

Guidance: Regulatory compliance checking

What is a regulatory compliance check?

EBRD requires FIs to establish whether or not the company concerned in a transaction is in compliance with environmental and social (E&S) legislation and regulations and is likely to remain so during the period of the transaction. This includes all relevant laws and regulations with respect to the environment, health and safety, labour and community impacts.

FIs should check that the company is in compliance with all relevant environmental, health, safety and labour regulations and permits. Copies of the documentation that warrant and/or demonstrate compliance should be kept with financial documentation.

Applicable legislation and regulations will vary by business sector and country.

Why should FIs check regulatory compliance?

It is in the FIs' interest that companies' activities comply with relevant E&S laws and standards. Failure to do so may result in operational delays, fines and penalties for damages or charges for remedial action, and may affect the viability of the company and/or the value of any security taken.

Further, in certain circumstances, the FI may become liable for a company's actions if it provides finance to a company that is/was operating illegally. For example in some countries, the FI would become liable for contaminated land/property where the FI (i) was exercising management control over; or (ii) had become the "owner for the time being" (e.g. where the original polluter cannot be found/pursued), of such contaminated land/property. This is especially the case if damage, pollution or injury is caused and the company responsible can no longer be found by the regulatory authorities.

How do FIs carry out a regulatory compliance check?

In general, compliance can be checked by:

- securing warranties from the company to confirm compliance with all relevant legislation and regulations;
- examining permits, inspection reports and associated documentation to ensure permits are current, corrective actions mandated by inspection bodies are implemented and to compare permitted emission limits with those measured at the site; and/or
- contacting regulatory/enforcement authorities to obtain their assessment of the company's compliance, and what action (if any) they have taken or intend to take. Regulatory authorities should also be able to provide information on any imminent changes in E&S regulatory requirements.

Please refer to EBRD's E&S risk management procedures for guidance on the type of regulatory compliance check required, based on the risk level of the transaction.

How do I know which laws or regulations need to be complied with?

It is often difficult for a FI to know which E&S laws or regulations a potential customer or investee must comply with. The most authoritative source will normally be the local governmental and regulatory authorities that have responsibility for environmental, health and safety, and labour matters.

In some higher risk transactions, it may be useful to contact the regulatory authorities to establish their opinion and requirements regarding the company's current and future E&S compliance. FIs may also wish to

engage specialists to support when carrying out detailed checks (e.g. checking site permits/licences) for higher risk transactions.

FIs should bear in mind that an operating permit for a business does **not** necessarily prove that it is operating legally – such a permit may only set out permitted emission levels. A company could have a valid permit and yet be operating illegally, due to emissions to air or water being above the limits specified in its permit.

FIs should also be aware that the absence of enforcement action by the authorities does not necessarily demonstrate legal compliance, as many regulatory authorities lack the resources to make frequent inspections. A regulator’s failure to enforce environmental, health, safety or labour laws may itself be illegal, and open to challenge in the courts from other interested parties such as local residents or environmental pressure groups.

What if a company is not in compliance?

FIs are normally required, through their agreements with EBRD, to ensure that their customers or investees comply, at a minimum, with local and national environmental, health, safety and labour standards and regulations.

In reality, companies may not always be fully compliant with legislation or regulation. Where a company is unable to provide evidence of compliance or there is evidence of regular or serious breaches in compliance, this fact should be included in the transaction documentation. FIs should form a judgement as to whether the transaction should be refused on these grounds or approved subject to improvement conditions aimed at achieving compliance.

In deciding whether to accept or reject the transaction where the company is not fully compliant, FIs should judge the following factors:

- the severity of the breach and its impact (e.g. any pollution that may be occurring as a result);
- whether the company has the willingness and resources to achieve compliance within a reasonable and specific time frame;
- the available opinions of regulators
- the cost of achieving compliance or the financial consequences of non-compliance (and the consequent impact on the borrower’s credit worthiness); and
- any resulting financial, legal or reputational risk to the FI.

If the FI believes that the operations of the company concerned pose a significant risk to human health or the environment, that its compliance breaches are likely to result in unacceptable financial or reputational consequences, or that the costs of achieving compliance are prohibitive for the company, then the transaction should be rejected.

If the FI has good reason to believe that the company can achieve compliance and improve its E&S performance within the transaction lifetime, consider approving the transaction. If approved, agree an E&S corrective action plan, which sets out how the company will achieve compliance, improve E&S performance and the costs, responsibilities and timelines for doing so. Include this plan as a covenant in financial documentation.

“Deep pocket” syndrome

The appearance of a new financial partner, such as a bank or new investor, and new management may in some cases change the status quo, and encourage regulatory authorities to take a tougher line on enforcement of E&S legislation if they perceive that a company has the finance available to invest in improvements (the so-called “deep pocket” approach).

It is therefore prudent to assume that a company will have to comply with the letter of the law on E&S legislation, and financial projections should reflect this. You should aim for your customers or investees to achieve full compliance with local E&S regulations as soon as possible.

If the business is non-compliant when the transaction is agreed, encourage the company to discuss and agree a compliance plan with the regulatory authorities. This will help regulators understand the company's position and minimise the risk of any "deep pocket" approaches by the authorities.