **any** standard systems

57% incorporate E&S screening criteria into their KYC/new client on boarding processes and systems

IMPLEMENTATION EXAMPLE 3:
A Pension Fund's Exclusion Lists

Our exclusion list includes the following sectors in which we do not wish to invest:

- Tobacco;
- Alcohol (although we do have some flexibility to include companies which derive a small percentage of their profits from the sale of alcohol)
- Gambling;
- Firearms;
- Nuclear power (certain funds we invest in might include nuclear power companies, however, we only invest if they also invest in renewable energy); and
- Weapons (as described in further detail below).

Weapons exclusions

In 2006 we conducted an extensive review on the changing conduct of warfare in the 21st century, covering the International Humanitarian Law (IHL) and the Treaty on Conventional Armed Forces in Europe. The aim was to review our existing weapons exclusion policy that articulated we would not invest in companies that were "significantly involved" in the design, manufacture and sale of weapons. Based on this review we adapted our existing policy of 20 years to be: 1) much more explicit on the types of companies we exclude; and 2) based on internationally accepted normative standards. As a result, in addition to the IHL exclusions, we also exclude companies that produce:

- Nuclear weapons, cluster bombs and landmines;
- Inherently offensive rather than defensive weapons.

However, we are able to invest in companies that comply with internationally accepted standards.

STUDY FINDING...

Factors that can determine E&S risk levels include but are not limited to:

- Industry sector;
- Nature of the goods financed;
- E&S performance of the client/investment company;
- Country where the client/investment company or the project is located;
- Amount of funds involved; and
- E&S issues raised by stakeholders.

Many of the FI study participants use specific tools to screen new transactions and identify those with higher E&S risks, which subsequently require further investigation. The result of such screening is typically a categorisation of the risk involved by the proposed transactions into high/medium/low E&S risk. Some of the FIs use traffic light colours to reflect the level of E&S risk (e.g. red for high, yellow/amber for medium, and green for low E&S risk).

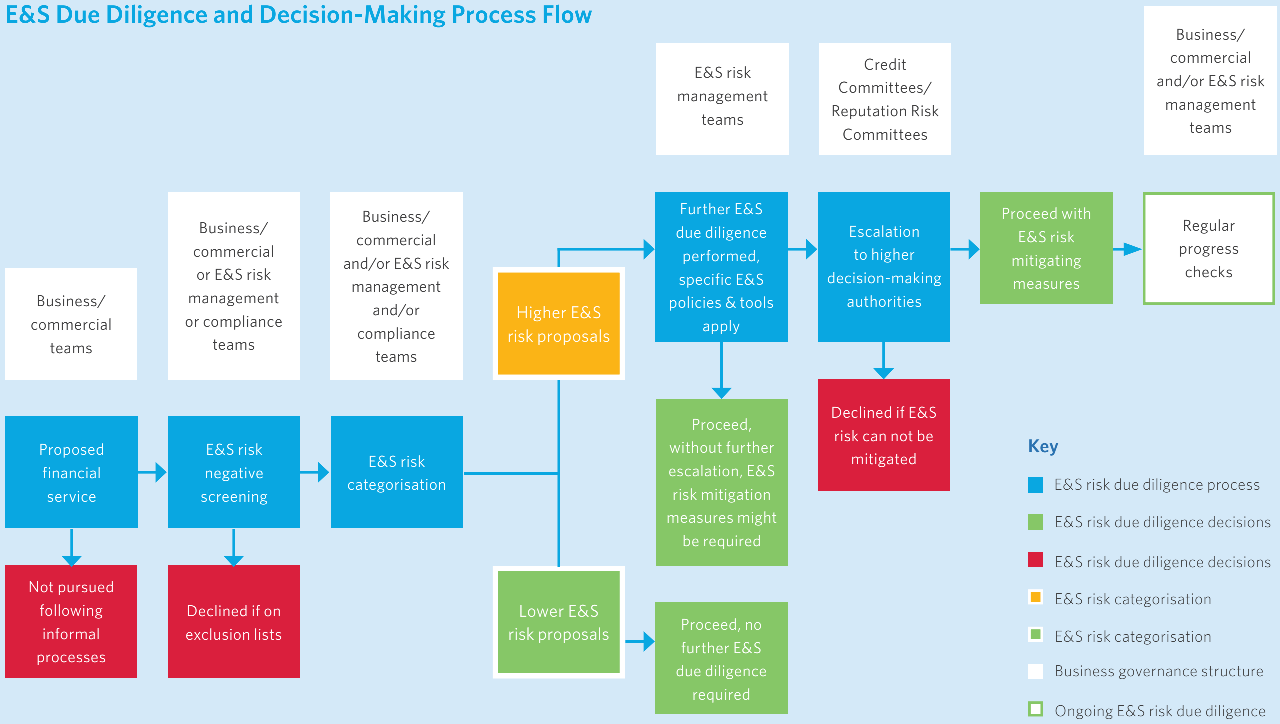
Each FI uses its own methods and considerations to determine the level of E&S risk involved by a proposed transaction.

When FIs identify particular E&S issues through the initial screening process that translate into medium or high E&S risks for the FIs, it is only then that further E&S due diligence is conducted. In this way, E&S due diligence and risk management approaches are designed to be commensurate with the potential level of E&S risk. There is no "one size fits all" approach to E&S due diligence.

The following diagram provides an illustrative example of an E&S due diligence and decision-making process flow for a financial service proposal, based on qualitative interview information. Some FIs formalise such due diligence processes in their internal policies/procedures, while for others it can be mostly an informal process. FIs might have some or all of these elements in place.

IMPLEMENTATION EXAMPLE 4:

E&S Due Diligence and Decision-Making Process Flow



When FIs consider financing/investing in companies with identified E&S risks, many FIs request that the companies improve their E&S performance, whether prior to the financing (as a "condition precedent"), or during the financing. In the latter cases, E&S requirements/conditions are included in the financing documentation and regular monitoring of progress (on-going due diligence) is necessary.

E&S risk due diligence governance structure

A number of functions within an FI can be involved in performing the E&S due diligence, such as:

- Business/commercial teams (e.g. front officers, client relationship managers, fund managers, commercial deal teams);
- E&S risk management teams[24];
- Risk management teams;
- Compliance teams; and
- Credit Committees/Reputation Risk Committees.

Depending on the centralised/decentralised model used for E&S due diligence, E&S risk management teams are set up at either central/head office level in the organisation (e.g. as part of the central risk management structures) or in the business divisions (e.g. with the business/commercial teams).[25] 83% of the surveyed FIs have E&S risk management teams.

Our research indicates that business/commercial teams are typically responsible for gathering information and identifying transactions with higher E&S risks. E&S risk management teams are involved in performing further E&S due diligence and providing E&S risk advice/recommendations. If dialogue on E&S issues with the company is deemed necessary, the front office teams will typically conduct it with support from the E&S risk management teams. The ultimate responsibility for managing E&S risks can rest either with E&S risk management teams or with the business teams.

24 The teams of E&S risk specialists within FIs have various names e.g. E&S Risk Management, ESG, Governance & Sustainable Investment, Sustainable Development & Social and Environmental Responsibility, Responsible Investment. Because this study focuses on risk-based E&S due diligence, we refer to them throughout the report as "E&S risk management" teams.

25 Some FIs have separate Corporate Social Responsibility teams responsible for developing certain issue-based policies (e.g. on human rights), engaging with external stakeholders on E&S issues and/or for reporting on sustainability topics.

STUDY FINDING...

E&S risk management teams are typically responsible for:

- E&S policy making (including support for their implementation);
- Acting as an in-house consultant on E&S issues;
- Providing the necessary internal trainings on E&S issues; and
- External engagement (e.g. participation in industry initiatives).

Where deemed necessary, higher risk transactions are escalated to higher decision-making authorities such as Credit Risk Committees or Reputation Risk Committees.

When the financing/investment is approved with conditions (i.e. when the client/investee company must comply with specific E&S requirements), the E&S risk managers are usually involved in the periodic reviews. When financing/investment is approved without conditions, the responsibility for monitoring the company for any relevant E&S changes belongs to the relationship/investment managers. The history and/or nature of the relationship with a company are very important factors in progressing discussions on E&S issues.

In some of the FIs the compliance function is also involved in the E&S due diligence process; in such cases the compliance function acts as an extension of the E&S risk management teams.

Given that most FIs have a limited number of in-house E&S risk managers, FI interviews revealed that informal networks have proven valuable in ensuring more robust E&S due diligence practices. The E&S risk management teams provide training to other functions within the organisation (e.g. to local risk managers), who become part of an informal network that supports E&S due diligence undertakings.

Some FIs with international operations have stated that having key people in the regions who support E&S due diligence implementation has been helpful in making sure that E&S due diligence practices become integrated into local practices, context and organisational culture.

IMPLEMENTATION EXAMPLE 5:
Bank E&S risk management team seen as a business partner

Over time, the E&S risk management and commercial teams have developed stronger relationships. In some regions/product areas the situation has changed from one of reactive responses, and sometimes challenges between commercial versus E&S risk objectives, to one where both teams are using E&S due diligence to identify business opportunities. The E&S risk management team is now seen more as a business partner.

3.3.4 Findings on specific E&S risk due diligence for each type of financial service

E&S due diligence processes differ not only for the various types of FIs, but also for various types of financial services.

Diagram 3: Survey responses on E&S Due Diligence Undertaken by Financial Service Type

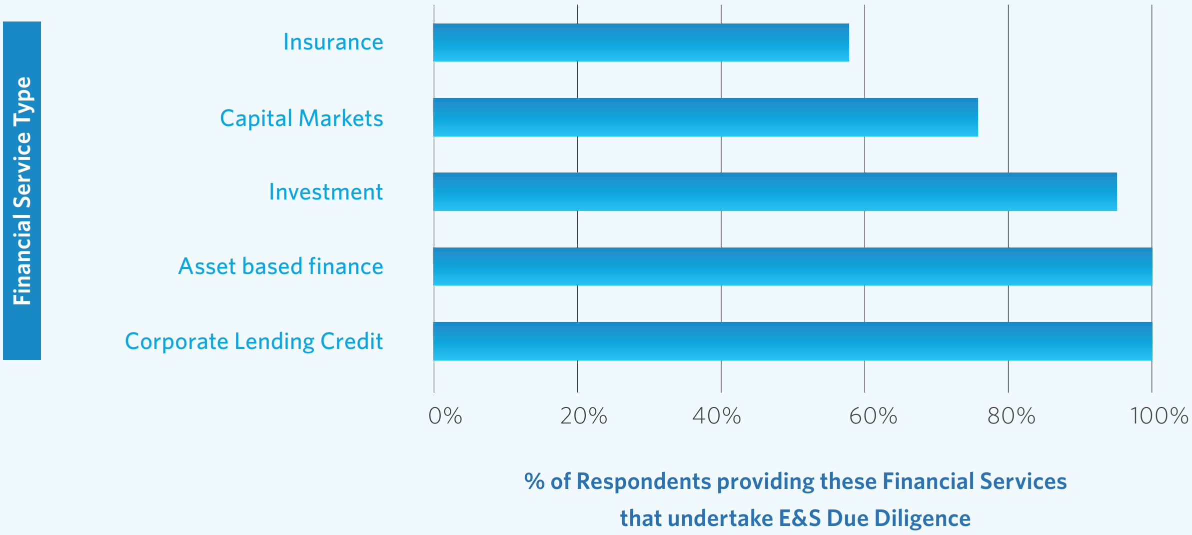


Diagram 3 offers an overview of the proportion of surveyed FIs who conduct E&S risk due diligence for each category of financial services.

Corporate Lending

Corporate Lending facilities are typically provided by commercial banks.

All surveyed FIs that provide Corporate Lending facilities to large companies conduct related E&S due diligence.

Currently there are no internationally agreed standards on E&S due diligence for this type of financial services. The recent extension to the scope of the Equator Principles to include project finance-related corporate and bridge loans would be applicable only to a very small part of an FI's (EP adopter) lending portfolio.

KEY POINT

E&S due diligence for Corporate Lending is conducted at a higher level, compared to, for example, Asset-Based Finance, where a more in-depth E&S due diligence at the financed asset, project or site level is possible. FIs studied cite several factors, including the characteristics of the financial services and the availability/non-availability of specific E&S impact assessments and reports.

The different types of Corporate Lending can be distinguished as:

- General lending facilities (e.g. working capital, overdraft) that do not have an underlying asset[26]; and
- Lending facilities that have an underlying asset, but which do not qualify as Asset-Based Finance as defined for the purposes of this report (e.g. loans related to forestry or agricultural plantations, trade finance for E&S sensitive equipment, mortgage loans for property development).

26 Physical assets such as a plant, property or equipment.

For the general lending facilities that do not have an underlying asset, E&S due diligence is limited to a company E&S risk assessment, usually based on publicly available information. Implementation Example 6 below is consistent with a client risk assessment in accordance with the IFC Performance Standards (Performance Standard 1).

IMPLEMENTATION EXAMPLE 6:
A Bank's Company E&S risk assessment

When we conduct E&S risk assessment at a company level, we take into consideration the following aspects:

- The **commitment** of the company to manage E&S issues (e.g. the company's policies on E&S issues and its commitment to uphold international E&S standards);
- The **capacity** of the company to manage E&S issues (e.g. the company's E&S management systems); and
- The **track record** of the company in managing E&S issues (e.g. whether there are NGO campaigns, fines or lawsuits against the company related to E&S matters).

Some FIs use external service providers that create E&S risk profiles and databases of companies based on available public information.

For lending facilities that have an underlying asset, an E&S screening of the respective asset is performed in addition to the company E&S risk assessment. As mentioned, such screening/assessment is conducted at a more general level than for Asset-Based Finance.

Some of the surveyed FIs specify in their respective credit policies which industries they lend or do not lend to (exclusion lists) and/or identify sectors with higher E&S risk.

Other FI study participants state the E&S due diligence requirements for Corporate Lending in specific sector policies. Such sector policies set out minimum E&S requirements for a company to be eligible for financing and typically all companies are assessed against these requirements. In developing sector policies, FIs often categorise companies to reflect their level of E&S performance when benchmarked against respective industry best or good practice standards (e.g. compliant/near compliant/non-compliant).

For some FIs studied, depending on the E&S risk categorisation of the proposed financing (i.e. high, medium or low), further E&S due diligence and engagement with the company and/or escalation to a higher decision-making authority might be required. Where financing is approved with conditions, specific covenants may be included in the loan documentation and monitoring of progress takes place at regular intervals.

Asset-Based Finance

All 35 surveyed FIs who provide Asset-Based Financing[27] have E&S due diligence requirements for such transactions.

In some cases FIs assess structured finance transactions using the same or similar standards that they apply for project finance.

KEY POINT

E&S due diligence approaches for project finance above certain applicable thresholds (such as the USD 10 million total project finance capital costs thresholds for Equator Principles transactions) are fairly similar for the FIs who apply the Equator Principles, the IFC Performance Standards or other comparable standards.

Given that this type of financing is provided for a particular asset, for FI interview participants providing Asset-Based Finance, the E&S due diligence process typically includes:

- An E&S risk assessment of the asset; and
- An E&S risk assessment of the company.

Based on our study results, an initial review of the transaction is almost always conducted by the front office teams, resulting

27 For the purposes of this report, "Asset-Based Finance" is defined as a method of funding specific projects typically secured by the project assets, including the revenue-producing contracts (e.g. project finance, structured finance).

in an E&S categorisation of the project based on the magnitude of its potential impacts and risks. Implementation Example 7 below is consistent with the World Bank/IFC approach to categorisation of projects and representative of practices of a growing number of FIs.

IMPLEMENTATION EXAMPLE 7:
A Bank's E&S risk categorisation for Asset-Based Finance transactions

Our E&S risk categorisation for Asset-Based Finance transactions is aligned to the World Bank/ IFC categorisation. Accordingly, projects can be categorised as:

- Category A (high E&S risk) – Projects with potential significant adverse social or environmental impacts that are diverse, irreversible or unprecedented;
- Category B (medium E&S risk) – Projects with potential limited adverse social or environmental impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures; and
- Category C (low E&S risk) – Projects with minimal or no social or environmental impacts.

The level of subsequent E&S due diligence is based on the project categorisation. Further E&S due diligence is carried out for Category A and B projects and for projects located in low-income OECD countries. No further E&S due diligence is required for Category C projects.

For most FI study participants, Category A projects usually require sign-off from higher decision-making authorities within the FI (e.g. Group Risk Committee).

Investment

Thirty-four out of the 36 FIs surveyed which provide investment services conduct related E&S due diligence.[28]

The United Nations-backed Principles for Responsible Investment constitutes a voluntary international framework which signatory FIs use to incorporate E&S and governance issues into their decision-making and ownership practices. A number of the FI study participants are signatories of the UNPRI.

