

# **Environmental Governance in International Banking**

Exploring the Emergence of the Equator Principles

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## Declaration

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# **Environmental Governance in International Banking: Exploring the Emergence of the Equator Principles**

## ***Abstract***

Voluntary business regulation at the transnational level is becoming a significant feature of global environmental governance. The thesis considers the origins of the Equator Principles, a voluntary code of conduct created by commercial banks to manage environmental and social risks associated with project financing in developing countries. Based on the operational policies of the International Finance Corporation (IFC), the framework has thus far been adopted by over 60 commercial banks since its launch in June 2003, representing over 85 percent of the global project finance market.

The thesis argues that the rise of private environmental governance in the commercial project finance market is closely linked to the emergence and diffusion of environment and social norms in the international system. It traces the normative origins of the Equator Principles to the theory and practice of environmental project review first institutionalized at the World Bank in the early 1970s, then later expanded and applied to the IFC's private sector projects as well. The thesis argues that the rise of a corporate accountability movement in the financial sector was the principal reason why commercial banks decided to collaborate and create a common industry standard based on environmental and social norms institutionalized in multilateral institutions.

It makes three main contributions to our understanding of private environmental governance formation. First, the power of transnational advocacy groups to influence corporate behavior is determined by the legitimacy of the norms they promote as well as political opportunities presented by market structures. Secondly, international organizations are increasingly facilitating and legitimizing voluntary business regulation as the most effective institutional form of governance for integrating public interest concerns into transnational markets. And third, voluntary business regulation, such as the Equator Principles, is positioning private actors and forms of authority at the center of transnational rule-making processes, producing systems of rules that both challenge and reinforce international law, regimes and institutions.

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## ***Abbreviations***

ABI	The Association of British Insurers.
ADB	The Asian Development Bank.
AfDB	The African Development Bank.
AFL-CIO	The American Federation of Labor and Congress of Industrial Organizations.
APP	Asia Pulp and Paper.
BBA	The British Bankers' Association.
BCSD	The Business Council on Sustainable Development (now World BCSD).
BMU	The German Federal Ministry for Environmental Protection, Conservation and Nuclear Reactor Safety.
BOO	'Build-Own-Operate'.
BOOT	'Build-Own-Operate-Transfer'.
BOT	'Build-Own-Transfer'.
BP	(The World Bank's) Bank Procedures.
CAO	(The IFC's) Compliance Advisor/Ombudsman.
CERCLA	(The United States) Comprehensive Environmental Response, Compensation and Liabilities Act.
CERES	Coalition for Environmentally Responsible Economies.
CIEL	The Center for International Environmental Law.
CIFOR	The Center for International Forestry Research.
CRBM	Campagna per la Riforma della Banca Mondiale.
EA	Environmental Assessment.
EBRD	The European Bank for Reconstruction and Development.
ECA	Export Credit Agency.
ECOSOC	The United Nations Economic and Social Council.
ED	(The World Bank's) Environment Department.
EIA	Environmental impact Assessment.
EIRIS	Ethical Investment Research Service.
EMP	Environmental Management Plan.
EMS	Environmental Management Systems.
EP1	The Equator Principles (original version, June 4, 2003)
EP2	The Equator Principles (revised version, July 6, 2006)
EPA	(The United States) Environmental Protection Agency.
EPFIs	Equator Principles Financial Institutions.
FDI	Foreign Direct Investment.
FOE	The Friends of the Earth.
FSC	The Forest Stewardship Council.
GATT	The General Agreement on Tariffs and Trade.
GEF	The Global Environment Facility.
GP	(The World Bank's) Good Practices.
GRI	The Global Reporting Initiative.
ICC	International Chamber of Commerce.
IDB	The Inter-American Development Bank.
IFC	International Finance Corporation.
IIC	The Inter-American Investment Corporation.
ILO	The International Labor Organization.
IMF	The International Monetary Fund.
IPE	International Political Economy.
IPO	Initial Public Offering
IRN	The International Rivers Network.
ISO	The International Standards Association.
IUCN	International Union for the Conservation of Nature and Natural Resources.
MAI	The Multilateral Agreement on Investment.
MIGA	The Multilateral Investment Guarantee Agency.

