# Environmental and Social Risks

## 1. Introduction

The global financial community is increasingly becoming aware that environmental and social (E&S) issues associated with customers' business activities can create risks to financial institutions themselves. E&S impacts caused, or perceived to have been caused, by a business can result in consequences such as production delays, negative publicity, threats to operating licences and unforeseen expenditures. These impacts can, in turn, result in risks for FIs that invest in, or lend to, these businesses.

EBRD has a mandate to promote sustainable development through its lending and investment activities, and fostering sustainability is one of EBRD's highest priorities. EBRD expects its financial intermediaries (FIs) to implement E&S risk management systems in order to support this mandate, as well as to limit their own exposure to risks associated with inadequate E&S performance.

## 2. What are E&S risks?

E&S risks are the potential negative consequences to a business that result from its impacts (or perceived impacts) on the natural environment (i.e. air, water, soil) or communities of people (e.g. employees, customers, local residents).

Failure to effectively manage E&S issues in a business can lead to a range of financial, legal and reputational consequences for the company, examples of which can be found below:

*Financial impacts*

- Costs associated with remedying contaminated land to enable sale, meet legal requirements or avoid damage to employees' health
- Write-downs of asset value due to irremediable contamination or obsolescence of equipment
- Low productivity due to lost time caused by a high rate of workplace accidents
- Unexpected costs associated with meeting regulatory compliance requirements or payment of fines

*Legal impacts*

- Fines for non-compliance with environmental, sanitary, health, safety and labour laws
- Legal obligations to restore land used for waste disposal (landfill) or resource extraction at the end of the project's economic life. There may also be unexpected costs associated with such requirements
- Damages arising from legal liability for damage to the environment, human health or property (e.g. compensation claims)
- Suspension of operations by regulators or due to an accident or fire

*Reputational impacts*

- Loss of sales due to a poor public perception of the company or its products (e.g. food hygiene scares, labour violations)
- Increased recruitment/induction costs and lower productivity due to poor reputation or E&S incidents, e.g. chemical spills

Although FIs have their own direct E&S impacts, e.g. energy use, their principal exposure to E&S risk arises – indirectly through lending or investing – from their corporate customers' business activities. As outlined above, a company's management of environmental or social issues can impact its business. This can, in turn, impact FIs. For instance, a customer may be unable to service a loan due to E&S-related cash-flow problems, or the FI may face reputational damage through association with a client's E&S impacts.

### 3. What are the potential consequences of E&S risks for FIs?

A company's E&S performance is likely to have financial, legal and reputational implications for its business, as well as for the FI. It is important that these implications are understood, considered and addressed during transaction appraisal and in subsequent monitoring activities, in order to minimise and manage the risk to the FI.

Examples of risks to FIs from customers' or investees' failure to manage E&S performance are found below.

#### *Financial impacts*

E&S issues can create financial pressures on a client that impact its performance, which may reduce the value of the business or ability to service a loan, resulting in the loan being restructured or written off (in the case of a borrowing client).

Where FIs take collateral or own assets (e.g. during security enforcement procedures) that become associated with poor E&S performance, they may also face costs related to the impairment of the saleability or value of that collateral.

#### *Legal impacts*

In some cases, FIs may be held legally liable where they are deemed to be the legal owner of assets or a business that caused, or is causing, damage to the environment, human health or property.

#### *Reputational impacts*

Where a customer or investee company has been involved in E&S incidents, the FI may also face negative media and stakeholder attention due to its association with the company. This can result in stakeholder campaigns against the FI, loss of retail and/or business customers, and may even impact its market value.

### 4. What are the key drivers of E&S risk for FIs?

The key drivers of E&S risk for FIs are related to the characteristics of their corporate customers and investments. The four key drivers are:

- *Sector*: Businesses whose operations are highly dependent on access to natural resources, such as those in the oil, gas and forestry sectors, often face a high level of environmental risk. Similarly, businesses whose operations pose significant health and safety hazards to workers or have significant socioeconomic impacts on local communities, such as mining, often face a high level of social risk.
- *Geography*: Different kinds of E&S risk are more or less prevalent in different parts of the world. For example, in some regions, issues such as child labour may be common. In another example, climate change is expected to have varying impacts around the world, e.g. an increase in the risk of drought in some regions and an increase in flood risk in others.
- *How the business understands and manages E&S risk*: A number of factors can affect a business's understanding of, and ability to manage, its E&S risks. For example, a business might face significant inherent E&S risks but also be sufficiently financially robust and competent to manage them. A company that has historically paid close attention to E&S issues may have fewer risks and liabilities than a company that has ignored them.

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- *Indirect risks*: Indirect risks are risks arising from a business's value chain, i.e. its suppliers and customers. In some sectors, indirect risks can be more material than direct risk and can have major consequences for the business. For example, a clothing manufacturer could face significant increases in the cost of cotton if its supplier is required by new environmental regulations to install new technology to reduce water waste.

### 5. How can FIs manage E&S risk in their business activities?

EBRD expects FIs to implement E&S management systems (ESMS) in order to identify, assess, manage and monitor E&S risks in their business activities, as well as in their own operations.

An ESMS should utilise a risk appraisal process in order to:

- make an informed decision on whether the E&S risk associated with the transaction is acceptable;
- control E&S risks associated with the transaction; and
- realise any potential E&S benefit associated with the transaction.

It is important to note that there may be E&S opportunities for FIs, e.g. providing financial services to support customers in putting energy efficiency measures in place or accessing markets for sustainable products.

An ESMS should be driven by an overall strategy and policy commitments and have a clear governance framework. It should be supported by management information, the technology to meet its objectives and communication with relevant stakeholders, such as EBRD. Further details and guidance on developing an ESMS are available in the EBRD Environmental and Social Risk Management Manual for FIs (E-manual).