Frequently Asked Questions (FAQs) on Environmental and Social Risk Management (ESRM) in Lending

ESRM and Banking

1. What is the meaning of ESRM for Financial Institutions (FIs)?

An Environmental and Social Risk Management (ESRM) system is a *framework* that *integrates social and environmental risk management* into a Financial Institution's (FIs) core business processes. It is a *set of actions and procedures* that are *implemented concurrently* with the FI's existing risk management procedures.

2. What are some of the key E&S risks banks should consider in lending?

Environmental risks: Air, water, sound pollution, waste management, land contamination, loss of biodiversity.
Social risks: Basic Human Rights, Land acquisition and involuntary resettlement, Community Health Safety and Security, Indigenous people and cultural heritage and Labour issues including Remuneration and wages, working hours, Health and safety, Disciplinary procedures, Discrimination, Child labour, Forced labour, Freedom of Association

3. Why should Banks care about E&S risks?

- If the banks' clients are impacted by litigation, fines, shutdown of business, loss of international market share due to Environmental and Social (E&S) reasons then Non-Performing Loans (***NPL)*** may increase.
- Managing E&S risk is a requirement of the Central Bank so it is a ***compliance*** issue for the financial sector. In addition, all clients must abide by all E&S related local laws and regulations.
- ***Decrease in the value*** of collateral may result from E&S issues in the collateral and there might be additional cost of cleaning up as the collateral is in the bank's book. For example, if a contaminated piece of land has been taken as collateral then it will be difficult to get premium-selling price in the market. Further, the bank might have to incur additional cost of cleaning up.
- E&S risks could lead to ***Reputational Risk***
- Financial Institutions care about E&S issues to enhance Shareholder value and ***brand*** promise. Proper E&S Management System attracts international investors.

4. A bank finances hundreds of industries and chances of fatal accident happening in any of them is quite low. Why spend time and resources for something that might or might not happen?

It is impossible to predict where and when an accident will happen, and hundreds and thousands of lives will be lost and how much of financial loss the bank will have to bear. According to 2009-2011 study, 126 workers have died only due to electrical accidents alone. There are high worker fatalities for fire, in mining sites due to mine collapse in garments industries and other manufacturing units. However, if the banks have a process in place, they know that they have measures in place for mitigating against such risk. No bank would want to be branded as one that finances polluting and unsafe industries. Industrial fatalities have become a common concern and numbers of incidents are rising every day. There has been many legal cases recently which hampers project delivery and results in delays. Therefore, unless and until some actions are taken, banks will keep on writing off loans as the E&S risks were not managed properly.

5. **We understand Climate Change is a reality but what link does it have with Banking?**

   Climate change is set to have a dramatic economic impact. It is already altering the availability of and demand for resources, supply and demand for products and services, the performance of physical assets, and the need for innovation. Failure to consider climate change in investment strategies can undermine projected financial returns and affect the non-financial risk management of institutions, particularly on development, environmental, and social issues. For example, extreme events like flood and drought or cyclone may disrupt supply chain, CAPEX and OPEX might increase, workers and staff might be impacted, or their productivity might decrease. Therefore, bankers need to identify these risks prior to lending.

Applicability of the ESRM Implementation Manual

6. **Will asking about E&S issues create barrier to accessing finance for businesses?**

   No. Just like any other risk, E&S risk will also be considered as a core credit risk and once the process of due diligence will be streamlined, on one hand it will reduce transaction processing time, on the other it will ensure that the Banks are not financing environmentally and socially harmful businesses. The idea is to finance high-risk projects, fully knowing what the E&S risks are and managing them properly. ESRM does NOT mean saying "no" to all high-risk projects.

7. **Financial Inclusion is important for Pakistan. If we ask so many questions to our micro and small clients, then they will have difficulty in accessing bank funds. How do we deal with this situation?**

   The ESRM Implementation Manual takes a risk-based approach. The E&S footprint of Micro and Small businesses is very limited. If they are not involved in any Exclusion List activities like having child labor or involved in gambling or alcohol, Banks can finance the same and there is no need for any additional due diligence. The ESRM Implementation Manual provides a threshold for different types of transactions and there are different tools and checklists introduced to reduce unnecessary work burden of banks/DFIs.

8. **Will there be any threshold for such E&S due diligence for example loans as small as Micro or SMEs will not require to go through this process?**

   The process of due diligence will be different for Microfinance and SMEs as compared to that for bigger loans. The standards will not be compromised but the due diligence will be much lighter for small businesses for the obvious reason that their impact on the environment and society is not that significant.