Investment-focused FI study participants have developed general responsible investment policies that require integration of E&S factors into their investment decision processes. Some FIs apply the responsible investment policies to all asset classes, not only to "green" (e.g. environmentally friendly or ethically screened) assets.

There are three main **types of investments**, depending on the asset class:

- Equity investments: private equity and listed equity investments;
- Fixed income investments (e.g. government or corporate bonds); and
- Investments in other non-listed assets (e.g. investments in real estate or sustainable energy funds, investments in commodities).

Some FIs studied have also developed issue-based policies that, for example, include commitments to international best practice in the areas of climate change, health and safety or social issues.

There are a number of FIs who do not have specific E&S policies, but rather use recognised standards to encourage best practice.

KEY POINT

Investment FIs use different strategies for managing related E&S risk, adapted for each asset class, similar to that applied by FIs for Corporate Lending.

28 Investment companies usually conduct Environmental, Social and Governance ("ESG") due diligence. Given that this report is focusing on the environmental and social issues, for the purposes of this report we will use the same terminology as for the other types of FIs i.e. "E&S due diligence".

For example, when assessing E&S risks for an infrastructure fund, which has an underlying asset, the FIs can assess the asset (e.g. toll road) itself. However, for investments in private equity funds, where there are no underlying assets, FIs can only assess the capacity of the fund manager to assess the E&S risks of the investee company.

The E&S due diligence processes for investments by the interviewed FIs typically consist of a combination of some or all of the following:

A. Negative screening

Through negative screening, FIs check the potential investee company against exclusion lists. For example, companies in certain industry sectors (e.g. defence, tobacco or online gambling) or which have significant E&S issues that do not improve over time (e.g. human rights issues) may be excluded from investment.

B. E&S Risk Assessment

E&S risk assessment of investee companies is an integral part of the appraisal process, often conducted at the beginning of the deal origination. It can be conducted from two perspectives:

- In order to identify whether there are particular E&S risks related to the investee companies that would become part of general funds (in such cases the focus of the E&S assessment is on companies in high E&S risk sectors); and/or
- In order to identify top E&S performers that would be included in ethical/sustainable funds.

Many of the interviewed FIs use E&S risk tools to identify the level of potential risk involved by proposed investments. Most potential investments are run through such E&S risk tools. The result of this screening is usually a categorisation of the proposed investments as high/medium/low E&S risk.

The assessment of high E&S risk engagements is often conducted in-house, while the assessment of medium and low risk engagements may be outsourced. Some FIs require E&S sign-offs for all the assets managed in-house. For medium-risk engagements, some FIs only require E&S information during one phase of the investment, for example, in the monitoring phase.

C. Investment decision and mitigating measures

When making an investment decision, FIs take into account the E&S risk rating resulting from the above-mentioned screening process, and also the investee company's willingness to work on E&S issues.

KEY POINT

The history and nature of the relationship with a company are very important factors in progressing discussions on E&S topics.

Where needed, FIs include the E&S risk mitigating requirements in the financing documentation and specific E&S action plans are agreed with the investee company.

D. Monitoring

Periodic reviews, usually yearly, take place in order to monitor the company's progress in fulfilling E&S requirements.
If needed, a new/corrected E&S action plan is agreed for the next period.

During the monitoring phase, further E&S due diligence is conducted through engagement and voting activities.

Engagement

FI study participants engage in in-depth dialogues on E&S issues with certain companies from their investment portfolio and use international standards and frameworks (such as the UN Global Compact principles) to stimulate best practice. The engagement can be part of an on-going dialogue or can be triggered by voting decisions and related matters. According to the FIs interviewed, the choice for engagement is made based on several factors, including the type and size of the FI's holding, the type of E&S issues and whether other investors are involved. Some FIs mentioned that they have predefined topics for engagement, covering a wide range of E&S and governance risks.

Voting

For FIs studied, voting comprises the activities of FIs as active owners through participation in the General Meetings of Shareholders. Investment FIs interviewed have voting policies/standards and principles on corporate governance that underpin their voting decisions at the companies in which they invest. Voting decisions are primarily based on investment considerations. The majority of agenda items are non-E&S related, however, in some cases FIs use this opportunity to engage the investee companies and raise concerns on E&S issues, explain their expectations and invite comments.

E. E&S assessment before divesting

Some FIs conduct E&S assessments in all stages of an investment: pre-investment (negative screening and E&S risk assessment), post-investment (monitoring), and also at the exit stage, when the FIs decide to divest. E&S assessment of the investee company at the exit stage aims to ensure that the investment satisfies certain E&S standards, in order to find a buyer for the investment.

IMPLEMENTATION EXAMPLE 8:
A private equity company's engagement with investee companies on E&S issues post-investment

E&S due diligence is performed as part of our investment appraisal process and can identify:

- "Red flags", which are high risk E&S issues that need to be addressed by the investee company before we disburse the investment, in legal terms a "condition precedent"; and/or
- "Areas for improvement", which are medium/low risk E&S issues that need to be addressed by the investee company post-investment. These areas of improvement are built into a corrective action plan for the following 6, 12 or 18 months.

An important aspect for increasing the chances of achieving E&S improvements is incorporating E&S requirements into legal documentation.

Post-investment, we periodically review correction plans and progress made by investee companies in fulfilling E&S requirements. Where applicable, we agree on new correction plans for the next period. Once E&S management systems are in place, they have to be able to prove they have improved the respective E&S issues.

Capital Markets

Fifteen out of 20 of the FIs surveyed which provide Capital Markets products and services, require some degree of E&S due diligence.

Currently there are no internationally agreed standards on E&S due diligence for this type of financial services.

KEY POINT

E&S due diligence approaches and processes for Capital Markets are seen as least defined and with the greatest degree of variability between FIs.

Based on the FI study participant responses, the E&S due diligence approach for Capital Markets transactions (e.g. bonds issuance, IPOs) generally distinguishes between:

- Transactions that do not have an underlying asset; and
- Transactions that have an underlying asset.

For the transactions that do not have an underlying asset, FIs can only perform an E&S risk assessment of the company.

In such cases, FIs assess the company's approach to E&S issues, similar to the E&S due diligence conducted for general lending facilities (as described above in the section on "Corporate Lending"). Such E&S risk assessment typically takes into consideration the commitment, capacity and track record of the company to manage E&S issues.

For the transactions that have an underlying asset, FIs can perform an E&S risk assessment of the company, as well as an E&S risk assessment of the asset.

In such cases, FI study participants often follow a similar approach as for the Asset-Based Finance transactions, as mentioned in the section on "Asset-Based Finance" above. This includes an initial E&S categorisation aligned to the IFC categorisation approach and subsequent different levels of E&S due diligence depending on the category (A, B or C).

In general, FIs opined that it can be much more difficult to assess and manage E&S risks in Capital Markets transactions with consistency, due to the tight timeframes and to issues related to disclosure and transparency.

For example, the level of transparency for an Initial Public Offering (IPO) depends on where the transaction is listed and whether the respective stock exchange has E&S standards for listing or not. Hong Kong listings are, for example, more transparent on E&S issues than the UK ones, given that the Hong Kong Stock Exchange has E&S standards for listings. In such circumstances FIs find it difficult to maintain a uniform approach to E&S due diligence.

Insurance

Twelve out of the 18 FIs surveyed and interviewed who offer insurance products and services conduct E&S due diligence to some extent.

The United Nations Principles for Sustainable Insurance (PSI) that were launched in June 2012 constitute a set of voluntary global principles for the insurance industry to address environmental, social and governance risks and opportunities. Seven out of the 18 FIs surveyed and interviewed who provide insurance products and services are signatories of the PSI.

Insurance study participants have different approaches to E&S due diligence depending on the type of activity:

A. **Investment/asset management activities** (sometimes referred to as "responsible investment"); and
B. **Insurance activities** (sometimes referred to as "responsible/sustainable insurance").

For the **investment/asset management activities,** insurance companies conduct the same type of E&S due diligence to that of investment companies, as described in the section on "Investment" above, particularly in the pre-investment stage (e.g. negative screening and E&S risk assessment).

E&S risk management for insurance activities is currently less defined. Some insurance study participants conduct some level of E&S due diligence, however, this is not necessarily formalised.

This study covers only E&S risk due diligence related to insurance products and services provided to companies[28] and not to private individuals.[29]

From an E&S risk management perspective, insurance products and services can be classified into two main categories:

- **Direct or primary insurance,** which involves the insurance contract/policy concluded between the insurance company and the company that receives financial protection or reimbursement against losses; and
- **Reinsurance,** which involves the insurance purchased by an insurance company from one or more other insurance companies, as a means of risk management, often to cover "peak" risks.[30]

With regard to reinsurance, it is relevant to make the distinction between:

- **Facultative reinsurance**, in which a particular risk is reinsured from a primary insurance company; and
- **Treaty reinsurance**, in which a group of policies or risk categories are covered together.

For direct/primary insurance and facultative reinsurance, the (re)insurer knows the concrete risks and companies it insures. Consequently, E&S due diligence for such insurance products and services can be considered.

For the treaty reinsurance, the individual risks (whether E&S or other types of individual risks) and individual companies are usually not known. Consequently, these cannot be evaluated by the reinsurer.

A few of the leading insurance companies that participated in our study explained that they initially started to conduct E&S due diligence for their investment activities. During the course of our research, we found that E&S due diligence for insurance activities has a predominantly ethical/reputation risk perspective rather than a financial risk perspective. Depending on the object/activity being insured in many cases, insurance companies would not, for example, be impacted by the E&S performance of their clients, due to the fact that they do not finance them.[31] In these cases, insurance companies mainly run the risk of non-payment of insurance premiums, which are far less significant than an investment loss.

28 Such as insurance for public liability, professional and management liability, employment practices liability, commercial property or insurance for individuals offered as a package to corporate clients for their employees.

29 Such as life, property or casualty insurances provided directly to private individuals.

30 See the definition on page 20 of the UNEP FI publication, "The global state of sustainable insurance".

31 Certain insurance companies/groups may also provide financing in the form of loans (such as mortgage loans), however, not as a core business. Our research focused on mapping E&S due diligence practices for the core insurance products and services, and consequently does not cover aspects related to financing by insurance companies.

According to some of the insurance companies we interviewed, E&S issues are not factored per se into insurance decisions because they are rarely quantifiable and there is a lack of sufficient research on the potential impacts to the insurance company arising as a result of the E&S issues of its clients.

KEY POINT

When FIs conduct E&S risk due diligence for their insurance activities, it is mostly correlated to the specific insurance product.

FIs typically assess certain E&S aspects related to their clients' businesses when these are relevant for the risk insured. For example, a client's health and safety measures may be assessed in order to determine the risk of fire, or to take another example, the quality of a client's environmental management system may be checked for environmental liability insurance. Following such due diligence, the companies that do not have appropriate health and safety measures or environmental management systems are either not insured or incur higher insurance premiums.

Some examples of E&S risk management practices specified by the interviewed insurance companies include:

- Setting up a group-wide committee to define sensitive business issues and the insurance company's approach to managing them. For one insurance company, the committee was commissioned by the Board, consistent with the company's Corporate Responsibility Strategy. Alternatively, some FIs have Reputation Risk/Risk Compliance Committees that can issue recommendations on sensitive issues. In some cases, if the business does not agree with the recommendations, the cases can be escalated to the Managing Board.
- Where specific E&S policies do not exist, one of the interviewed insurance companies uses exclusion lists and underwriting guidelines, which exclude certain high E&S risk sectors. These are complemented by a list of medium E&S risk sectors, where potential transactions are escalated to group level for further assessment and decision.
- Implementation of a product approval policy, which requires screening of products for responsible/irresponsible businesses. Such screening includes potentially controversial product features including indirect encouraging of irresponsible customer behaviour, mis-selling, as well as product accessibility concerns.
- Exclusion of business relationships involving sanctioned countries and countries identified as having high levels of corruption or political risk, or tax haven jurisdictions.

More recently, in connection with the introduction of the PSI, certain insurance companies have started to look at the broader E&S issues associated with their clients and are seeking to approach E&S risk management in a more formalised way.

Some of the interviewed insurance FIs mentioned that they are now developing their approach to risk management to be more holistic, to include a wider range of risks, such as reputational risk, and to integrate E&S risk considerations into existing client risk profiling activities.

Interviewed insurance companies indicated that adequately managing E&S risks "makes good business sense", as it helps avoid potential underwriting losses and damages to the company's reputation. While the correlation is not currently supported by hard data, underwriters often retrieve evidence that clients that are well managed from an E&S standpoint will represent a better risk profile overall. This proxy is sometimes referred to as the "halo effect".

Very few of the interviewed insurance companies have a formalised approach to assess the sustainability risk of their insurance transactions.

IMPLEMENTATION EXAMPLE 9:
E&S risk management framework for an insurance company

We have a Sustainability Risk Framework in place to manage the sustainability risk in our core business, which applies to our investment and insurance activities.

The framework includes specific policies for a number of sensitive sectors and issues, including defence industry, oil and gas, mining, dams, animal testing, forestry and logging, nuclear weapons proliferation, human rights and environmental protection. Each of the policies contains a set of pre-defined criteria for screening business transactions, which could also lead to the exclusion of certain companies/countries from our business.

If potential sustainability issues are identified through the screening process, further due diligence is conducted in order to identify potential E&S risks and establish whether the principles expressed in our policies are complied with. The due diligence process results in a recommendation to:

- Proceed;
- Proceed with certain conditions; or
- Abstain from the respective transaction.

If there is disagreement about the recommendation, the case can be escalated to the next management level.

A specific feature of the insurance sector is the involvement of **insurance brokers.** The insurance brokers search for the lowest-priced (re)insurance cover, in what is currently a very competitive market. Consequently, their ability to include additional E&S due diligence requirements is seen as very limited. In addition, even where an insurance company does not accept a transaction directly (e.g. based on E&S considerations), the transaction may be covered by another insurance company and included in its portfolio indirectly, through reinsurance.

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3.3.5 Findings on challenges of conducting E&S due diligence

FI study participants acknowledged that they face numerous challenges in their implementation of E&S due diligence

KEY POINT

FIs encounter a multitude of challenges when conducting E&S due diligence.

approaches. Some of the interviewed FIs cited challenges in consistent implementation of E&S approaches across geographies or business lines. Other interviewed FIs highlighted that even when they have all the right E&S policies in place and screen their clients on E&S issues, this still does not mean that problems will not occur on the ground.

Table 6 below reflects a compilation of the main challenges identified by the FI study participants through the online survey (see **Appendix E** for additional data) and the interview process.[32]

32 The challenges are listed in alphabetical order. Any one of the challenges can be significant depending on the specific circumstances.

Table 6: E&S due diligence challenges faced by study participants

FI E&S due diligence challenges	Description
1. Ability to influence companies on E&S issues	The challenges in influencing clients/investee companies are described in **Section 4.2.**
2. Availability of time and resources for conducting E&S due diligence	• Limited availability of E&S specialists, internal and external; • Cost of conducting E&S due diligence, for the FI and for the clients/ investee companies; • Time restrictions due to the high volume of transactions; and/or • Time restrictions due to FIs' involvement at the later stages of joint financings/participations.
3. Challenges with consistent implementation within an FI	E&S due diligence implementation varies within the FIs' organisations; the further away from headquarters, the more challenging it is to apply the same level of E&S due diligence.
4. Client/investee company's willingness to improve E&S performance	In many cases there is resistance from companies to implement international E&S standards that they do not find justified in the local context. In developing countries, some companies believe that such requirements may place them at a competitive disadvantage to other local companies.
5. Differences in E&S approaches between countries	The larger FIs typically have clients in adhering and non-adhering countries. In adhering countries, E&S due diligence is considered "straight-forward" due to adequate legislation on E&S issues and its enforcement. In non-adhering countries (developing and emerging markets), the nature and enforcement of national laws pertaining to E&S issues may be variable. Different priorities (i.e. economic versus E&S) lead to different approaches to E&S issues between developed and emerging markets countries. This results in challenges in enforcing OECD standards in developing countries, where it is seen as a potential competitive disadvantage compared to applying local law.
6. Differences in E&S approaches between investors	Some investors do not ask E&S questions, which creates an uneven playing field and makes it difficult for other FIs to have E&S requirements in joint financings/ investments. Even within the same category of FIs that do assess E&S issues, the approach can be very different.
7. Due diligence on social issues	It is more difficult to conduct due diligence on social issues compared to environmental issues. Environmental issues can be more quantitative/objective (e.g. measuring greenhouse gas emissions) whereas social issues can be more qualitative/subjective in nature.