NEPA	(The United States) National Environmental Protection Act.
NGO	Non-Governmental Organization.
NWF	The National Wildlife Federation.
OCP	Oleoducto de Crudos Pesados (pipeline)
OD	(The World Bank's) Operational Directives.
OEA	(The World Bank's) Office of Environmental Affairs.
OECD	Organization for Economic Co-operation and Development.
OED	(The World Bank's) Operations Evaluations Department. (now Independent Evaluations Group (IEG))
OP	(The World Bank's) Operational Policies.
OPIC	The United States Overseas Private Investment Corporation.
PPA	Power Purchasing Agreement.
PPAH	(The World Bank's) Pollution Prevention and Abatement Handbook.
PRI	(The IDB's) Private Sector Development Department.
RAN	The Rainforest Action Network.
RBS	The Royal Bank of Scotland.
RED	(The World Bank's) Regional Environmental Divisions.
SEC	(The United States) Securities and Exchange Commission.
SPI	(The World Bank's) Summary Project Document.
SRI Funds	Socially Responsible Investment Funds.
TNC	Transnational Corporation.
UN	The United Nations.
UNCED	The United Nations Conference on Environment and Development.
UNCHE	The United Nations Conference on the Human Environment.
UNCTC	The United Nations Centre on Transnational Corporations.
UNDP	The United Nations Development Program.
UNEP FI	The United Nations Environment Program Finance Initiative.
UNESCO	The United Nations Educational, Scientific and Cultural Organization.
USCAP	The U.S Climate Action Partnership.
WBCSD	The World Business Council on Sustainable Development.
WestLB	West Deutsche Landesbank
WRI	The World Resources Institute.
WSSD	The World Summit on Sustainable Development.
WWF	The World Wildlife Fund.

## ***1. Introduction: The Greening of Global Project Finance***

### **Introduction**

Capital is crossing national boundaries like never before. The increasingly permissive environment for global capital has enabled a dramatic growth in the scale and pace of financial market transactions, resulting in unprecedented profits for transnational investors. While recent events have also illustrated the risk that banks are exposed to in this integrated market environment, their revenue potential has increased remarkably during the past two decades. Alongside the deregulation of banking in OECD countries, financial globalization has produced a new tier of global banks that are increasingly influencing the distribution of long-term capital across countries and industry sectors. Whether providing financing in support of commercial logging in Indonesia, oil and gas production in Central Asia or telecommunications infrastructure in Nigeria, the growth of commercial financing directly to development projects have made global banks central to the national economic development aspirations of many countries.

While such projects often stimulate economic growth by expanding exports, they may also generate significant adverse impacts on the environment and local communities. As a result, transnational corporations (TNCs) operating in developing countries (and the commercial banks that finance their expansion) are increasingly facing public demands for greater corporate accountability and transparency, as host country laws and regulations are often deemed inadequate or poorly enforced. In the 1990s, the commercial project finance industry became the source of much criticism from environmental activists because of the ecological and social harms associated with large, capital-intensive projects, such as power plants, open-pit mines, pipelines, and ports. It manifested itself in public campaigns against several commercial banks with a long-standing presence in the project finance market being accused of encouraging deforestation in Indonesia, undermining the human rights of indigenous people in Ecuador, or fueling corruption in Chad.

In June 2003, ten large commercial banks announced their joint intention to voluntarily apply the World Bank's environmental and social standards and project review procedures to their project financing worldwide. By adopting the Equator Principles, they publicly declared a commitment to screen all project proposals for adverse environmental and social impacts. Under the framework, they must require borrowers of funds for large projects to commission environmental impact assessments (EIAs), conduct consultations with project-affected communities, and develop an environmental action plan that identifies mitigation measures and benchmarks. In turn, compliance with the action plan would be integrated into the loan agreement between the commercial bank and the borrower, and a violation of it could in principle be used by the commercial bank as a legal justification to withhold loan disbursements.

Hailed as a milestone in the evolution of responsible lending practices, the Equator Principles have become the most well-known and far-reaching voluntary initiative in the financial sector.<sup>1</sup> It emerged out of policy discussions between leading commercial banks, in consultation with the International Finance Corporation (IFC), the private sector lending arm of the World Bank Group. To date, more than 60 financial institutions - including Barclays, HSBC, Citigroup and ABN Amro - have publicly declared a commitment to apply the framework to their project financing, representing over four-fifths of the global project finance market. This remarkable support for the policy framework within the commercial banking industry stands in sharp contrast to the situation less than a decade ago, when commercial lenders commonly argued that applying the World Bank's standards to their project finance investments was not within their commercial mandates to maximize shareholder value. More broadly, this attitude reflected the long-standing view that a private financial institution could not and should not restrict the decision-making autonomy of borrowers on matters not directly relevant to the financial risk of the project loan.