9. **If the bank is struggling to recover money and the transaction is a Non-Performing Asset, then what is the point of imposing E&S rules for that transaction?**

All new loan proposals (received after the issuance of the ESRM Implementation Manual) for the applicable categories will have to be screened against required E&S standards. The requirements of this Implementation Manual will not be applicable for earlier loans in the banks/DFI's portfolio or loans that have been marked as Non-Performing Asset or for restructuring. However, for renewal ESDD will have to be done.

10. Is the ESRM Implementation Manual going to override the Green Banking Guideline rolled out by SBP in 2017?

No. The ESRM implementation Manual has been designed to help Banks/DFIs in compliance of SBP's Green Banking Guideline (GBGs). The GBGs have three main pillars: Managing Environmental risk in lending, Green Business Facilitation and Own Impact Reduction. The ESRM Implementation Manual provides procedures, tools and templates related to the first pillar of managing environmental impact in lending with an addition of social risks.

11. Banks/DFIs have developed Green Banking Policy as a requirement for SBP's Green Banking Guideline issued in 2017. After the ESRM Implementation Manual is issued, what will the banks/DFIs required to do?

The ESRM Implementation Manual provides a template for developing Banks/DFI's E&S policy and procedure. Once the Implementation manual is issued, banks/DFIs will need to develop E&S Risk Management policy and ESMS (procedural document) in line with the guidance provided in the implementation manual and align with the bank's credit approval procedure for managing E&S risks adequately.

12. The Green Banking Guidelines have both Green Finance and Environmental Risk Assessment. Why is a new Implementation Manual needed? Should the Banks scrap everything that has been done so far and start from scratch?

The ESRM Implementation Manual builds on the work banks and DFIs have conducted after the Green Banking Guidelines were issued in 2017. Therefore, progress made to date still holds and there is no duplication. This ESRM Implementation Manual only provides tools and procedures to strengthen implementation of the Green Banking Guidelines.

The ESRM Implementation Manual introduces the following features to be more streamlined, interactive, and user-friendly in nature:

- The manual provides a robust, auto-generated quantitative risk rating system to reduce the subjectivity of a qualitative risk assessment method listed in the Green Banking Guidelines.
- The manual has a bigger focus on social and climatic risks, which are becoming relevant and crucial for Pakistan.
- The E&S Due Diligence (ESDD) Checklist in the manual incorporates guidance notes to assist Relationship Managers in performing E&S due diligence.

- The manual, in addition to investment threshold, defines applicability based on sector-specific E&S impacts and the loan categories have been expanded to include retail, trade, microfinance, small and medium enterprises (SME), corporate financing, and project financing. The manual introduces a differentiated risk-based approach.
- The organizational roles and responsibility defined in the manual are built upon the principles of integration of E&S risks into a bank or FI's overall credit policy. The manual clearly delineates the responsibility of different functions of a bank/DFI in terms of E&S risk assessment and the decision-making process based on E&S risk rating.

13. If a bank plants 5000 saplings along Lahore-Islamabad Highway, can that be considered as ESRM?

Planting 5000 saplings is a great initiative and shows the bank's commitment towards the environment and this activity is considered as Corporate Social Responsibility (CSR). However, it is not enough. When a bank identifies and manages its E&S risks in their lending products and services, it is considered as ESRM, which is part of their credit appraisal process.

ESMS Implementation

14. What challenges do the FIs Face in implementing ESRM?

- Lack of resources both in terms of personnel and physical
- Lack of training for employees and lack of understanding of the clients.
- Lack of leadership and guidance from senior management.
- Time consuming and perceived as additional work burden

15. What is the current practice in the FIs in terms of ESRM?

The current level of implementation varies significantly from bank to bank. Some banks don't have any processes in place to identify and manage E&S risks, other's collect IEE and EIA report and NOCs as a procedure, some international banks follow their global policies and processes in managing E&S risks.

16. Why is it not enough to rely on government approvals and licenses? Why do banks need to do their own E&S due diligence?

- The process of IEE and EIA is for transactions beyond a certain threshold. There are no specific requirements for SMEs where there are risks of pollution, child labor, discrimination and harassment, unsafe working conditions etc.
- IEE, EIA and NOCs come with definite recommendations. Since the banks don't have any process of dealing with E&S risks, these recommendations may not be considered while making credit decisions nor are they monitored for compliance leading to a situation where these risks are left unattended and unmanaged, so the banks need to put in place policy and processes to manage E&S risks in lending.