FI E&S due diligence challenges	Description
8. Knowledge of E&S issues of client/ investee companies	Smaller companies and companies in developing countries often have limited knowledge of E&S issues and of international E&S standards. For such companies, translation of international E&S standards from high-level policy to suitable, practical and pragmatic approaches remains low.
9. Knowledge of E&S issues within the FIs' organisations	Training is a challenge with large FIs, particularly training employees who are geographically the furthest from the central offices. It can take time to change mind-sets in the international/remote offices of an FI. As a consequence, E&S due diligence processes are often less developed in the more remote group entities.
10. Lack of available E&S information	• In emerging markets E&S information is not easily available or is available only in the local language; • Smaller companies often do not publish E&S information/reports, many of them do not even have websites; • FIs rely on publicly available information in order to determine the level of potential E&S risk. There may not be much information available (e.g. because it is a small company, or information is published in a foreign language), however, this does not necessarily mean there are no E&S issues; • Limited access to information in many Capital Markets deals due to extensive involvement of law firms (e.g. for prospectus documentation, which results in resistance from the companies to share information about (E&S) risks).
11. Limited access to the company due to intermediaries	This occurs for example in syndicated loans, where only the lead arrangers may have access to the company, or in investments in funds set up by other FIs.
12. Limitations in terms of exiting a relationship	The possibility of exiting a financing relationship may, in some cases, be limited due to the characteristics of financial services. For example, in many private equity investments exiting entails finding another FI willing to buy-out the participation (e.g. another bank to re-finance the company or another investment company to buy the equity participation). Similarly, FIs have limited possibilities to exit longer term lending relationships once the funds have been disbursed.
13. Stakeholders have different interests and FIs are situated in the middle	It can be difficult for FIs to manage stakeholders, as stakeholders may not share the same focus or interests. For example, a project can have certain impacts on biodiversity, but contributes to the alleviation of poverty; a biodiversity-focused NGO might have concerns about the project whereas other stakeholder groups, including the local government, might determine that the benefits of the project outweigh the biodiversity concerns.

3.4. Findings on human rights risk due diligence

3.4.1 Introduction

As discussed in **Section 1**, one of the key changes of the 2011 update of the OECD Guidelines was the introduction of a new Human Rights Chapter (IV) based on the UNGPs "pillar two"[33], the corporate responsibility to respect human rights. The text box below includes specific provisions of the UNGPs relating to the corporate responsibility to respect human rights.

> Under the corporate responsibility to respect human rights, Guiding Principle 13 of the UNGPs states that the responsibility to respect human rights requires that business enterprises:
>
> *"Seek to prevent or mitigate adverse human rights impacts that are directly linked to their operations, products or services by their business relationships, even if they have not contributed to those impacts."*
>
> Guiding Principle 14 states:
>
> *"The responsibility of business enterprises to respect human rights applies to all enterprises regardless of their size, sector, operational context, ownership and structure. Nevertheless, the scale and complexity of the means through which enterprises meet that responsibility may vary according to these factors and with the severity of the enterprise's adverse human rights impacts."*
>
> Guiding Principle 15 states:
>
> *"In order to meet their responsibility to respect human rights, business enterprises should have in place policies and processes appropriate to their size and circumstances."*

In addition to the provisions above the UNGPs suggest that:

> *"Human rights due diligence can be included within broader enterprise risk management systems, provided that it goes beyond simply identifying and managing material risks to the company itself, to include risks to rights-holders."*

This is important because it requires a shift from risks to the company (i.e. the FI) to risks to rights-holders, which some FIs highlighted as a potential challenge in relation to their current risk management practices.

According to the Interpretive Guide on the Corporate Responsibility to Respect Human Rights by the UN Human Rights Office of the High Commissioner, the decision by the UN Human Rights Council to endorse the UNGPs:

> *"[...] established the Guiding Principles as the global standard of practice that is now expected of all States and businesses with regard to business and human rights. While they do not by themselves constitute a legally binding document, the Guiding Principles elaborate on the implications of existing standards and practices for States and businesses, and include points covered variously in international and domestic law."* [34]

The above provisions have resulted in much discussion about what is required of FIs, in particular related to the four components of human rights due diligence recommended in the UNGPs:

1. **Policy**[35] on human rights;
2 **Impact assessments** to understand how existing and proposed activities may affect human rights;
3. **Integration** of human rights policy throughout the company (e.g. business strategy, product development, leadership, training); and
4. **Tracking and reporting** regular updates of human rights impact and performance.

33 The UNGPs encompass three principles or "pillars" on the roles that states and business enterprises have in relation to upholding human rights: 1) The state duty to protect human rights; 2) The corporate responsibility to respect human rights; and 3) Access to remedy. For the purposes of this study, we will focus on the second pillar only.

34 The Corporate Responsibility to Respect Human Rights, An Interpretive Guide, page 1.

35 The UNGPs also elaborate that business enterprises should express their commitment to meet this responsibility through a statement of policy that: 1) Is approved at the most senior level of the business enterprise; 2) Is informed by relevant internal and/or external expertise; 3) Stipulates the enterprise's human rights expectations of personnel, business partners and other parties directly linked to its operations, products or services; 4) Is publicly available and communicated internally and externally to all personnel, business partners and other relevant parties; and 5) Is reflected in operational policies and procedures necessary to embed it throughout the business enterprise.

INSTITUTE FOR HUMAN RIGHTS AND BUSINESS (IHRB) REPORT

A recent IHRB report provides guidance to investors on incorporating human rights into their E&S due diligence processes:

> *"Investors also have a responsibility to respect human rights and should also formally and systematically integrate human rights into their own due diligence processes. This includes mainstream investors as well as responsible investors, as minority and majority shareholders and across all asset classes."*

Investing the Rights Way: A Guide for Investors on Business and Human Rights, Institute for Human Rights and Business, 2013.

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3.4.2 Findings on approaches to risk-based human rights due diligence by FIs

As outlined in **Section 3.3.**, FIs have very different approaches to E&S due diligence. Based on our findings, current approaches to human rights risk due diligence are typically consistent with the overall E&S due diligence approach adopted by a particular FI. The E&S due diligence practices described in **Section 3.3.** also apply to human rights due diligence. The FI interview process identified examples of emerging good practice in integrating human rights considerations into E&S due diligence processes, such as:

- **By country:** Including human rights aspects in country risk profiles;
- **By client:** Assessing the ability of the client to mitigate risks (e.g. through assessing E&S performance relating to commitment, capacity, and track record); and
- **By policy:** Including human rights aspects within sector policies or in a separate human rights policy.

SURVEY SAYS...

90% of survey respondents that have a policy/ position statement on human rights said it is integrated into and/or coordinated with E&S risk policies.

In general, for all types of human rights adverse impacts, the UNGPs and the OECD Guidelines indicate that a "basic human rights due diligence process" consists of the four components mentioned in **Section 3.4.1** above and as set out in the Table 7 below.[36] The table provides commentary from FI study participants on these four components. It should be noted, however, that the general view of FIs studied is that these are more easily understood and applicable for clients or investee companies than they are for FIs.

36 Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework, principles 16–21, pages 16–24.

Table 7: Commentary from study participants on the four components of the UNGPs

Component of the UNGPs	Component typically used/applied?	Comments
1. **Policy** on human rights	Yes	• **56%** of survey respondents have a policy/position statement on human rights and an additional **29%** consider human rights issues in their E&S due diligence processes (85% of total survey respondents). • Of those that have a human rights policy, **50%** have had the policy in place for **over 5 years**. • The most important "trigger" to develop a human rights policy was "recognition of the importance of human rights in business activities". • 4 survey respondents cited the UNGPs as a "trigger" to develop a policy.
2. **Impact assessments** to understand how existing and proposed activities may affect human rights	Mixed responses – some FIs indicated yes and some no to survey questions on use/applicability	Human rights aspects are covered within overall E&S risk assessment, particularly if risks are identified. FIs typically perform due diligence only in transactions where human rights have been identified as an issue, as part of an overall E&S screening process. For certain transactions such as Asset-Based Finance, FIs assess human rights issues through the Equator Principles and the IFC Performance Standards.
3. **Integration** of human rights policy throughout the company (e.g. business strategy, product development, leadership, training)	Mixed response – some FIs indicated yes and some no to survey questions on use/applicability	• **87%** of survey respondents that have a policy/position statement on human rights said it is part of their main risk management framework (e.g. credit risk processes, approval processes, investment decision criteria, etc.) The data above is based on two separate yes/no questions for each point, therefore responses are not mutually exclusive and one FI could respond "yes" to both questions.
4. **Tracking and reporting** regular updates of human rights impact and performance	Mixed response – some FIs indicated yes and some no to survey questions on use/applicability	• Different legal and regulatory rules apply to different types of FIs, with respect to the possible level of transparency (e.g. the banking secrecy rules). Disclosure of information on companies with which banks and other FIs engage on human rights issues is sometimes subject to rules on client confidentiality. • FIs interviewed mentioned challenges in "on-going" due diligence, due to resource and time constraints and in the absence of a strong business case (e.g. if financial requirements are met by the client).

3.4.3 Findings on challenges faced by FIs on human rights issues and the UNGPs

When interviewed, a number of FIs articulated specific challenges relating to human rights issues and the UNGPs as summarised in Table 8 below. It should be noted that these are only the general views of the FIs captured in the interviews and are not a reflection or interpretation of the UNGPs or specific text of the UNGPs.

Table 8: Challenges faced by study participants on human rights due diligence and the UNGP

FI challenges on human rights issues and the UNGPs	Description of challenge
1. Implementing the UNGPs	Many FIs find it difficult to implement the UNGPs in relation to the different financial services. Additionally, FIs interviewed on this topic cited a lack of practical tools, guidance and case studies to support implementation in due diligence processes. FIs feel it is important to distinguish between human rights due diligence for new transactions or clients vis-à-vis existing transactions; E&S risk triggers and access to information will vary accordingly.
2. Integrating the UNGPs within existing E&S due diligence processes	Some FIs expressed that they need more clarity on whether it is sufficient to address human rights issues as an extension of their existing E&S due diligence, or whether it is necessary to undertake other steps related to human rights due diligence.
3. Lack of clarity on definitions used in the UNGPs	Interview findings indicate there is a lack of clarity on many definitions, in relation to the financial sector, for example, "business relationships" and "business partners". Setting aside the question marks raised by FIs about the nature of "business relationships" (see **Section 4.1.4**), FIs view themselves to be indirectly linked to an adverse human rights impact through the financial services they provide to their clients. For example, an FI which (co)finances a company for the construction of a mine typically views its linkage to the potential adverse E&S impacts related to building the mine as indirect.
4. Lack of clarity on the role of FIs versus clients	Some FIs interviewed cited a lack of clarity on the role of FIs versus the role of their clients in assessing, identifying and managing human rights issues, particularly given expectations of different stakeholders.
5. Lack of clarity on the role of clients versus governments	In countries where laws and enforcement of human rights are weak, some FIs mentioned it can be difficult to conduct due diligence. The role of clients versus governments is not always clear, particularly when there are joint ventures between both.

FI challenges on human rights issues and the UNGPs	Description of challenge
6. The UNGPs are viewed as indirectly relevant to FIs	A number of FIs interviewed consider that they are **indirectly linked** to human rights issues through the provision of financial services to their clients. Some FIs highlighted that they are not the ultimate drivers for the E&S performance of their clients. A number of FIs are generally of the view that it is their responsibility to engage with clients to understand how their clients are managing human rights issues, as it is related to sound business risk management.
7. How clients or investee companies implement the UNGPs	A lack of transparency on how clients apply the UNGPs makes it harder to assess their performance within E&S due diligence processes of FIs. Some FIs articulated in the interviews that they would like to better understand: (a) how their clients or investee companies are dealing with the UNGPs; (b) how they can support their clients or investee companies; and (c) to what level and extent it is appropriate to ask for a comprehensive human rights due diligence from their clients or investee companies.
8. Application of the UNGPs by governments in emerging markets	A number of FIs from emerging markets pointed out that the "UNGPs need to be ratified by their governments for it to be useful". One of the Indian FIs interviewed mentioned there is currently no driver or mechanism for FIs in India to apply the UNGPs.
9. Access to human rights experts	The UNGPs advise enterprises to draw on independent human rights expertise. However, a significant challenge identified by FIs is the lack of access (perceived or otherwise) to consultants with knowledge and expertise on specific human rights issues.

The challenges indicate that even where FIs comply with the four components of the UNGPs discussed above (e.g. have human rights policies in place and integrate these throughout the company), the execution or implementation may be variable across different business teams or geographies.

> "We worked with the International Finance Corporation in Sub-Saharan Africa on human rights issues. We categorised sectors in which we were active as high, medium and low risk. However, for high-risk sectors it is difficult to know how a client is involved in adverse impacts (e.g. child labour). In one specific incident we applied pressure on the state, but without much result. As some issues are state specific it is hard to do due diligence."
>
> **Bank**

37 During the FI interview the use of the term "ratified" here was not meant in the legal sense, but more to describe the uptake and implementation by the government.

4. Mapping exercise: findings on the OECD Guidelines and financial institution leverage

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4.1. The OECD Guidelines

4.1.1 Introduction

Whilst the OECD Guidelines apply to enterprises including FIs operating in or from adhering countries in respect to their direct operations, it is not clear how the OECD Guidelines apply to such FIs in the specific context of the financial services they provide. The FIs themselves are unclear as to what their response to the OECD Guidelines should be and NCPs have recently also highlighted the need for clarity on the applicability of the OECD Guidelines to the financial sector when claims involving FIs have been raised.[38]

Whilst the FI study sample is limited in size and may not be representative of the entirety of the financial sector, this report nevertheless seeks to provide some insight as to the challenges FIs may face in applying the OECD Guidelines and raises some important questions for future consideration by the OECD Working Party for Responsible Business Conduct.

As mentioned previously the OECD Guidelines stipulate enterprises should:

> *"Seek to prevent or mitigate an adverse impact where they have not contributed to that impact, when the impact is nevertheless **directly** linked to their operations, products or services by a **business relationship".***[39]

This provision applies to all E&S matters covered by the OECD Guidelines, including human rights.[40] The applicability of this provision to the financial sector is re-iterated by the Norwegian NCP in its initial assessment of a recent instance raised against a Norwegian FI:

> *"The NCP finds that the relevant provisions for further examination are the updated Guidelines Chapter II (General Policies) section A paragraph 12 and Chapter III (Human Rights). The consideration of this specific instance...provides an opportunity to examine how the Guidelines apply to investors and the financial sector in more concrete terms".*[41]

The role of the NCPs is to further the effectiveness of the OECD Guidelines and procedural guidance on this is described in Part 2 of the OECD Guidelines.[42]

4.1.2 Findings from FI study participants in adhering countries

Of the FI study participants located in countries that adhere to the OECD Guidelines, there was one consistent view expressed: that whilst the OECD Guidelines are known to them, due to their "generic" nature, the OECD Guidelines are not typically used to assess E&S risks or implement E&S due diligence. Thirteen out of 52 survey respondents apply or refer to the OECD Guidelines in the context of E&S risk due diligence. Six out of 52 survey respondents ask whether their clients/investee companies apply or refer to the OECD Guidelines in assessing E&S risks.[43]

The surveys further revealed that FIs that use the OECD Guidelines typically refer to them in order to "frame" questions on E&S issues in discussions with clients or investee companies. These FIs might also refer to the OECD Guidelines in E&S policies or position statements, but the OECD Guidelines are typically not used in any other documents or processes related to E&S due diligence. It should be noted that this does not mean that FIs do not have E&S due diligence policies/processes in place; as evidenced in **Section 3.3.** the leading FIs have had policies and processes in place for several years.

In the interviews, many FIs described the OECD Guidelines as "generic", particularly in comparison to more "practical" standards such as the IFC Performance Standards (see **Table 5** mapping international frameworks, principles, frameworks and standards to FIs and financial services in **Section 2.3.**). FIs mentioned that the IFC Performance

38 As noted, for example, by the UK NCP in the Initial Assessment for the "Complaint from a civil society organisation against a UK bank (C) in respect of a business relationship with a company in Russia" dated 10 January 2013: "The UK complaints also raise some general issues about applying the OECD Guidelines in the financial sector, and the UK NCP will ask the OECD to consider these in the context of its current work in this area."

39 The OECD Guidelines, Chapter II, Paragraph 12, page 20.

40 The OECD Guidelines include similar provisions specifically in relation to the human rights impacts in Chapter IV Human Rights, paragraph 3 and Commentary on Human Rights paragraph 43.

41 OECD Specific Instance NBIM Initial Assessment, **http://www.regjeringen.no/upload/UD/Vedlegg/csr/Kontaktpunktet/121126-INITIAL-ASSESSMENT-NBIM.pdf**.

42 The OECD Guidelines, page 68 and 71 onwards.

43 Some FIs survey participants suggested that it is more practical to check participation in initiatives such as UNGC.

Standards can be included as part of specific E&S due diligence requirements in their risk management processes, as they are sufficiently detailed.