Against this backdrop, the primary objective of this thesis is to explain why the Equator Principles emerged and subsequently gained widespread approval among commercial banks operating in the global project finance market. More specifically, why would commercial banks voluntarily subject their project financing activities to a set of public standards at a time when their financial power in the global economy was unprecedented and growing? On the back of extraordinary profits, it seems counterintuitive that they would publicly announce their commitment to apply a due diligence framework that curtails their decision-making autonomy when making financing decisions about large projects, and requires borrowers to undertake impact mitigation measures that may add both time and cost to project preparation. In an increasingly competitive marketplace, financial institutions that apply such practices could very well lose business in cases where potential borrowers do not see the commercial value in abiding by them and have access to alternative sources of project financing with no such strings attached.

The emergence of the Equator Principles reflects a broader trend in global governance towards the greater inclusion and influence of private actors in transnational rule-making. The recent decade has seen a proliferation of new forms of private governance that organize TNCs around sets of voluntary commitments to responsible corporate conduct. In many cases, they aim to capture the efficiency gains that stem from harmonizing business norms and practices across national jurisdictions. These initiatives often take the form of voluntary codes of conduct, industry standards and guidelines that define norms for corporate behavior in relation to a wide variety of public interest concerns, such as human and civil rights, environmental issues, corruption, and labor.<sup>2</sup> For example, the Coalition for

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<sup>1</sup> The document that describes the Equator Principles, as well as press releases from all the financial institutions that have adopted them, can be found at [www.equator-principles.com](http://www.equator-principles.com). (See Appendix 1)

<sup>2</sup> For brief overviews, see Bendell (2004), pp.25-28, Lipchutz and Fogel (2002), pp. 125-129, Newell (2001), pp.91-95, and Utting (2005), pp.2-3.

Environmentally Responsible Economies (CERES) emerged out of discussions between companies, environmentalists and churches, calling on the private sector to reduce pollution, conserve non-renewable resources, and use sustainable energy as evaluation criteria for selecting Board members. Similar voluntary regulation is facilitated by the World Business Council on Sustainable Development (WBCSD), the International Chamber of Commerce (ICC), and the U.S Climate Action Partnership (USCAP).

Therefore, the Equator Principles is a useful case study for studying broader institutional transformations in global environmental politics, particularly the growth of private rule-making processes at the transnational level. The next section will briefly present the theoretical approach that will be employed.

### **1.1 The Equator Principles and International Norms**

In advancing our understanding of why private governance emerges, it will argue that an analysis of the timing, content, and institutional design of institutional arrangements hold many clues as to why private actors are able and willing to collectively organize themselves behind a common framework.<sup>3</sup> In explaining the timing of the Equator Principles, the analysis finds that the growing interest in environmental and social lending policies among commercial banks was intimately tied to the emergence of a broader corporate accountability movement in Western Europe and North America in the late 1990s.<sup>4</sup> This broader movement was comprised of a loosely connected network of non-governmental organizations (NGOs), which included environmental and human rights activists, and religious and consumer groups, and converged around a perceived need to set and enforce standards for responsible business practice and hold TNCs accountable for their impacts on the environment and local communities.<sup>5</sup>

In the financial sector, this movement consisted primarily of ‘transnational advocacy groups’, or NGOs organized in transnational networks that mobilize domestic

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<sup>3</sup> In this context, ‘governance’ can be defined as ‘the creation and implementation of rule systems that facilitate the coordination and cooperation of social actors and determine the distribution of costs and benefits of collective action.’ (Koenig-Archibugi 2006, p.3)

<sup>4</sup> For a discussion of TNCs and public accountability, see Koenig-Archibugi (2004). For an overview of the emergence of a ‘corporate accountability movement’ in the United States and Europe in response to globalisation, see Bendell (2004). For further examples of environmental NGO campaigns against the corporate sector, see DeWinter (2003), Keay (2002) and Wapner (2002), pp. 43-46. For examples of campaigns against private financial institutions, see Emel (2002).

