Photo: Jerry Galea/OxfamAUS

Sustainable project financing: getting the basics right

The big picture

There is global recognition that financial institutions have significant influence and leverage on business practice through project finance, and that disclosure, transparency and accountability are critical for sustainable financing.

The global demand for water, energy, minerals and land is driving foreign direct investment. There is increased appetite for risk, including capital investment in emerging economies, conflict-prone countries, and geographic regions with weak governance. Such investment often involves large-scale projects in natural resource extraction and management, and infrastructure. Increasingly, it occurs in economies in reconstruction as a result of natural disaster and conflict.

The private sector can be an important driver of economic growth and poverty reduction, provided appropriate regulations and controls are in place. Such regulation helps protect both the natural environment and the livelihoods and human rights of men, women and children. It is particularly important when investing in projects in emerging economies, and where the risks of conflict and corruption are high. The risks for mining companies are significant, as their operational characteristics make them particularly prone to fraud and corruption.

Financial institutions — involved in the provision and management of investment banking, project finance, stock analysis, issuances and trading, mergers and acquisitions, pension funds, asset management, export credit agencies and other forms of financial services — are in a strong position to influence (both positively and negatively) the impact of large-scale projects through the provision of capital and financial services.

This is particularly important in sectors such as mining, hydropower, agribusiness, logging and infrastructure, where peoples' rights to water and land, and the rights of Indigenous Peoples and women in particular can be violated. Financial institutions can, and must, choose not to invest if international standards are not upheld.

As a minimum, financial institutions must commit to 'do no harm'. However, they can do more than this by establishing and adhering to a robust due diligence framework that is based on transparency and accountability. This will assist in combating bribery and corruption, minimise the risks of project-related conflict, support poverty reduction and foster sustainable development.

To achieve this, financial institutions need to better understand and redefine risk. What is required is a shift in vision, decision-making, and investment practice so that social and environmental risks are given equal weight as credit, reputational and shareholder risks, and the interests and rights of project-affected communities are taken into account.

Investors must do more than just develop good policies; they must disclose and implement their social and environmental risk management systems.

The precautionary principles of identifying, mitigating and preventing adverse impacts must be at the core of environmental and social risk management systems. The absence of regulatory frameworks, incentives, or a 'level playing field' as new financiers enter the market, are no reason not to pursue sustainable financing decisions and take responsibility for the social and environmental impacts of those transactions.

Oxfam does not underestimate the significant changes that financial institutions need to make to better manage social and environmental risks, and make a positive contribution to poverty reduction and development issues. What follows is designed to keep the critical social and environmental issues 'front of mind' and at the top of investors 'to-do' list.

Financial institutions should bear full responsibility for the environmental and social impacts of their transactions.

Financial institutions must also pay their full and fair share of the risks they accept and create. This includes financial risks, as well as the social and environmental costs that are borne by communities.

Source: The Collevecchio Declaration on Financial Institutions and Sustainability, Italy, 2003.

Sustainable project financing

What makes investment due diligence challenging and necessary?

Investment in large scale projects can be difficult for environmental, social, technical and geo-political reasons. Some of the key challenges financiers need to respond to are:

- High-value commodity prices and natural resource scarcity is driving investment competition
- Increased appetite for investment risk (technical, geographic, political)
- 'Pared-back' risk management expenditure post global financial crisis
- Increasing investment in emerging economies, conflict and post-conflict zones, and locations with weak governance
- Bribery and corruption impacts on reputation, costs, poverty reduction and development
- Growing social and regulatory pressure
- Short-term investment timeframes and returns incompatible with sustainable development issues
- Frequency of merger and acquisition activity (particularly in the mining sector)
- Transboundary impacts and risks (particularly in hydropower)
- Scale and speed of projects and rise of new financiers
- Complex financial and regulatory landscape, including public-private partnerships, multiple investors, and an increase in debt and equity finance
- Lack of transparency in the investment sector
- Inconsistent assessment of how risks should be evaluated and reflected in project finance decisions
- Lack of demand, interest and oversight from asset owners and investment managers in sustainable project financing

Are the standards working?

Responsible investment standards such as the Equator Principles (EP) and the United Nations Principles for Responsible Investment (UNPRI) provide useful guidance. However, it must be recognised that they do not reflect international law and best practice in all areas, including human rights. Despite the growing number of EP 'adopter banks', these principles lack transparency, implementation, monitoring and external compliance mechanisms. As a consequence, practice among EP banks is not uniform. Unlike EP banks, the International Finance Corporation audits its compliance with the Performance Standards and responds to complaints from project-affected communities through the office of the Compliance Advisor Ombudsman.

There are a growing number of multi-stakeholder initiatives for specific sectors (for example, the World Commission on Dams, the Hydropower Sustainability Assessment Forum, the Roundtable on Sustainable Palm Oil, and the Extractive Industry Transparency Initiative (EITI)). While not binding they are considered by stakeholders to provide authoritative guidance. Some lack external accountability.

In addition to engaging with these mechanisms, financiers should take a positive and pro-active role in supporting legislative developments that strengthen corporate accountability and disclosure.

Basic project finance due diligence

In developing a due diligence 'risk framework', investors, directly and through their clients and business relationships, must identify, mitigate and prevent the adverse impacts of their investment decisions. They must, as a minimum, assess and disclose information in relation to:

- The potential social and environmental impacts of a project, including gender and human rights impacts, at the outset and at each phase of the project
- If and how the free, prior and informed consent of Indigenous Peoples has been given for the project
- Plans for resettlement (if required) including in relation to livelihood restoration, compensation and benefit sharing agreements
- Client commitments to revenue transparency including country-by-country reporting of revenues paid to host governments, and to disclose their contracts with the host government
- Anti-bribery and anti-corruption measures
- The likelihood that the project will cause or exacerbate conflict and arrangements for the use of security personnel
- The design of project-based grievance mechanisms
- The 'guiding principles' for corporate-community and stakeholder relations
- The management of supply chain risks including procurement policies

Some useful references

- Ernst & Young, *Fraud and corruption in mining and metals: focus on business ethics,* 2010
- BankTrack, *The do's and don'ts of sustainable banking, A BankTrack manual,* 2006
- OECD, *Due diligence guidance for responsible supply chains of minerals from conflict-affected and high risk areas,* 2010
- Oxfam, *Better returns in a better world – responsible investment: overcoming the barriers and seeing the returns,* 2010
- Human Rights Council, *Guiding principles on business and human rights: implementing the United Nations 'protect, respect and remedy' framework,* May 2011

Authors note: This fact sheet (May, 2011) has been developed by Serena Lillywhite and Christina Hill at Oxfam Australia. It draws on work by Ernst & Young, BankTrack and the OECD, among others. It reflects the work of several Oxfam affiliates, particularly Oxfam Australia, Oxfam America and Oxfam Great Britain.

Oxfam's private sector work is focused on ensuring large scale projects make a positive contribution to poverty reduction. Improved due diligence, greater transparency, disclosure and accountability by companies, governments and financial institutions is essential to assist communities protect their land and livelihoods, and claim their rights to negotiate in project decision making processes that affect them.

See Oxfam Australia website www.oxfam.org.au for further guidance on gender impact assessment, community-company grievance resolution and free, prior and informed consent.

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