Some FIs pointed out that the OECD Guidelines appear to be more relevant to the sector activities of their clients or investee companies (e.g. consumer goods, mining and metals) than to the financial sector. Based on interview information, some of the reasons for the limited use of the OECD Guidelines by FIs include:

- Lack of clarity on terminology resulting in a lack of common understanding of the role of FIs in the context of the OECD Guidelines (see **Section 4.1.4**);
- Limited capacity of FIs to identify, assess and reach a conclusion on human rights issues given their complexity (as discussed in **Section 3.4.3**);
- Lack of clarity as to what FIs can expect from NCPs and on what an FI's approach should be when a specific instance has been registered with an NCP relating to a client or investee company (see text box); and
- Lack of clarity on expectations of stakeholders (such as NGOs) and their use of NCP processes.

One result of the 2011 update of the OECD Guidelines to reflect the UNGPs, is that they have, according to some FI study participants, created a "sense of urgency on human rights", which has encouraged some FIs to focus more on this area. A number of FI survey participants headquartered in adhering-countries are now reviewing their E&S approaches in light of the updated OECD Guidelines to maintain consistency with good practices. A few interviewed FIs mentioned that there are a growing number of questions about whether or not FIs in adhering countries face a competitive disadvantage when operating in non-adhering countries.

Furthermore, FIs expressed a lack of clarity on how NCPs interpret the OECD Guidelines and the potential variances of NCP approaches that each adhering country will establish under their own regulatory environments. FIs feel a need for increased transparency on the criteria used by the NCP for the eligibility of a claim and the steps prior to making the claim publically available. It was suggested by some FI study participants that NCPs could also focus on facilitating dialogue among the parties involved in a claim and establish clear timelines for resolutions. A concern raised by some FI interviewees is that failure to establish a common understanding of these parameters can translate to a competitive disadvantage for FIs that operate in more robust NCP environments.

A number of FI study participants view the number of cases in which they can influence an E&S impact as rare (and in most cases in combination with other FIs). Hence, the suggestion from such FIs is that where an FI provides financial services to clients or investee companies that result in a complaint, NCPs that have established a mechanism to safeguard the application of the OECD Guidelines and in particular human rights issues should focus on the process and governance of E&S due diligence undertaken by the FI.

Greater clarity needed on the National Contact Point (NCP) process

"There were a few situations, mainly related to commodity financing, where under the Guidelines formal specific instances had been lodged with the NCP in relation to some clients. In one example, a cotton trading company, a client of the bank, was sourcing cotton through Uzbekistan. The bank was aware about the formal complaints, however, we were not clear on: 1) the process of the OECD Guidelines; 2) the nature and basis of the complaint; 3) the power of the OECD Guidelines in "policing" the companies; and 4) what the decision of the NCP would mean in relation to the decision the bank would take regarding the client."

Bank

4.1.3 Findings from FI study participants in non-adhering countries with which the OECD seeks "enhanced engagement"

This section discusses our findings about the difference in application of, or approach to, the OECD Guidelines based on survey responses and interviews with FIs in countries that adhere to the OECD Guidelines versus non-adhering countries with which the OECD seeks "enhanced engagement".

In non-adhering countries, FI study participants felt that it is generally not meaningful to refer clients or investee companies to the OECD Guidelines, citing a lack of familiarity with the OECD Guidelines. Interviews with FIs in China, India and South Africa, countries with which the OECD seeks "enhanced engagement,"[44] uncovered the following views:

- The priority and focus is on national regulations over international guidelines such as the OECD Guidelines; and
- Challenges of applying the OECD Guidelines in countries such as India where E&S due diligence and risk management practices in the financial sector are still in nascent stages.

> "The Indian banking sector is highly regulated and competitive. As one of the few players with an E&S policy we may be at a disadvantage in situations where our competitors do not have a specific E&S policy and may fund a project purely on its financial merit. The low level of E&S risk sensitivity within the banking sector poses significant challenge to implementing the OECD Guidelines."
>
> **Bank**

Rather than focusing on the applicability of the OECD Guidelines in non-adhering countries, FI study participants from these countries suggest seeking opportunities for collaboration. This could include, for example, collaboration between FIs headquartered in adhering and non-adhering countries as well as FIs headquartered in adhering countries with operations in non-adhering countries, to share good practices in approaches to E&S due diligence and risk management.

4.1.4 Findings from FI study participants on the interpretation of the OECD Guidelines

Our research has identified that, for a number of FIs it is unclear as to how the provisions above apply to the financial sector. According to some FI study participants, the lack of clarity can in some cases be attributed to:

- Differences in terminology used by the OECD Guidelines and the UNGPs compared to terminology used by the financial sector; and
- The fact that the OECD Guidelines were not written specifically for FIs and thus do not contemplate the differences in the business model of FIs as compared to other types of multi-national enterprises.

To further illustrate this, the sections below discuss FI interpretations relating to:

- Business relationships;
- Direct (and indirect) links to adverse impacts; and
- Leverage.

As mentioned above, a small number of FIs refer to the OECD Guidelines in the context of E&S risk due diligence (13 out of 52 survey respondents). The three terms above were discussed with an even smaller number of FIs; those that have considered the OECD Guidelines provisions in detail. The discussion below should therefore be seen as illustrative and not fully representative of the views of all FI study participants or the financial sector. Despite the small sample size, the findings might nevertheless provide useful insights as to the challenges faced by FIs in observing the OECD Guidelines.

44 http://www.oecd.org/general/theoecdsrelationswithitskeypartners.htm

Business relationships: definitions from the OECD Guidelines and UNGPs

According to the OECD Guidelines, the term **"business relationship"**[45] includes relationships with:

- Business partners;
- Entities in the supply chain; and
- Any other non-State[46] or State entities directly linked to its business operations, products or services.

The OECD Guidelines further refer to "business partners" as including (but not limited to) suppliers or sub-contractors[47].

The Interpretive Guide on the Corporate Responsibility to Respect Human Rights defines business relationships as follows:

> *"Business relationships refer to those relationships a business enterprise has with business partners, entities in its value chain and any other non-State or State entity directly linked to its business operations, products or services. They include indirect business relationships in its value chain, beyond the first tier, and minority as well as majority shareholding positions in joint ventures."* [48]

The Interpretive Guide gives an example of where an enterprise is directly linked to to an adverse impact by its operations, products or services by its business relationships, but where the enterprise itself may not have contributed to it as:

> *"Providing financial loans to an enterprise for business activities that, in breach of agreed standards, result in the eviction of communities".*[49]

Business relationships: views from FIs

Our research found that how the OECD Guidelines and FIs define "business relationships" can differ, which has implications for some FIs with regard to their interpretation of how the OECD Guidelines apply to them.

A number of FI study participants do not perceive the term "business partners", particularly when described to include suppliers or sub-contractors, to comprise their clients or investee companies. In practice, some FIs refer to "business partners" to include other entities with whom the FI has a type of partnership, such as other FIs with whom they develop a joint financial product. Other international standards used by the FIs such as the United Nations Principles for Sustainable Insurance (UN PSI) also make a distinction between the FIs' (in this case, insurance companies') clients versus business partners, which are seen as two separate categories.[50] Thus the term "business partners" can be interpreted in a number of ways that, in the absence of a definition of the term under the OECD Guidelines, could lead an FI to conclude that clients or investee companies are not "business partners" under the OECD Guidelines.

When considering "entities in the supply chain", a number of FI interviewees indicated that they generally understand this term to include their suppliers (e.g. entities involved in the procurement of goods and services for the FI, such as suppliers of IT services, stationary or electricity), but that their supply chains would not include their clients or investee companies. Some participant FIs could thus conclude that clients or investee companies are not "entities in their supply chains".

Depending on interpretation, clients or investee companies could arguably fall under the term "any other non-State or State entities directly linked to its [the FI's] business operations, products or services". However, the survey and interview process yielded no evidence to support this as an interpretation considered or supported by any of the FI study participants.

According to some FI study participants, if clients or investee companies do not fall under either one of the three categories, it could be argued that they are not entities with whom FIs have "business relationships" as defined under the OECD Guidelines.

The OECD community, however, takes the position that investments already fell within the remit of the OECD Guidelines under the 2000 version of the OECD Guidelines. Further, now that this remit has been broadened with the 2011 Update of the OECD Guidelines, their view is that a number of products and services beyond investments lead to a relationship between an FI and a third party that will be considered as one of the business partners under the OECD Guidelines.

45 The OECD Guidelines, Chapter II, Commentary 14, page 23.
46 In the context of the OECD Guidelines, these are adhering states.
47 The OECD Guidelines, Chapter II, Commentary 13, page 20.
48 The Corporate Responsibility to Respect Human Rights, An Interpretive Guide, Key Concepts, page 5.
49 The Corporate Responsibility to Respect Human Rights, An Interpretive Guide, Box 2, page 17.
50 United Nations Principles for Sustainable Insurance, Principle 2: "We will work together with our clients and business partners to raise awareness of environmental, social and governance issues, manage risk and develop solutions".

Direct links to adverse impacts: views from FIs

To re-iterate, the OECD Guidelines recommend enterprises should:

> *"Seek to prevent or mitigate an adverse impact where they have not contributed to that impact, when the impact is nevertheless **directly linked** to their operations, products or services by a **business relationship**."*

Whether an FI has a "business relationship" with an enterprise could in turn determine whether or not the FI is "directly linked" to an adverse impact. Some FIs interviewed would posit that if no business relationship is established, then an FI cannot be directly linked to an adverse impact as defined by the OECD Guidelines. Assuming there is a business relationship, the factors that determine whether an FI is directly linked to an adverse impact are also viewed by some FIs studied as subject to interpretation.

For example, a number of the FI study participants use the terms "direct impacts" to refer to the E&S impacts of their own operations such as the environmental impacts of their offices. FIs mention that these "direct impacts" would typically be handled by procurement teams. On the other hand, these FIs indicated that "indirect impacts" would refer to the E&S impacts of their clients or investee companies and would be handled by a combination of risk management functions and/or business/commercial teams. These FI interviewees thus perceive the link to adverse impacts caused or contributed to by their clients or investee companies as **indirect**. Some of these FIs maintained that consistent with this logic, this provision of the OECD Guidelines is not applicable to the particular financial services provided by them, as their link to adverse impacts is indirect.

It is useful to note that some FIs interviewed would support the interpretation that private equity investments and certain Asset-Based Finance transactions, in particular project finance, could in some cases create a **direct link** to the potential adverse impacts caused by their clients/investee companies. Consequently, they would view all other financial services (e.g. general banking facilities, asset management services) as creating an **indirect link** to adverse impacts.
It is also worth noting that some study participants mentioned that even within the same organisation or entity, an FI could in this way be both directly and indirectly linked through provision of different financial services.

The OECD Guidelines only refer to "impacts [...] directly linked" and do not have specific requirements for mitigating adverse impacts that could be viewed as indirectly linked to an FI. According to the FIs interviewed, this further adds to the lack of clarity about how the OECD Guidelines apply to the provision of financial products and services by FIs.

Leverage: views from FIs

When FIs consider the term leverage in the context of the OECD Guidelines, the view from the majority of the FIs interviewed is that given the nature of most of their financial products/services, they have limited leverage over their clients/investee companies in terms of the ability to effect change in the wrongful practices that would cause harm leading to adverse impacts. The exceptions would be certain private equity investments and certain Asset-Based Finance or project finance transactions. Beyond these exceptions, some of the FI study participants mentioned that there may be certain circumstances when they do have some leverage (at least as it is defined by the OECD Guidelines) over a client or investee company. The factors that determine when FIs may have leverage over their clients/investee companies are discussed in **Section 4.2.**

One FI engaged as part of the study process pointed out that FIs may use the term leverage to refer to maximising financial gains and losses by, for example, borrowing money or buying fixed assets. Therefore when referring to leverage in the context of the financial sector, it could create yet another layer of confusion in the "definitional divide" mentioned earlier.

4.2. FI leverage

4.2.1 Introduction

This section discusses the findings of the study on leverage over a client or investee company, notwithstanding that the challenges relating to the interpretation of this term is an important finding of this study (as discussed in **Section 4.1.**).

According to the OECD Guidelines' Commentary on General Policies, meeting the expectation in the provisions discussed in **Section 4.1.1** above would entail an enterprise (in this case an FI), acting alone or in co-operation with other entities (e.g. other FIs), as appropriate, to use its leverage to influence the entity causing the adverse impact (i.e. client or investee company) to prevent or mitigate that impact.[51]

Further, according to the OECD Guidelines:

> *"leverage is considered to exist where the enterprise has the ability to effect change in the wrongful practices of the entity that causes the harm".*[52]

With regard to the topic of leverage, the UNGPs state:

> *"If the business enterprise has leverage to prevent or mitigate the adverse impact, it should exercise it. And if it lacks leverage there may be ways for the enterprise to increase it. Leverage may be increased by, for example, offering capacity-building or other incentives to the related entity, or collaborating with other actors. There are situations in which the enterprise lacks the leverage to prevent or mitigate adverse impacts and is unable to increase its leverage. Here, the enterprise should consider ending the relationship, taking into account credible assessments of potential adverse human rights impacts of doing so."*

A discussion on the decision-making logic presented by the UNGPs on adverse impacts, business relationships and leverage is in **Appendix F.**

4.2.2 Findings from FIs on the level of leverage over a client or investee company

Overall, this study found no clear parameters that consistently determine the leverage of an FI to influence a client or investee company causing the adverse impact to prevent or mitigate that impact. A few FIs even indicated they believe they have no ability to influence a client or investee company and instead focus on upfront screening processes, using exclusion lists to ensure they do not engage with companies which do not meet their E&S requirements.

Based on interview information, the only types of FIs that indicated they could have leverage as defined in the context of the OECD Guidelines, are private equity companies and FIs involved in some cases of Asset-Based Finance. For example, where a private equity company has a majority stake in an investee company, it has access to directly engage/influence the management or the Board of Directors on E&S issues as part of the general approach to restructure/transform the company.

> "We have an opportunity to drive E&S performance, but not necessarily the responsibility. Our fund managers would definitely not agree with the "responsibility".
>
> **Asset Manager**

Some banks that participated in the study mentioned that from the mix of different financial services they provide, the only instance in which it could be successfully posited that their link to the adverse impact is direct is in some cases of Asset-Based Finance. For example, in project finance transactions, a bank or group of FIs might be funding a single asset, so any adverse impacts related to that asset could be directly linked to the FI. The view from the study participants was that the FI could therefore potentially have some leverage to prevent or mitigate the adverse impact but study findings show that is dependent on a number of different factors (see box on **page 55**).

For financial services such as Corporate Lending, Capital Markets and Investment (except in some cases private equity) FIs studied view their link to the adverse impact as indirect. For example, if a bank is providing a general purpose corporate loan to an oil and gas company which is associated with human rights violations, the bank would maintain that the provision of the service (i.e. the loan) does not create a direct link to the human rights violations of the oil and gas company and that it would also be difficult to attribute the use of the funds directly to the violations. Thus, in the view of some FI study participants, whilst the bank might be able to engage the oil and gas company management team to potentially influence the company's general E&S approach (e.g. E&S policies and processes), the ability to influence the company's

51 The OECD Guidelines, Chapter II, Commentary 20, page 24.
52 The OECD Guidelines, Chapter II, Commentary 19, page 24

performance and behaviour, including its possible subsidiaries, would be limited (i.e. related to the adverse impact) and not necessarily within the remit of the OECD Guidelines or UNGPs.

Where FIs did indicate they have some level of influence or leverage, even with the same type of FI and for the same type of financial service, our research found that the level of influence or leverage can vary significantly. This study has attempted to identify some of the more common qualitative and quantitative factors which, according to the FIs surveyed and interviewed, could determine the level of leverage or influence an FI might have in relation to the provision of financial services, described in the box below.

Some of the common factors that determine the level of leverage/influence associated with a particular financial service include:

- Amount of funds involved, size of holding, proportion of total amount involved;
- Duration or tenor (e.g. of investment, loan, project);
- Nature and strength of relationship (e.g. historical relationship with existing client, ownership stake);
- Potential for poor E&S approach to negatively impact client/investee company performance or shareholder value;
- Potential for poor E&S performance of client or investee company to negatively impact your institution (e.g. reputational risk, credit or investment risk);
- Potential of the client or investment to be publicly linked to adverse impacts; and
- Where multiple financiers are involved, proportion of parties with or without similar E&S objectives (e.g. through syndications, shared ownership).

