

## **Environment in the project finance practices of banks**

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Abstract for 2009 Annual Conference of the Asia Pacific Academy of Business in Society

**Title: Environment in the project financing practices of banks**

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The environmental impacts of bank activities have been the focus of both practitioners and academics since the 1980s. Banks impact the environment in two ways: directly, through their day-to-day activities and, indirectly, through the products and services they offer (Case 1999; 2001; Hugenschmidt, Janssen et al. 2001; Jeucken 2001; Kahlenborn and Dal Maso June 2001). The latter are considered to be far more substantial in terms of their potential environmental impact (Gray and Bebbington 2001; Hugenschmidt, Janssen et al. 2001). Project financing, a key service of banks, has been highlighted as one of the primary ways in which banks impact the environment (Ganzi, Seymour et al. 1998; Thompson 1998; Thompson and Cowton 2004).

Project financing is defined in the banking sector as financing provided for the realisation of a project, where the future income generated by the project is the means for repaying the loan (Ganzi, Seymour et al. 1998; Basel Committee on Banking Supervision November 2005). A wide range of projects are financed this way—such as power plants, wind farms, sewage treatment facilities, manufacturing plants, hotels/resorts, office buildings, and even residential real estate. Two, sector-specific, voluntary initiatives to assist banks to implement environmentally-sustainable project-financing practices have been drawn up by the bank sector: the Equator Principles launched in 2003 and the United Nation Environmental Programme Financial Initiative's (UNEP FI) Statement launched in 1995. The Equator Principles specifically calls on signatories to refuse to finance projects that do not meet basic environmental and social standards (UNEP FI 1997; 2004).

The objectives set out in the initiatives are ambitious and the fact that 68 banks have adopted the Equator Principles, and 170 financial institutions have signed the UNEP FI's Statement, would suggest that the banking sector is serious about the management of environmental issues in financing decisions (EP 2009; UNEP FI 2009). The environment does not score highly on the agenda of banks that have not signed voluntary initiatives therefore environmental issues are not given much leverage in the actual project finance decisions (Barannik 2001; Jeucken 2001; Tarna 2001; Weber, Fencher et al. 2008); UNEP 2000). However studies found that organisations that have committed to environmental initiatives do not act in a more environmentally conscious manner than organisations that have not signed such initiatives (Thompson and Cowton 2000; Gray and Bebbington 2001).

Extensive resources are invested by project proponents in project planning, and studies are undertaken including some that provide information on environmental issues. Environmental documents prepared in such project planning are routinely used by decision-makers in relevant authorities to decide whether a project can proceed (e.g. environmental impact assessment statement), or to determine if a site needs to be remediated before construction can begin (e.g. environmental due diligence reports).

Is it possible that bankers are not aware that these studies exist or of the content of these documents? Or perhaps they do not find the information in these documents useful in their decisions about project financing?

This paper reports an in-depth study of two commercial banks: one in Europe, the other in Australia. Qualitative research was conducted, interviewing some 24 employees in middle and senior-level positions. Participants represented a number of different departments in the banks that engaged in the project finance process. Internal documents that governed and guided their project financing process (such as credit policies and procedural guidelines, work-flows and service-level agreements) were collected, analysed and used to describe in detail how the project financing was carried out. Emphasis was placed on understanding the actual operating procedures in the banks, the key players involved and their roles, and the governing thought processes, etc. as this was regarded as essential to understanding the role of environmental matters within the banks' processes. This rationale drew on Brown and Hill (1995), Nitz and Brown (2001) and Brown (2003) who advocate the need for environmental practitioners to immerse themselves in the processes they wish to influence in terms of potential integration of environmental considerations directly into those processes.

The results supported earlier findings that banks are primarily interested in the environment when it translates into potential financial repercussions for the bank (Gray and Bebbington 2001; UNEP FI CEETF 2004). Financial repercussions of environmental issues can be positive, in which case it is seen as a business opportunity, and negative where it represents risks (Coulson and Dixon 1995; Thompson 1998; Thompson 1998; Haque 2000; Jeucken 2001; Richardson 2002; Thompson and Cowton 2004). Four key features of projects that bankers regularly investigate when they determine whether to provide financing were identified: the cash-flow proposed for the project, the quality of the borrower, the quality of the security and the characteristics of the market for the product. When environmental considerations affected any one of these it manifested as potential financial repercussions for the project, compelling bankers to consider the environment in the project financing.

The study revealed that bankers relied on experience with similar projects, the valuation reports, and government land-contamination databases, to alert them to potential environmental risks. Only rarely did bankers review environmental studies, which they found long, technical and convoluted. A lack of useful tools to identify, assess and manage environmental issues has been identified previously as the key reason why many banks may fail to integrate environmental issues effectively into their practices (Tarna 2001; Weber, Fencher et al. 2008). Environmental issues were always communicated to decision-makers via the risk assessment system in the banks that were studied, and potential risks they foresaw were mitigated through the conditions attached to the loan.

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