- The banks are investing money and its only prudent to identify all risks including E&S risks. They do site visits prior to lending and instead of relying only on licenses and permits they see first-hand the situation in a client's operation, thus best suited to do proper E&S due diligence.

17. What is an ESMS?

An Environmental and Social Management System is a set of policies, procedures, tools and internal capacity to identify and manage a financial institution's exposure to the environmental and social risks of its clients/investees.

An Environmental and Social Management System states a financial institution's commitment to environmental and social management, explains its procedures for identifying, assessing and managing environmental and social risk of financial transactions, defines the decision-making process, describes the roles, responsibilities and capacity needs of staff for doing so and states the documentation and recordkeeping requirements. It also provides guidance on how to screen transactions, categorize transactions based on their environmental and social risk, conduct environmental and social due diligence and monitor the client's/investee's environmental and social performance.

18. What are the costs involved in setting up an ESMS in a Bank?

The main cost of implementing ESMS is training staff to understand the E&S risks in lending. The banks can train their own trainers or key staff and these trainings are currently being offered by IFC and SBP. Developing an ESMS is done in-house, and all the tools, templates and checklists are provided in the ESRM Implementation Manual so there is no need to hire a consultant to set up the process. EIA or ESIA and the cost of doing the same is borne by clients and not by the bank. Only in the case of large and complex project finance where additional information is required to make a credit decision, the banks may hire independent consultants/ firms to carry out a study. This might incur cost for the bank if the client is not willing to pay for it.

19. NEQS have already classified different sectors as High, Medium and Low risk as per E&S risks. Why can't Bank's follow this classification? Why do bankers need to do their own E&S due diligence?

NEQS classification is at the sectoral level and that Banks are required to do E&S due diligence at the transaction level. The NEQSs classify industries based on their pollution level, the industries with liquid effluents are classified into three categories (A, B or C) while the industries with gaseous emissions are classified into two categories (A or B). As an example, a leather processing unit may be classified by NEQS as high risk given the toxic liquid effluent they discharge, however the bank might be financing an ISO certified Leather Unit that has robust procedures in place to manage all its liquid waste, has an Effluent Treatment Plant so no polluted water is discharged. In this case, the bank might categorize this client as low risk. Therefore, banks will need to consider NEQs classification to understand the level of E&S due diligence that would be required, however Banks will need to do their E&S due diligence at transaction level to make an informed credit decision.

20. In case of loan files, what sort of documents need to be maintained in loan files?

Some banks have online systems and information is stored digitally while others maintain documentation in physical files. Every loan file should have a fully completed ESDD checklist, copies of all permits, Environmental Protection Agency clearance certificate/ NOCs, fire license, factory license, buyer's audit report, ESAP, E&S covenants in the loan agreement, and subsequent supervision reports following disbursement.

21. Clients are reluctant to provide any E&S related information. They will not sign a loan agreement that has E&S clauses in it and the Bank will just lose the client. What can the bank do?

First, the ESRM Implementation Manual is issued by SBP and all banks in Pakistan would be requesting similar information from the clients. Which means there will be a level playing field for managing E&S risks and the banks will not lose business. If E&S risks are identified and not included in legal documents, then there is no way a client can be compelled to comply with the E&S requirements. Gradually, clients will understand that in order to do Banking in Pakistan, they will need to comply with local laws and regulations.

22. What can a Bank do if the borrower does not implement E&S Action Plan post disbursement?

Banks/DFIs first need to identify the gaps, document them in a time bound action plan, which will be part of the loan agreement to make sure clients do comply. In the action plan there might be condition precedents--- things the client will have to do before the first disbursement. There might be covenants, which will be considered events of default--- if the client does comply, the bank may move out of the transaction and the loan will be prepaid. For example, if the client starts employing child labor in its operation knowing fully well its an excluded activity. If there are other challenges in implementation, maybe the client does not have the capacity or the resources, maybe they have applied for a license but there are delays at the government office--- the RM will initiate fresh discussion with the client, draw up a revised action plan and the client's risk rating might be revisited.

23. What has been done to enhance ESRM implementation so far?

- An Environmental and Social Risk Management (ESRM) Implementation Manual has been developed, which will complement SBP's Green Banking Guidelines issued in 2017.
- Awareness raising for the financial sector is ongoing (both Bankers and Trainers)
- SBP will be actively monitoring progress of the implementation of the ESRM Implementation Manual, so a Green Banking Monitoring and Evaluation Reporting Template has been included in the Manual.