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4.2.3 Findings on leverage or influence associated with different financial services

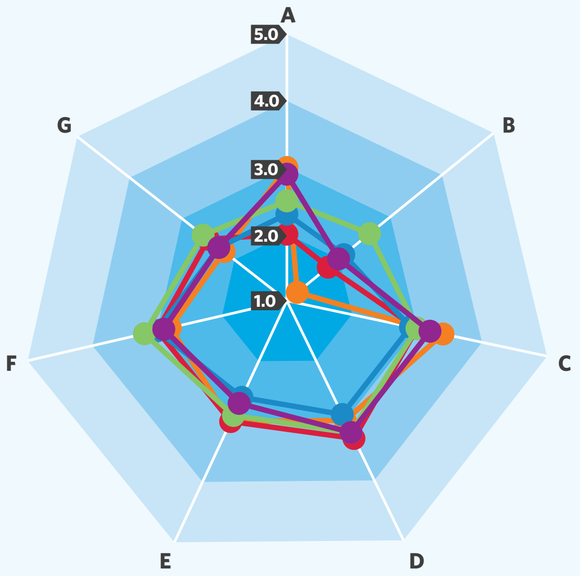
This section discusses the nature of FIs' leverage in relation to different financial services, taking into account a number of variables such as clients, geographies and sectors. The discussion focuses on specific situations in which FIs might have some degree or points of leverage in relation to the characteristic of the financial service.

Our study found that the level of leverage or influence of FIs differs not only by the nature of the FI's business and the type of financial service or investment, but even within one type of financial service. For example: (1) some FIs feel they potentially have a greater level of influence over their clients' E&S performance in Capital Markets transactions whilst other FIs were of the view that they had little to no influence in Capital Markets transactions; and (2) an FI may feel it can have influence over one client's E&S performance on a Capital Markets transaction and yet the same type of transaction with a different client will yield little to no influence for that FI over its client's E&S performance depending on the nature of the relationship with the client. Therefore, it could be concluded that the potential level of influence of an FI over its client/investee company's E&S performance is variable and dependent on a wide range of variable factors as listed above.

Diagram 4 below reflects the averaged responses of FIs on certain factors that could potentially determine the level of influence for the different financial services they provide.

DIAGRAM 4:

Importance of factors in determining influence over clients/investee companies to manage E&S risks (where 1 is less important and 5 very important).



- Corporate Lending and Credit
- Asset-Based Finance
- Investment
- Capital markets
- Insurance

A. Amount of funds involved etc.
B. Duration
C. Nature and strength of relationship
D. Potential for poor E&S approach to negatively impact company performance
E. Potential for poor E&S performance to negatively impact your institution
F. Potential of the client or investment to be publicly linked to adverse impacts
G. Proportion of other financiers with similar E&S objectives

The diagram shows that FIs rate several factors as equally important in determining some degree of leverage or influence over clients or investee companies. In general, based on the research data, the most important factors across most of the financial services are:

- Potential for poor E&S approach to negatively impact client or investee company performance or shareholder value;
- Nature and strength of relationship (between the FI and client or investee company);
- Potential of the client or investee company to be publicly linked to adverse impacts; and
- Potential for poor E&S performance to negatively impact the FI.

Additionally, during the interviews many FIs highlighted the importance of the nature and strength of relationship in determining the level of influence. It was generally felt that the stronger the relationship with the client or investee company, the greater the ability to have some degree of influence over its management of E&S issues. According to the views of the FI study participants, a relationship can be deemed stronger as a result of:

- A better understanding of the client or investee companies' business by the FI; and
- Enhanced engagement and dialogue between the FI and management of the client or investee company; and
- Historical relationship between the FI and client.

The factors with the most variability in importance between different financial services in determining a degree of leverage or influence were amount of funds involved and duration. They were generally not seen as important compared to the three factors discussed above. The amount of funds involved is seen as more important for Insurance and Investment services, but is of much less importance for Capital Markets services. Duration is the least important factor overall, but is more important for Asset-Based Finance than other financial service types. Duration might be considered by some FIs studied as more important to project finance transactions, for example, given the long-term nature of large projects typically relating to infrastructure and oil and gas. In such cases such FIs would posit that it is important to assess E&S risks which might potentially impact cash flows or the repayment of loans over a longer duration.

Table 9 below expands on each of the factors rated in the diagram above:

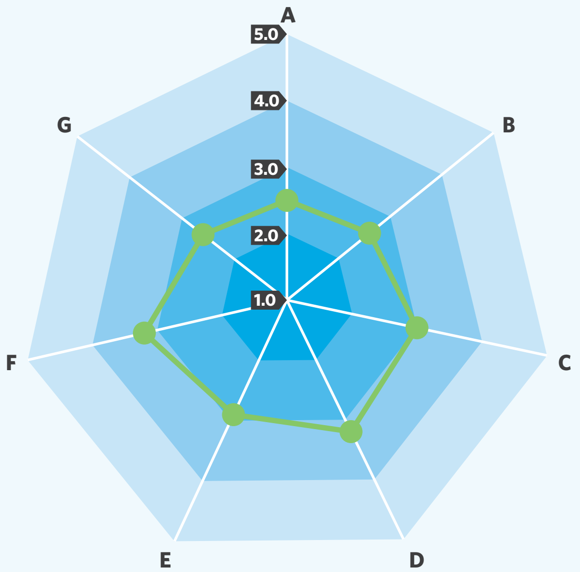
Table 9: Feedback from study participants on factors that influence the level of leverage over a client or investee company

Factor	Comments
Amount of funds involved, size of holding, proportion of total amount involved, etc.	Generally, the amount of funds involved is not as important a determinant of the level of influence, as compared to some of the other factors. It is a more relevant factor for Insurance and Investment services, but is of much less importance for Capital Markets services.
Duration or tenor (e.g. of investment, loan, project)	Whilst duration is the least important factor overall, it does have more relevance for Asset-Based Finance and Corporate Lending than other financial services.
Nature and strength of relationship (e.g. historical relationship with existing client, ownership stake)	The nature and strength of relationship is often cited as one of the determinants that provides the opportunity for most influence. It is important for all financial service types. In addition to the description of the strength of relationship between an FI and client or investee company above, the following factors can also influence the nature and strength of a relationship: • **Share of financing**: the portion of the client's financing needs which are met by a single FI; • **Duration of relationship**: the time period over which an FI has provided services (e.g. for existing long-term relationships, a common understanding and level of respect can increase the level of influence); and • **Reputational exposure**: as a result of sole financing to a particular client or investment in a company.
Potential for poor E&S approach to negatively impact client/investee company performance or shareholder value	This is the factor with the highest average rating across the five financial services so generally FIs consider this to be one of the most important determinants of influence. However, this does vary across the different types of financial services, for example, it is less important for Corporate Lending compared to Capital Markets (discussed below). However, as mentioned above even for Capital Markets the view on the level of leverage varies quite significantly between FIs.
Potential for poor E&S performance of client or investee company to negatively impact your institution (e.g. reputational risk, credit or investment risk, etc.)	This is generally seen as one of the important factors for Investment, Capital Markets, Corporate Lending and Asset-Based Finance. In situations where, for example, the investee company is at risk or is breaching national laws on E&S issues, an FI might have influence over management on legal grounds. However, the level of influence is dependent on the willingness of the investee company to understand and rectify the issue. In this case the level of influence is greatest if appropriate covenants (e.g. related to adherence to national E&S laws or specific E&S requirements) are included in the investment contracts.

Factor	Comments
Potential of the client or investment to be publicly linked to adverse impacts	This varies on a case-by-case basis. In very specific circumstances, and to a certain degree, public campaigns against clients or investee companies can potentially increase the level of influence. However, the evidence for this is only anecdotal. It is one of the most important factors for Corporate Lending, and Asset-Based Finance. For Asset-Based Finance and Corporate Lending involving an asset, FIs might view public campaigns on adverse impacts related to the project as a significant risk to its success (e.g. operational issues leading to non or delayed repayment of loans). If the risk is deemed too high to continue without it being mitigated the FI might have some influence over the client to take corrective action (e.g. community engagement). However, the level of influence will depend on the size of funding provided by the FI and its relative importance to the overall project if in syndication.
Where multiple financiers are involved, proportion of parties with or without similar E&S objectives (e.g. through syndications, shared ownership)	This factor is particularly important for Asset-Based Finance. For this financial service the greatest influence is likely to be had when an FI is the only or majority lender to a client, in a non-competitive environment. If multiple financiers are involved in a transaction the influence an FI can have depends on: • Their role in the syndication (lead versus participant and majority versus minority stake); and • Number of parties with a similar approach to E&S issues. As a lead arranger the level of influence is typically higher than as a participant. If an FI is not a lead arranger, but a participant, then the level of influence is highly dependent on the number of parties that place importance on E&S issues and due diligence. The principles discussed above can also apply to syndications involving other financial services such as: • Investment: for example, if a private equity company or asset manager as a minority shareholder is able to collaborate with other minority/majority shareholders on E&S issues; and • Capital Markets: for example, if a Bank arranging an IPO has the same E&S requirements/questions as the stock exchange.
Other factors which determine the level of influence	For some FIs in non-adhering countries, legal and regulatory requirements are the most important determinants of influence. The level of influence can be higher within the financing/investment approval process than outside such process, where it is more difficult to mandate, for example, human rights due diligence. The level of influence depends on the timing of due diligence; it is much higher upfront than at the later stages when on-going due diligence takes place.

DIAGRAM 5 – Asset-Based Finance:

Importance of factors in determining influence over clients/investee companies to manage E&S risks (where 1 is less important and 5 very important).



A. Amount of funds involved etc.

B. Duration

C. Nature and strength of relationship

D. Potential for poor E&S approach to negatively impact company performance

E. Potential for poor E&S performance to negatively impact your institution

F. Potential of the client or investment to be publicly linked to adverse impacts

G. Proportion of other financiers with similar E&S objectives

Based on our study findings, for **Asset-Based Finance**, one of the most important factors determining leverage or influence over a client is the proportion of other financiers with similar E&S objectives. For example, in large-scale project finance transactions, where multiple financiers are involved, an FI may have influence if there are a number of FIs with similar E&S requirements involved. In addition, our interview process revealed that an FI may potentially have a higher influence if:

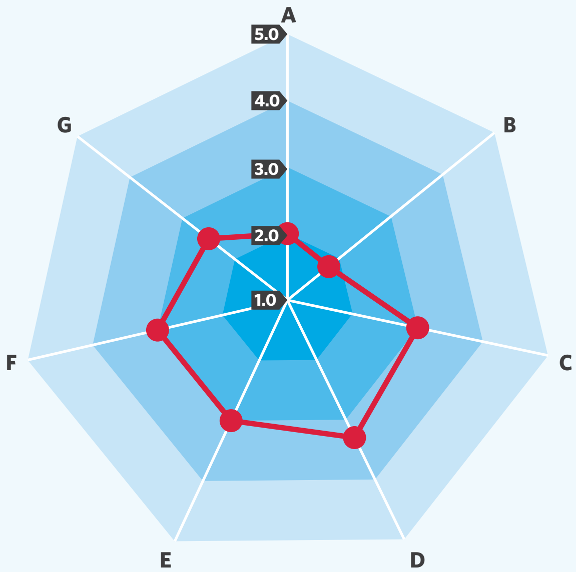
- The FI is the lead financier or arranger; and/or
- The FI is involved early on in the process; and/or
- Loan covenants are included in financing documentation.

Many FI study participants view loan covenants as the most effective way to apply influence over clients in terms of mitigating risks that could occur after initial loan disbursement. As mentioned previously, in some transactions involving a single asset (e.g. project finance), FIs indicate this is where they could have leverage to influence the client or investee company causing the adverse impact to prevent or mitigate that impact.

The potential for poor E&S approach to negatively impact company performance was also mentioned by FI study participants as an important determinant of influence; an FI may, for example, be able to influence a company if there is a risk of non-payment of a loan due to E&S issues associated with the asset being financed.

DIAGRAM 6 – Capital Markets:

Importance of factors in determining influence over clients/investee companies to manage E&S risks (where 1 is less important and 5 very important).



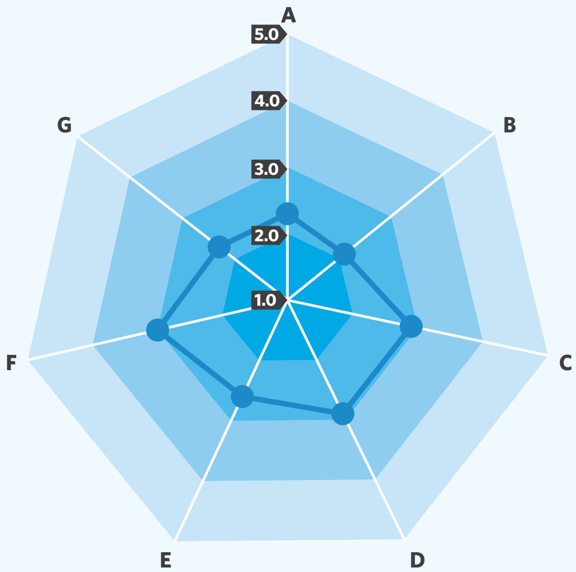
- **A.** Amount of funds involved etc.
- **B.** Duration
- **C.** Nature and strength of relationship
- **D.** Potential for poor E&S approach to negatively impact company performance
- **E.** Potential for poor E&S performance to negatively impact your institution
- **F.** Potential of the client or investment to be publicly linked to adverse impacts
- **G.** Proportion of other financiers with similar E&S objectives

For **Capital Markets**, our study found that one of the most important factors determining influence over a client is the potential for poor E&S approach to negatively impact company performance. For example, it was discussed during the interviews that if an FI is providing services to a company on an IPO, and the IPO is at risk of a lower valuation as a result of poor E&S performance, the FI could highlight the risk to the CEO of the company as part of an on-going strategic dialogue related to the IPO. In such cases an FI might have some level of influence in being able to put forward a business case to the CEO or other management (as the decision-makers) to improve the E&S performance of the company. However, it was felt that the success of this endeavour would be dependent on the willingness of the CEO or other management to engage and proactively respond to suggestions from the FI.

According to the bank FIs interviewed, in Capital Market transactions it can, however, be difficult to assess the potential for poor E&S approach to negatively impact company performance partly due to significant variability in the disclosure and transparency requirements of different stock exchanges. Limited information about E&S issues may, as an example given by FI interviewees, make it difficult to engage the client, even where the FI knows there are potential E&S risk issues that may require further management. Thus, it could be argued that the level of influence for Capital Markets transactions varies considerably.

The research data revealed that one of the least important factors of influence is duration, given the short timeframes of Capital Market transactions (e.g. IPOs, which typically last 6–9 months).

DIAGRAM 7 – Corporate Lending:
Importance of factors in determining influence over clients/investee companies to manage E&S risks (where 1 is less important and 5 very important).



A. Amount of funds involved etc.
B. Duration
C. Nature and strength of relationship
D. Potential for poor E&S approach to negatively impact company performance
E. Potential for poor E&S performance to negatively impact your institution
F. Potential of the client or investment to be publicly linked to adverse impacts
G. Proportion of other financiers with similar E&S objectives

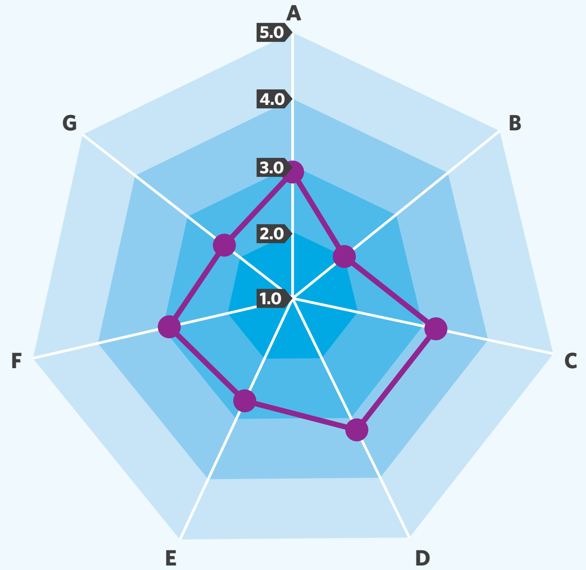
For **Corporate Lending**, our research indicates that one of the most important factors determining influence over a client, is nature and strength of relationship with the client. This was viewed as particularly important by FI study participants as E&S due diligence undertaken may be limited to a company E&S risk assessment. According to FIs interviewed, the strength of relationship between an FI and its client becomes important:

- To understand their E&S performance; and
- To engage in discussions with the client to manage E&S risks if they are identified.

An FI might thus have more influence over a client if a relationship is deemed strong, as described in the Table 9 on factors above..

Interestingly, and in contrast to the other financial services, some FIs providing Corporate Lending indicated that the potential for poor E&S approach to negatively impact company performance may be variable in determining potential level of influence. For example, company shares can fluctuate according to overall company performance, market conditions, etc. However, we were told in the interviews that despite such fluctuations of the share value, in general the larger clients are often able to repay loans from other company assets. Where clients are more able to meet their financial obligations, the view of the FIs interviewed was that FIs might have a limited level of influence.

DIAGRAM 8 – Investment:
Importance of factors in determining influence over clients/investee companies to manage E&S risks (where 1 is less important and 5 very important).



- **A.** Amount of funds involved etc.
- **B.** Duration
- **C.** Nature and strength of relationship
- **D.** Potential for poor E&S approach to negatively impact company performance
- **E.** Potential for poor E&S performance to negatively impact your institution
- **F.** Potential of the client or investment to be publicly linked to adverse impacts
- **G.** Proportion of other financiers with similar E&S objectives

For **Investments**, the most important factor in our study that determines influence over an investee company for Investment services, is the potential for poor E&S approach to negatively impact company performance. In general, our research found that for investors such as pension fund managers, asset managers and private equity companies, the ability to influence also depends on the type of investment. For example:

- For investments in non-listed assets such as infrastructure, the ability to influence can be higher than for investments in funds;
- For investments in funds, the ability to influence is limited, unless other investors are like-minded. Despite the ability to put resolutions to the Board of the company, the ability to sway investors can be limited.

Private Equity

The highest potential of having leverage or influence appears to be held by private equity companies, which can have significant opportunity to influence the E&S performance of investee companies. According to FI study participants, private equity companies are in a special position to influence investee companies given:

- Their (often majority) stakes in the companies;
- Closeness to the management of investee companies; and
- Their long-term involvement in the company.

Private equity companies can implement E&S risk policies in portfolio companies as part of a wider risk management strategy. This ability to promote good E&S practices remains as long as the private equity company is the majority or largest shareholder. Even as a significant minority shareholder, it was suggested by private equity FI study participants that there is an ability to instigate change when working with other shareholders who share the same E&S objectives.
However, private equity companies highlight that even when they do have significant influence, the process for achieving change can be a lengthy and resource intensive process. They further emphasise that exiting an investment is often very difficult due to several factors: (1) the rate of return on the investment (as agreed with shareholders) can be difficult to achieve; (2) claiming back the initial investment can be difficult; (3) making judgement on whether it is the "right thing to do" can be complicated involving several different considerations; and (4) exiting entails finding another FI willing to buy-out the participation. The Implementation Example 11 below demonstrates the importance of integrating E&S requirements into legal documentation for the cases where a decision to exit the investment is made.

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IMPLEMENTATION EXAMPLE 11:
E&S legal covenants used by a private equity company when exiting from an investee company

Based on prior experience we now integrate E&S requirements into legal documentation with our investee companies. In a recent case this was essential in allowing us to exit the company that was in breach of local E&S laws.

The investee company is situated next to a river, which over the course of the investment had its status changed to "drinking water" by the local authorities. As a result the factory would need to invest approximately €1 million to treat its waste water to meet the stricter requirements for water disposal into the river. The CEO of the investee company did not agree with the decision of the local authorities and found the situation unfair and an infringement of his company's rights. Despite several appeals to the CEO no action was taken to comply with the new requirements. We called a default under the investment contract and based on the E&S covenants, managed to recover our full investment.

Where E&S requirements are not included in legal documents, private equity companies mentioned the need to identify other actions such as influencing management by, for example, using their position as a member of the Board. Private equity companies can advise management including the CEO to address E&S issues (e.g. payment of minimum wages). Other mechanisms such as introducing E&S key performance indicators (KPIs) to assess management performance (e.g. CEO bonus linked to E&S criteria) were also viewed by private equity study participants as useful levers to apply influence.

"To influence a local company operating in an emerging economy it's important to use case studies from other comparative geographies rather than western ideas".

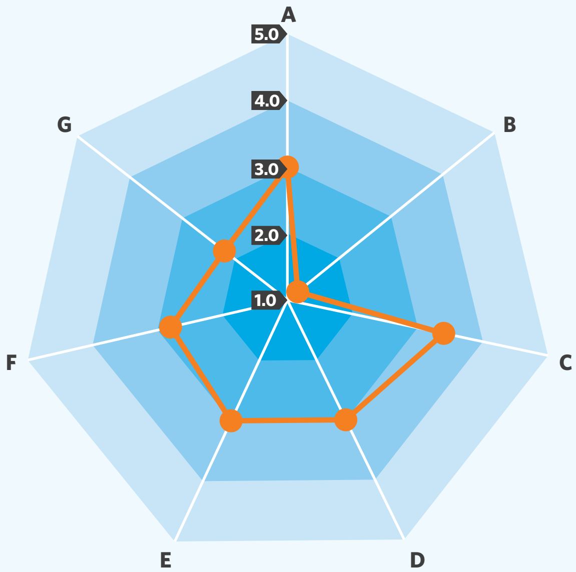
Private equity company

Asset Managers including pension funds

For asset managers, our research indicates that the potential level of influence is dependent on the size of the investment holding in the investee company. Asset managers with larger or majority investment holdings may potentially have a higher level of influence. As minority investors, some asset managers rely on other/majority investors to try to influence the investee company to manage E&S issues, whilst some collaborate with like-minded investors. We were told during the interviews that much depends, however, on the attitude of management of investee companies. Even for minority holdings, where management is receptive to E&S advice, asset managers can have some level of influence.

DIAGRAM 9:

Insurance – Importance of factors in determining influence over clients/investee companies to manage E&S risks (where 1 is less important and 5 very important).



- **A.** Amount of funds involved etc.
- **B.** Duration
- **C.** Nature and strength of relationship
- **D.** Potential for poor E&S approach to negatively impact company performance
- **E.** Potential for poor E&S performance to negatively impact your institution
- **F.** Potential of the client or investment to be publicly linked to adverse impacts
- **G.** Proportion of other financiers with similar E&S objectives

Through the provision of **Insurance** products and services, insurance companies do not finance their clients. Therefore, according to the insurance FI study participants, they perceive their potential influence over clients as very low. They further mentioned that it is not common for insurers to engage with companies on E&S issues, unless these are specifically related to a risk or set of risks to be insured.

For the situations in which a certain level of influence can be exercised, based on our survey results, the nature and strength of relationship is considered the most important factor in determining the insurance companies' influence over their clients. The duration of the insurance product is seen as the least important factor; insurance contracts are usually concluded and renewed for periods of one year.

The insurance companies interviewed indicated that the ability to influence clients is further limited by the participation of insurance brokers. As mentioned in **Section 4.2.3** above, in very competitive market circumstances, the ability to include additional E&S due diligence requirements is seen as very limited. Only where insurance companies have established good and trusted relationships with brokers are they able to engage the brokers to start considering E&S issues.

4.2.4 Case Studies at the Transaction Level

The following case studies are based on recent transactions of FI study participants and consider the issue of leverage or influence of an FI across a range of financial services and geographies. For each case, the "indicative level of influence" (higher, lower or mixed) is based on the "factors that determine leverage/influence" (duration, amount, nature of relationship, etc.) as were referenced in the interviews. In a number of cases, a few key factors emerge as having the most bearing on the ability of the FI to influence a client's/investee company's behaviour, sometimes with surprising results. The case studies further illustrate the variability in outcomes, including situations where indicative levels of influence should be high and yet the FI was unable to affect the client company's behaviour or outcome.

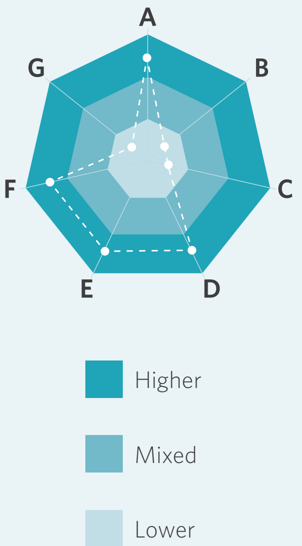
It should be noted that the case studies present a specific situation involving particular types of FIs and clients/investee companies. They provide a snapshot of the situation at a specific point in time, which may or may not have changed at a later stage. They also represent the views of FIs which provided input but do not represent the views of all FIs involved in the specific transaction. For these reasons, the case studies should be viewed as **illustrative only** and not a normative representation of any particular type of FI or financial service.

CASE STUDY: **Transaction 1**

Financial Product/Service
Initial Public Offering (IPO) (Capital Markets)

Country or Region Africa

Description
Investment bank providing IPO underwriting for a Hong Kong listing of Asian mining company's African assets. Poor labour and health, safety and environment (HSE) practices at African operations attract NGO campaign, prompting Hong Kong Stock Exchange (HKSE) to ask further E&S questions before allowing the listing to proceed. Bank seeks to engage the management of the Asian mining company on identified E&S issues.



Factors that could determine the level of influence for this transaction:	Indicative Level of influence
A Amount of funds involved, size of holding, proportion of total amount involved	$$$$
B Duration or tenor (e.g. of investment, loan, project)	Short-term, IPO underwriting
C Nature and strength of relationship (e.g. historical relationship with existing client, ownership stake)	Initially weak
D Potential for poor E&S approach to negatively impact client/investee company performance or shareholder value	NGO campaign against company for its labour and HSE practices at African assets
E Potential for poor E&S performance of client or investee company to negatively impact your institution (e.g. reputational risk, credit or investment risk)	May affect ability to launch IPO successfully and impact potential investor appetite
F Potential of the client or investment to be publicly linked to adverse impacts	As above
G Where multiple financiers are involved, proportion of parties with or without similar E&S objectives (e.g. through syndications, shared ownership)	Multiple banks involved, but only one bank engaged on E&S issues

Outcome

The bank suggested that the company engage an independent labour consultant, who went onsite and proposed an Action Plan to address identified E&S issues. The company disclosed work done to address labour and HSE issues in IPO prospectus. The IPO went forward and the company CEO praised the bank for its support.

Analysis

The fact that there were multiple banks involved did not contribute to the level of influence the bank was able to exert with the client company. Rather it was the combination of the HKSE warning about poor labour and HSE practices and the NGO campaigns that pushed the company to focus attention on E&S issues. In addition, an initially weak relationship was converted into a very strong relationship when the bank was able to successfully support the company in resolving its E&S issues, thus giving HKSE the comfort it sought prior to listing.

Key factors

- The bank was able to convert a weak relationship into a strong relationship by supporting the mining company's efforts to improve its E&S performance
- The bank was the only bank to actively support the company in addressing E&S issues whilst the other banks remained passive

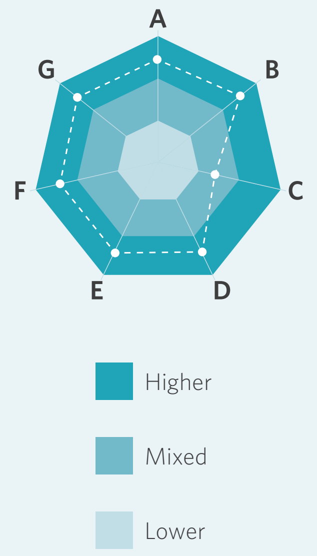
[HKSE listing requirements include E&S issues, whereas not all stock exchanges do]

CASE STUDY: **Transaction 2**

Financial Product/Service
Term Loan
(Corporate Lending)

Description
Bank provides corporate loan to large Asian mining company with poor human rights track record.

Country or Region Asia



Factors that could determine the level of influence for this transaction:	Indicative Level of influence
A Amount of funds involved, size of holding, proportion of total amount involved	$$$$
B Duration or tenor (e.g. of investment, loan, project)	Medium Term
C Nature and strength of relationship (e.g. historical relationship with existing client, ownership stake)	Poor relationship to start with client unwilling to listen to banks; with increased pressure from civil society and banks, the company became more receptive to banks
D Potential for poor E&S approach to negatively impact client/investee company performance or shareholder value	Multiple NGOs and campaigns; increased sensitivity over company asset
E Potential for poor E&S performance of client or investee company to negatively impact your institution (e.g. reputational risk, credit or investment risk)	Reputation risk to all financiers
F Potential of the client or investment to be publicly linked to adverse impacts	Yes, as above
G Where multiple financiers are involved, proportion of parties with or without similar E&S objectives (e.g. through syndications, shared ownership)	Multiple banks involved

Outcome
The company has made significant strides to improve its approach and positioning on sustainability.

Analysis
In what started out as a weak relationship, the banks were able to develop a stronger relationship over time by actively engaging the client to make the case as to why failure to address E&S issues would negatively impact the company's bottom line (as well as access to international capital). Banks working collaboratively were able to influence the client's understanding of E&S risks and relevant standards resulting in the client hiring a sustainability officer and developing E&S commitments at a policy/corporate level.

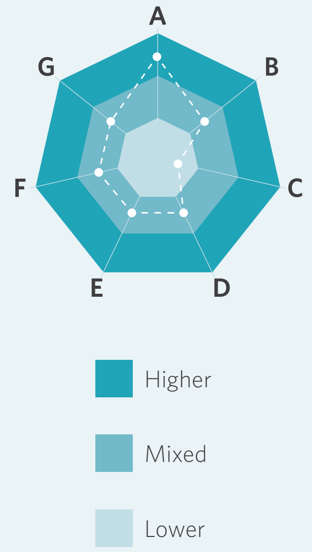
Key factors
- Weak relationship with a company unwilling to consider E&S standards was converted into a stronger relationship with a company more willing to implement E&S standards
- Banks worked together to encourage better E&S performance at the company level

CASE STUDY: **Transaction 3**

Financial Product/Service
Medium Term Note Programme (Capital Markets)

Country or Region Asia

Description
Several banks involved with capital raising efforts of a large Asian technology manufacturing company with poor labour standards and working conditions. The company has made some recent commitments to improve labour conditions due to high-profile supply chain influence from a prominent off-taker of goods.



Factors that could determine the level of influence for this transaction:	Indicative Level of influence
A Amount of funds involved, size of holding, proportion of total amount involved	$$$$
B Duration or tenor (e.g. of investment, loan, project)	Medium Term
C Nature and strength of relationship (e.g. historical relationship with existing client, ownership stake)	Weak relationship with company resistant to international standards/change
D Potential for poor E&S approach to negatively impact client/investee company performance or shareholder value	Poor labour standards and working conditions at factories and facilities publicly acknowledged internationally (**high**) but little pressure at country level (**low**)
E Potential for poor E&S performance of client or investee company to negatively impact your institution (e.g. reputational risk, credit or investment risk)	Potential reputation risk to all financiers (**high**), but nature of transaction meant lower likelihood of impacts to the FIs (**low**)
F Potential of the client or investment to be publicly linked to adverse impacts	Poor labour standards and working conditions at factories and facilities publicly acknowledged internationally (**high**) but little pressure at country level (**low**)
G Where multiple financiers are involved, proportion of parties with or without similar E&S objectives (e.g. through syndications, shared ownership).	Multiple banks involved but only one bank requesting information on E&S standards

Outcome
One bank requested information about labour standards and was excluded from the transaction.

Analysis
Given the complexities of the local operating environment and due to the nature of the financial product, of the multiple banks involved, only one undertook any level of E&S due diligence. The company cut the bank out of the transaction without any further engagement or discussion on the issues and the deal went ahead. In this case, the bank had no leverage over the client even though there were several other international banks involved.

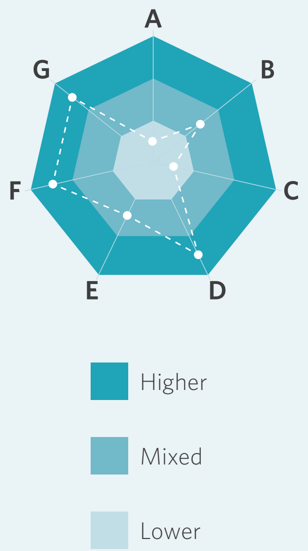
Key factors
- A weak relationship with a client unwilling to engage or consider E&S issues
- Presence of several banks did not improve leverage as they were not actively undertaking any form of E&S due diligence or risk assessment

CASE STUDY: **Transaction 4**

Financial Product/Service
Investment
(Asset Management)

Country or Region Africa

Description
Investment through a fund of a London Stock Exchange listed oil and gas company. Company given license to survey oil and gas potential in a World Heritage Site. E&S team in Asset Manager is made aware of the 2% shareholding the fund and seeks to engage company.



Factors that could determine the level of influence for this transaction:	Indicative Level of influence
A Amount of funds involved, size of holding, proportion of total amount involved	$
B Duration or tenor (e.g. of investment, loan, project)	Depends on client (investor) desire to hold investment
C Nature and strength of relationship (e.g. historical relationship with existing client, ownership stake)	Weak relationship with company resistant to international standards/change
D Potential for poor E&S approach to negatively impact client/investee company performance or shareholder value	Negative attention on company and potential impacts on World Heritage Site
E Potential for poor E&S performance of client or investee company to negatively impact your institution (e.g. reputational risk, credit or investment risk)	Potential reputation risk to all financiers (**high**), but actual stake in company small (**low**)
F Potential of the client or investment to be publicly linked to adverse impacts	Negative attention on company and potential impacts on World Heritage Site
G Where multiple financiers are involved, proportion of parties with or without similar E&S objectives (e.g. through syndications, shared ownership).	Multiple asset managers involved

Outcome
Asset Manager still holds 2% investment. Ability to exit shareholding limited due to investor fiduciary duty.
NGO campaign against the Asset Manager likely.

Analysis
Other asset managers with larger shareholdings sought to engage management, but could not affect outcome.
In addition to the Asset Manager's inability to exit, the ability to influence outcome was limited due to small amount of shareholding and attitude of company.

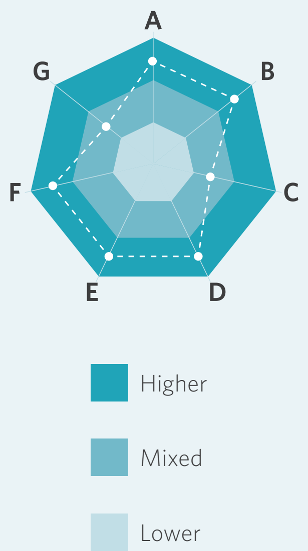
Key factors
- Weak relationship with the investee company
- Even though multiple asset managers involved, fiduciary duty limitations meant they had no influence over the investee company's E&S performance

CASE STUDY: **Transaction 5**

Financial Product/Service
Project Finance

Country or Region Asia

Description
Oil and gas pipeline project involving sensitive river crossings and endangered species which attracted NGO attention and multiple campaigns. Financiers brought in once project construction already 80% complete and adverse impacts had already occurred; no baseline study had been done at the outset.



Factors that could determine the level of influence for this transaction:	Indicative Level of influence
A Amount of funds involved, size of holding, proportion of total amount involved	$$$$$
B Duration or tenor (e.g. of investment, loan, project)	Long-term – 15+ years
C Nature and strength of relationship (e.g. historical relationship with existing client, ownership stake)	Good relationship with international MNE (**high**); poor relationship with local shareholder (**low**)
D Potential for poor E&S approach to negatively impact client/investee company performance or shareholder value	Multiple NGOs and campaigns; project already 80% complete and impacts already occurred
E Potential for poor E&S performance of client or investee company to negatively impact your institution (e.g. reputational risk, credit or investment risk)	Reputation risk to all financiers
F Potential of the client or investment to be publicly linked to adverse impacts	Multiple NGOs and campaigns; project already 80% complete and impacts already occurred
G Where multiple financiers are involved, proportion of parties with or without similar E&S objectives (e.g. through syndications, shared ownership).	Initially many banks in syndication working together to influence E&S outcomes (**high**), but in face of client resistance and stage of project completion the banks pulled out; leaving remaining FIs with less leverage and ability to affect outcomes (**low**)

Outcome
Several banks in the syndication tried to influence client and project outcomes but as the project was largely complete the damage had been done; the banks pulled out of the project. The project went ahead and eventually some banks joined later.

Analysis
On the face of the project, most of the factors that determine leverage were high. However, in reality the banks had very little ability to influence the client or the outcome of the project. This was largely a timing issue (i.e. project 80% complete when banks brought in). Had the banks been brought in earlier and had requested appropriate E&S due diligence, the outcome may have been different.

Key factors
1. Weak relationship with local operator unwilling to consider E&S standards
2. Banks in syndication with differing views/positions on E&S approach

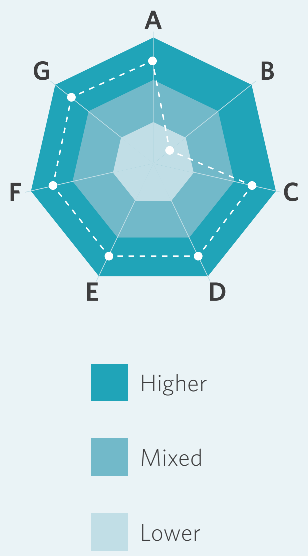
[Additional factor: Project impacts already realised]

CASE STUDY: **Transaction 6**

Financial Product/Service
Bond issue (Capital Markets)

Country or Region Asia

Description
Investment bank providing international bond issue for an Asian company. Some concerns about environmental issues prompt lead bank to request further E&S disclosures in the bond offering circular. Company initially resistant.



Factors that could determine the level of influence for this transaction:	Indicative Level of influence
A Amount of funds involved, size of holding, proportion of total amount involved	$$$$ (several USD billion)
B Duration or tenor (e.g. of investment, loan, project)	Short-term
C Nature and strength of relationship (e.g. historical relationship with existing client, ownership stake)	Strong
D Potential for poor E&S approach to negatively impact client/investee company performance or shareholder value	Significant attention on environmental issues
E Potential for poor E&S performance of client or investee company to negatively impact your institution (e.g. reputational risk, credit or investment risk)	May affect: (1) ability to launch deal successfully; and (2) potential investor appetite
F Potential of the client or investment to be publicly linked to adverse impacts	As above
G Where multiple financiers are involved, proportion of parties with or without similar E&S objectives (e.g. through syndications, shared ownership).	Other three bond underwriters supported lead bank approach and disclosure requirements

Outcome
The company agreed to commit to disclose material E&S issues in bond offering circular.

Analysis
The company was resistant to change and the request to improve E&S disclosures. However, the other three bond underwriters supported the lead bank in its approach and disclosure requirements. As it was the company's first international bond issue, it listened to the banks.

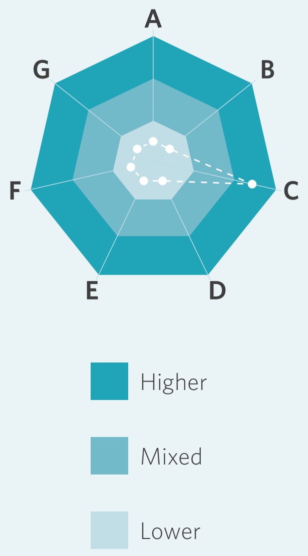
Key factors
- The bank was able to ask for further E&S disclosures because it had the support of the other three bond underwriters involved in the transaction.
- The bank was viewed as credible because of its understanding of the client's sector and key E&S issues.

CASE STUDY: **Transaction 7**

Financial Product/Service
Corporate Broker, Advice (Capital Markets)

Country or Region Africa

Description
Junior London Stock Exchange (LSE) listed mining company sought to move to main board of LSE and sought bank's advice. Bank advised the company that improved E&S performance would help enhance its case.



Factors that could determine the level of influence for this transaction:	Indicative Level of influence
A Amount of funds involved, size of holding, proportion of total amount involved	$
B Duration or tenor (e.g. of investment, loan, project)	Short-term
C Nature and strength of relationship (e.g. historical relationship with existing client, ownership stake)	Strong
D Potential for poor E&S approach to negatively impact client/investee company performance or shareholder value	Small operations, no NGO attention
E Potential for poor E&S performance of client or investee company to negatively impact your institution (e.g. reputational risk, credit or investment risk)	Small operations, no NGO attention
F Potential of the client or investment to be publicly linked to adverse impacts	Small operations, no NGO attention
G Where multiple financiers are involved, proportion of parties with or without similar E&S objectives (e.g. through syndications, shared ownership).	Only one bank involved

Outcome
The company is currently in process of setting up ISO management systems, policy and reporting on E&S performance; now understands need to have strong narrative around E&S performance for main board.

Analysis
The company trusted the bank as its corporate broker and was thus open to the bank's advice that improved E&S performance would enhance its case to move to the LSE main board.

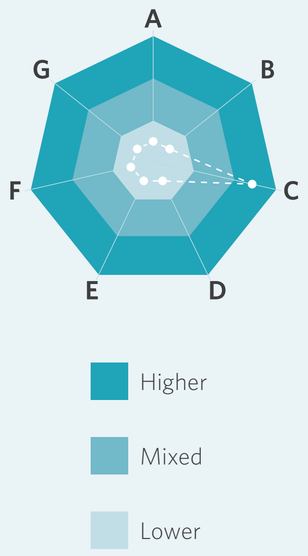
Key factors
- Strong relationship with the client meant that the bank was able to encourage the company to improve its E&S approach and performance.

CASE STUDY: **Transaction 8**

Financial Product/Service
Corporate Broking Mandate (Capital Markets)

Country or Region Asia

Description
As part of its strategy to raise funds and enhance its reputation, the company sought to be included in the Dow Jones Sustainability Index (DJSI) and to release its first sustainability report. The company approached bank for support and advice.



Factors that could determine the level of influence for this transaction:	Indicative Level of influence
A Amount of funds involved, size of holding, proportion of total amount involved	$
B Duration or tenor (e.g. of investment, loan, project)	Short-term
C Nature and strength of relationship (e.g. historical relationship with existing client, ownership stake)	Strong
D Potential for poor E&S approach to negatively impact client/investee company performance or shareholder value	Good operator
E Potential for poor E&S performance of client or investee company to negatively impact your institution (e.g. reputational risk, credit or investment risk)	Good operator
F Potential of the client or investment to be publicly linked to adverse impacts	Good operator
G Where multiple financiers are involved, proportion of parties with or without similar E&S objectives (e.g. through syndications, shared ownership).	Only one bank involved

Outcome
Based on the quality of the support and advice given to the company by the bank on the development of its first sustainability report as well preparation for potential inclusion on the DJSI, the company appointed the bank as its corporate broker. In return, the company's commitment to E&S issues made the engagement easier.

Analysis
In this case, the sustainability team of the bank helped to enhance the relationship with the client and led to additional revenues and opportunities for the bank.

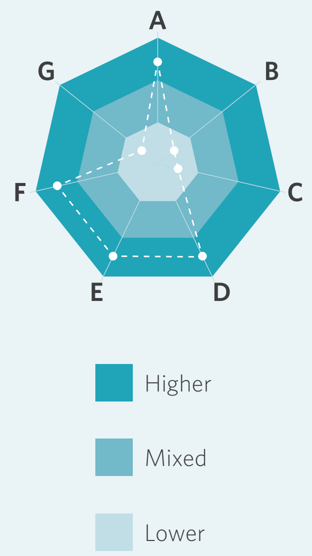
Key factors
- A strong, trusted relationship with a client willing to engage on E&S issues

CASE STUDY: **Transaction 9**

Financial Product/Service
Bond Issue (Capital Markets)

Country or Region Russia

Description
Russian company receiving negative media attention for its E&S track record seeks bond issue. When asked by the bank to include E&S disclosures in the bond memorandum, the Company resists.



Factors that could determine the level of influence for this transaction:	Indicative Level of influence
A Amount of funds involved, size of holding, proportion of total amount involved	$$$$ (1 EUR billion)
B Duration or tenor (e.g. of investment, loan, project)	Short-term
C Nature and strength of relationship (e.g. historical relationship with existing client, ownership stake)	Weak relationship with company resistant to E&S standards or disclosures
D Potential for poor E&S approach to negatively impact client/investee company performance or shareholder value	Poor performance has led to high reputational risk score, significant negative media attention
E Potential for poor E&S performance of client or investee company to negatively impact your institution (e.g. reputational risk, credit or investment risk)	Poor performance has led to high reputational risk score, significant negative media attention
F Potential of the client or investment to be publicly linked to adverse impacts	Poor performance has led to high reputational risk score, significant negative media attention
G Where multiple financiers are involved, proportion of parties with or without similar E&S objectives (e.g. through syndications, shared ownership).	Only bank asking for E&S disclosures; IPO banks had not pushed company on E&S issues

Outcome
Despite bank requesting additional E&S disclosures and seeking to engage the company, the company provided limited disclosure in its bond memorandum. The company only reports on material issues (i.e. based on cost) and does not consider E&S accidents, spills or deaths to be material.

Analysis
Because other banks had not previously challenged or pushed the company on E&S issues at the time of its IPO, the bank had limited ability to influence the company.

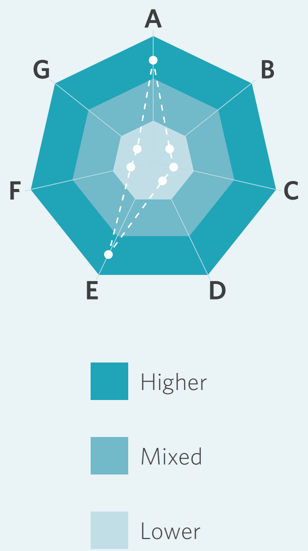
Key factors
- Weak relationship with the company
- The bank had no influence over the company's E&S performance as it was the only bank asking for E&S disclosures

CASE STUDY: **Transaction 10**

Financial Product/Service
Initial Public Offering
(Capital Markets)

Country or Region SE Asia

Description
A utility company sought underwriting for an IPO. The bank requested additional E&S disclosures and mention of climate change as a potential business challenge or risk. The company was not willing to disclose that climate change was a potential issue (particularly regulatory risk) for its business.



Factors that could determine the level of influence for this transaction:	Indicative Level of influence
A Amount of funds involved, size of holding, proportion of total amount involved	$$$$
B Duration or tenor (e.g. of investment, loan, project)	Short-term; IPO underwriting
C Nature and strength of relationship (e.g. historical relationship with existing client, ownership stake)	Weak relationship with client
D Potential for poor E&S approach to negatively impact client/investee company performance or shareholder value	SE Asian institutional investors not asking questions about climate change
E Potential for poor E&S performance of client or investee company to negatively impact your institution (e.g. reputational risk, credit or investment risk)	Bank had already been criticised for IPO of European coal-fired power company
F Potential of the client or investment to be publicly linked to adverse impacts	SE Asian institutional investors not asking questions about climate change
G Where multiple financiers are involved, proportion of parties with or without similar E&S objectives (e.g. through syndications, shared ownership).	Only two banks asking questions about E&S performance and climate change issues. Local bank not pushing E&S issues at all.

Outcome
The bank was only able to get limited disclosure in the Company's IPO prospectus.

Analysis
Due to lack of precedent in country and investor apathy toward climate change, the bank's ability to influence the client or outcome was limited. While it was helpful that there was one other international bank making similar requests, the local banks were not pushing E&S or climate change issues at all.

Key factors
- Weak relationship with unwilling client
- Local operating environment – institutional investors not asking questions about climate change

As noted previously, there is a great deal of variability not just in the factors that may determine leverage or influence but in the outcomes as well. Whilst there are a number of parameters or factors that can generally help assess whether or not FIs could have leverage or influence over their clients or investee companies, whether or not FIs actually have leverage or influence can be case-specific.

5. Summary of findings

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Based on the need for further clarification, this study has sought to map:

- The different approaches of FIs to risk-based E&S due diligence in the context of providing different financial services; and
- The level of leverage of an FI, perceived or otherwise, to prevent or mitigate adverse E&S impacts to which they may be linked through the provision of financial services.

The key findings presented below are not intended to present a view on how the OECD Guidelines should be applied by FIs nor apply these findings to the financial sector as a whole. Rather, the key findings seek to inform stakeholder discussions under the umbrella of the Proactive Agenda of the OECD Working Party on Responsible Business Conduct, on clarifying the practical meaning of observance of the OECD Guidelines by the financial sector and future work in this area.

1. Different business models of FIs and the specific mix of financial products and services they provide drive different E&S due diligence approaches

A number of factors influence the way an FI approaches and manages E&S risks, including the types of financial services offered, industry sectors of its clients or investee companies, and the geographic scope of its business. This study finds that one of the most important drivers for determining an FI's risk-based E&S due diligence approach is having a risk management approach that is suited to the risk profile of their engagements. In addition:

- E&S due diligence for financial services such as Corporate Lending is often limited to a company level E&S risk assessment. In comparison, for Asset-Based Finance, a more in-depth E&S due diligence is possible at the financed asset, project or site level.
- E&S due diligence approaches and processes for Capital Markets and Insurance are seen by FIs as least defined and with the greatest degree of variability between FIs. In general, FIs find it much more difficult to assess and manage E&S risks in Capital Markets transactions, due to the tight timeframes and to issues related to disclosure and transparency.
- FIs cite a number of challenges when conducting E&S due diligence, some of which include availability of time and resources for conducting E&S due diligence.
- E&S due diligence practices between developed and emerging economies can vary significantly. In some emerging economies, FIs indicate a tension between economic/commercial priorities versus E&S considerations.

2. FIs seek to systematically prioritise E&S due diligence for transactions and investments according to the level of potential E&S risk involved

FIs regard prioritisation as necessary when conducting E&S due diligence, due to the complexity of their business models (e.g. the universal banks) and also due to the high volumes of transactions/clients. Only when FIs identify particular E&S risk through an initial screening process, is further E&S due diligence conducted. In this way, E&S due diligence and risk management approaches are designed to be commensurate with the potential level of E&S risk. Some FIs cite on-going due diligence for existing clients and transactions as significantly challenging in the context of human rights as, for example, perception of impacts to right holders can and will vary over time. Moreover, access to client documentation and information is often more challenging once financial contractual agreements have been signed.

3. Awareness and implementation of the United Nations Guiding Principles on Business and Human Rights is variable

There are mixed levels of awareness of the UNGPs from FIs both in adhering and non-adhering countries. Of the FIs which participated in the study that are familiar with the UNGPs, in general, most are at the early stages of understanding the implications for their institutions and many find its interpretation for their business challenging. FIs that have reviewed the UNGPs express a lack of clarity on how the scope and terminology of the UNGPs applies to their institutions.

4. Most FIs do not apply the OECD Guidelines citing them as "too generic"

Of the FI study participants, some refer to the OECD Guidelines in their E&S policies, but few use them in the implementation of E&S due diligence as they are seen as too generic. It should be noted that this does not mean that FIs do not have E&S due diligence policies/processes in place.

Many FIs cite a lack of clarity on terminology, for example, "business relationships" and "business partners", "direct" links to adverse impacts, leaves them open to interpretation and creates confusion amongst stakeholders particularly in relation to the perceived levels of leverage/influence of an FI over a client or investee company. FIs also cite a lack of clarity on what they can expect from NCPs and on what the FI's approach should be when a specific instance has been filed with an NCP relating to a client or investee company.

FIs headquartered in non-adhering countries were of the view that the priority, and often challenge, in their countries of operation is implementation of national laws. They do not view the OECD Guidelines as readily relevant or easily applicable within their national contexts. They highlight that if national laws are followed, then companies (e.g. clients or investee companies) would automatically be in compliance with the OECD Guidelines and other international standards.

5. Leverage or influence over client behaviour on E&S issues varies, even within same product or service group

Stakeholder differences exist in the perceived level of leverage of an FI over the client or investee company causing the adverse impact to prevent or mitigate that impact. Overall, this study finds no clear parameters that could consistently determine the potential level of leverage/influence an FI may have over a client or investee company with respect to its management of identified E&S issues. The level of leverage/influence is generally seen by FIs as situation-specific and varies according to the type of financial service, sector and other factors.

Some banks that participated in the study mentioned that from the mix of different financial services they provide, the only instance in which they perceive their link to the adverse impact to be direct is in some cases of Asset-Based Finance. For financial services such as Corporate Lending, Capital Markets, Insurance and Investment (except in some cases of private equity), FIs view their link to the adverse impact as indirect and consequently their leverage or influence to be limited. Where FIs did indicate they have some level of leverage/influence, even with the same type of FI and for the same type of financial service, the level of leverage/influence can vary significantly, and depends on a number of different factors (e.g. strength of relationship with the client/investee company).

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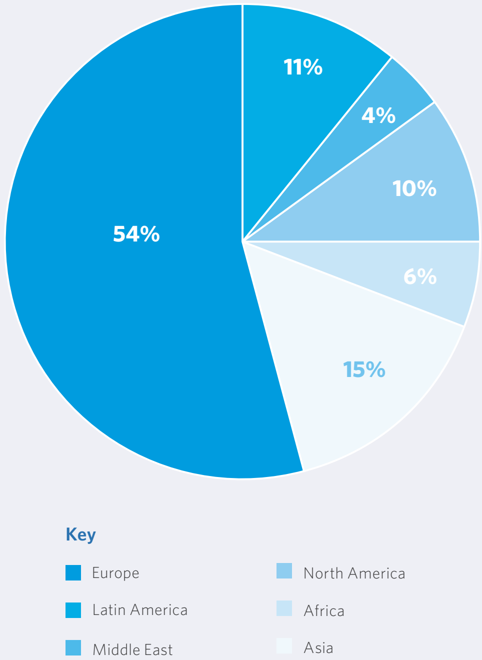
6. APPENDICES

Appendix A: Project Advisory Group Members

Actis
Barclays
Berne Declaration
BNP Paribas Fortis
Citi Corporate and Investment Banking
Equator Principles
European Commission
Foreign Affairs and International Trade Canada (DFAIT)
Global Witness
ING Bank
Japan, Ministry of Foreign Affairs
Japan, Permanent Delegation of Japan to the OECD
JP Morgan
Lloyds Bank
Netherlands, Ministry of Foreign Affairs
Norwegian National Contact Point
Business and Advisory Committee to the OECD (BIAC)
OECD Secretariat
Trade Union Advisory Committee to the OECD (TUAC)
OECD Watch
Office of United Nations High Commissioner, Human Rights
Observatoire de la Responsabilité Sociétale des Entreprises (ORSE)
Societe Generale
State Secretariat for Economic Affairs (SECO)
UK Government, Business, Innovation & Skills
UNEP Finance Initiative (FI)
UNI Global Union
UN Principles for Responsible Investment (PRI)
US mission of OECD in Paris
US Treasury
United Nations Working Group on Human Rights & Corporations

Appendix B: Breakdown of survey responses by geographical region



Appendix C: Representative interview questions

The interviews were conducted to gather qualitative information to supplement the quantitative data obtained from the online survey. A number of interview questions were formulated in advance, to serve as a starting point of the discussions and to ensure a certain degree of consistency throughout the interviews. However, given the aim of the interviews to yield qualitative information, fill in gaps and identify useful implementation examples, and also taking into consideration the wide scope of the research and the limited amount of time available for interviews, not all/the same questions were asked in each of the interviews. Additionally, interview questions were to a certain extent tailored to the specific (type of) FI being interviewed.

A representative list of the main topics and questions covered in the interviews is presented below.

E&S approach and implementation

1. Can you describe how you approach and implement specific environmental, social and human rights issues in your E&S due diligence processes?
2. How do factors such as external initiatives, geography, type of E&S issue/financial service or size of transaction influence the type/level of E&S due diligence carried out?
3. How do you approach on-going E&S due diligence?
4. How do teams responsible for E&S due diligence, within your organisation, work together?
5. What are the most significant challenges relating to E&S due diligence encountered by your institution?
6. How does your institution respond to E&S "dilemmas" when they arise?

Use/impact of E&S due diligence and leverage

7. How are E&S due diligence results factored into business decision-making?
8. Which factors determine the influence or leverage you have on a client or an investment holding with respect to management of its identified E&S risks and how?

Human Rights due diligence and the UNGP

9. Is your institution planning to apply or refer to the United Nations Guiding Principles for Business and Human Rights? If so, how?
10. Would your institution find additional guidance on applying or using the UN Guiding Principles for Business and Human Rights useful?

International frameworks and principles, guidelines, standards

11. Which E&S international frameworks and principles, guidelines, standards do you consider the most important/useful in your E&S due diligence and why?
12. How does your institution apply/refer to the OECD Guidelines?

Appendix D: References for Table 4: General characteristics of financial services

i. "The average maturity of PF loans [is] 8.6 years": Stefanie Kleimeier & William L. Megginson, 2000. "Are Project Finance Loans Different From Other Syndicated Credits?," Journal of Applied Corporate Finance, Morgan Stanley, vol. 13(1), pages 75–87. **http://arno.unimaas.nl/show.cgi?fid=11829**

ii. E.g. "When there is a flurry of IPO activity, the approval process slows down. The time can be as little as a few months to as much as six months." **http://usatoday30.usatoday.com/money/perfi/columnist/krantz/2006-02-13-ipo-how-long_x.htm**. "It will often take between six and nine months for a private company to go public" **http://www.streetdirectory.com/travel_guide/18694/corporate_matters/going_public_how_long_does_it_take.html**

iii. **http://www.ukexportfinance.gov.uk/about-us/introduction-to-ecgd**

iv. Speech by Andrew G Haldane, Bank of England, 2 September 2010. **http://www.bankofengland.co.uk/publications/Documents/speeches/2010/speech445.pdf**

v. 'Global Asset Management 2012', Boston Consulting Group **http://www.parisfundindustry.com/wp-content/uploads/2012/10/Global_Asset_Management_2012_tcm80-114834.pdf**

vi. **http://www.oecd.org/gov/budgetingandpublicexpenditures/49945473.pdf**

vii. FT/Thompson Reuters: **http://markets.ft.com/investmentBanking/dealMap.asp**

viii. Kleimeier (2000), ibid.

ix. **http://www.ey.com/Publication/vwLUAssets/Global_IPO_trends_2012/$FILE/Global_IPO_trends_2012.pdf**

x. Upper limits can be estimated in the USD billions. For example, to choose the largest shareholding in the largest listed company as an example of a potential upper limit, at the time of writing Fidelity Contrafund owned 12,213,558 shares in Apple Corp, at USD527.45 per share (USD6bn total).

xi. Syndicates may be very large – e.g. Qatargas 2 project involved 57 financers. **http://www.exxonmobil.com/Corporate/energy_production_lng_qatar.aspx**

xii. "An underwriter syndicate is usually formed when an issue is too large for a single firm to handle." **http://www.investopedia.com/terms/u/underwriter-syndicate.asp#axzz2HCCa7zIq**

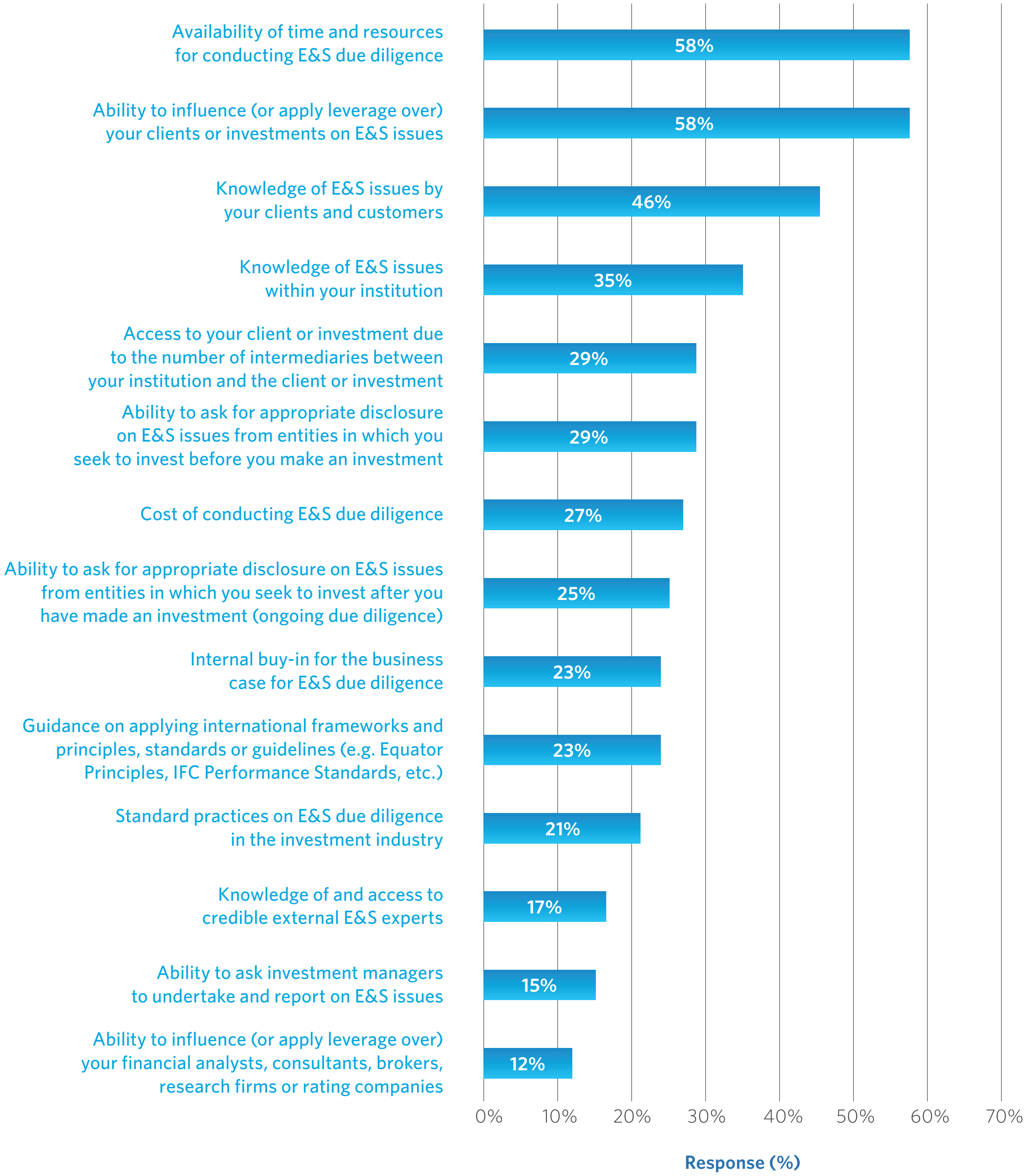
xiii. S&P Loan Market Guide, September 2011 **https://www.lcdcomps.com/d/pdf/LoanMarketGuide.pdf**

xiv. "Syndicate – a group of companies or underwriters who join together to insure very high-valued property or high-hazard liability exposures. Insurance exchanges, such as Lloyd's of London, use syndicates to write insurance." IMRI Risk and Insurance. **http://www.irmi.com/online/insurance-glossary/terms/s/syndicate.aspx**

xv. **http://www.hsbcnet.com/gbm/attachments/products-services/financing/project-finance.pdf**

Appendix E: Challenges in conducting E&S due diligence

Survey responses on the challenges in conducting E&S due diligence



Appendix F: UNGP decision-making logic on business relationships and leverage

The Interpretive Guide to the UNGPs presents the following decision-making logic:

Diagram 11: UNGP decision-making logic on business relationships and leverage

	Have leverage	Lack leverage
Crucial business relationships	**A** • Mitigate the risk that the abuse continues/recurs • If unsuccessful → B	**B** • Seek to increase leverage • If unsuccessful, seek to mitigate risk that the abuse continues/recurs • If unsuccessful, consider ending the relationship; ** or demonstrate efforts made to mitigate abuse, recognizing possible consequences of remaining
Non-crucial business relationships	**C** • Try to mitigate the risk that the abuse continues/recurs • If unsuccessful, take steps to end the relationship*	**D** • Assess reasonable options for increasing leverage to mitigate the risk that the abuse continues/recurs • If impossible or unsuccessful, consider ending the relationship*

* Decisions on ending the relationship should take into account credible assessments of any potential adverse human rights impact of doing so.
** If the relationshipis deemed crucial, the severity of the impact should also be considered when assessing the appropriate course of action.

According to the interpretive guide, a "relationship could be deemed 'crucial' if it provides a product or service that is essential to the enterprise's business, and for which no reasonable alternative source exists". In addition, "leverage is considered to exist where the enterprise has the ability to affect change in the wrongful practices of the supply chain entity".

One of the objectives of this study is to understand the applicability of this decision-making process to the financial sector. However, there are a number of challenges to doing this. One of the main challenges is that this paper and the decision-logic are based on tangible, short-term **supply chains**, where moving from one business partner to the other seems relatively easy. Many FIs might see this decision-making logic as applicable to their own supply chains and operations (e.g. office supply) but not to the financial services provided to their clients or investee companies. In addition, the key issue around interpretation of the term "business relationship" has already been discussed above.

As discussed in the section on E&S due diligence process and implementation, FIs in general adopt a risk-based approach to assessing clients and investee companies taking into consideration their risk appetite. They do not typically categorise clients as "crucial" or "non crucial" relationships. The objective of E&S due diligence is to ensure FIs do not enter into transactions or relationships with unacceptable risks. Similarly, sector exclusion lists exist to prevent an FI from engaging with a client or investee company in a sector deemed to be too risky. In the diagram above, boxes A, C and D which advise to "mitigate the risk that the adverse impact continues/recurs", are most relevant to the initial E&S due diligence processes.

Box B advises to "take steps to end the relationship", whilst boxes C and D advise "consider disengaging/terminating". However, the clarity and conciseness of the matrix is not likely to do justice to the complexity of the majority of relationships between an FI and its clients or investee companies given the provision of the product or service at hand. Terminating complex financial lending or investment relationships and the underlying legal agreements that support those relationships can be very difficult. Likewise, supply chain relationships are likely to also vary greatly in complexity and therefore ease of termination. For investors, particularly those with long-term investments, divesting (e.g. selling shares), can be a complex process involving lengthy legal considerations and actions as well as in some cases finding a buyer for the shares.
For a number of FIs, relationships are crucial at the aggregate level, for example if oil & gas clients are significant business for banks, a decision to divest from one is harder to make independently from the decision to divest from all. Similarly, where specific sectors play a significant role in country-level economic growth prospects and stability, it will be difficult for FIs to make independent decisions without taking into consideration political sensitivities in local or home markets.

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NB: In addition to the aforementioned references, a significant amount of material pertaining to the FI study participants (such as E&S policies, Sustainability reports, press articles, etc.) was reviewed. However, to maintain the anonymity of the study participants and protect the confidentiality of the content, such materials are not listed herein.

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