<sup>5</sup> DeWinter (2003), p.141. In general terms, an NGO is taken here as being an organization that is both ‘non-profit’ and ‘non-governmental’ (Bendell 2004, pp.12-13) But in more specific terms, the ECOSOC statute of the U.N states an NGO cannot 1) be a profit-making body; 2) should support the aims and work of the U.N., 3) should repudiate violence; 4) should be a representative body with an identifiable headquarters, and officers, democratically accountable to a policy-making conference; 5) should respect the norm of ‘non-interference in the internal affairs of states’, barring it from being a political party, and 6) cannot be established by an inter-government agreement. (adapted from Willets 2005, pp. 436-37)

pressure against TNCs that operate in developing countries.<sup>6</sup> Their growing influence manifested itself in a series of public campaigns against leading commercial banks involved in controversial development projects that were associated with widespread environmental damages.<sup>7</sup> In response to this development, commercial banks, and TNCs more generally, felt pressured to justify their pursuit of profit by demonstrating how their corporate activities benefited a wide variety of public policy objectives.<sup>8</sup> As such, commercial banks were initially forced to engage with environmental NGOs through the media and defend their practices. During this process, many admitted negligence or ignorance and introduced corporate environmental policies in an attempt to prevent future controversies and protect their reputation in the retail banking market.

In terms of its content, the Equator Principles are directly based on the environmental and social review procedures of the IFC, as well as the World Bank's environmental standards. As the foremost public financier of private infrastructure in developing countries, the IFC was influential in developing standards for commercial project financing, and aiding commercial banks reach an agreement. From the commercial banks' point of view, choosing to base the Equator Principles on the IFC's standards was driven by two objectives; to reduce the likelihood of public confrontations in the media with advocacy groups over the adverse impacts of large projects in developing countries, and to facilitate the harmonization of standards among both public and private financial institutions in order to increase efficiencies and prevent a 'race to the bottom' in environmental and social risk management practices. Achieving both of these objectives depended on negotiating a delicate balance between making public commitments to ethical financing while maintaining market competitiveness by keeping the cost of capital down.

Yet, the reputational damages caused by media controversies over particular projects meant commercial banks felt compelled to reassure the public that adverse environmental and social impacts would be identified and mitigated in order to restore the public legitimacy of commercial project financing. More specifically, it was no longer publicly acceptable for commercial banks to consider project financing purely as a financial transaction without recognizing and managing the broader development impacts of projects. In this respect, policy development was primarily driven by a need to meet broader standards of appropriateness defined by changing public expectations of corporate behavior, while ensuring that the cost of implementing the standards in their internal financing operations would not be prohibitive.

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<sup>6</sup> Keck and Sikkink (1998)

<sup>7</sup> See Missbach (2004) for a NGO perspective on the lack of environmental and social governance in commercial project financing.

<sup>8</sup> This dynamic between advocacy groups and TNCs is common across industries, see Jenkins (2001) and Newell (2001). In recent years, socially responsible investment funds (SRI funds) have increasingly put pressure on industry to align their practices with international environmental and social norms. (Graham and Woods 2006) This can be manifested in two ways; screening of investments against a defined set of ethical criteria, and stakeholder advocacy, in which SRI funds used their voting rights as shareholders to improve corporate regulatory policy. (see ISIS 2002)

Whereas the timing and content of the framework suggests that both transnational advocacy groups and international organizations significantly influenced private governance formation, the institutional design of the Equator Principles reflected the corporate power that commercial banks exercised in transnational rule-making processes. Specifically, whereas the Equator Principles do affirm the legitimacy of well-recognized international norms that are often the cornerstone of transnational advocacy campaigns, the framework does not create any rights or liabilities to anyone. In turn, this means the standards and procedures developed by the World Bank and the IFC as mandatory requirements that could be enforced through various accountability mechanisms in their public financing operations, are in fact entirely voluntary for the commercial banks that have adopted the Equator Principles. Furthermore, the commercial banks did not to adopt the IFC's disclosure policies that identify how and when project-level information is shared. Nor did they sign on to its exclusion list that identifies certain economic activities ineligible for financing. During the drafting process, this decision was not and could not be successfully challenged by any actor, including the IFC itself. Therefore, the freedom to pick and choose which standards and procedures to adopt, and how to integrate them into commercial project lending practices, represents an important source of power for commercial banks.

More broadly, the thesis argues that the emergence and diffusion of international norms stand at the center of this development, as they determine the social context within which banks define their interests and choose particular courses of action.<sup>9</sup> As norms refer to standards of behavior that define for actors what constitutes legitimate forms of behavior, understanding how they emerge, diffuse and become prominent within given issue areas may reveal the social constraints and opportunities that shape the rational choices of actors.<sup>10</sup> In this context, the causal and normative beliefs that actors hold, or that govern a particular issue area, determine whether consensual knowledge of the policy problem emerges, what meanings are attributed to different behavioral choices, and ultimately, how actors pursue their interests.<sup>11</sup> Understanding environmental and social standards and review procedures as sets of norms implies that they should not simply be viewed as informational devices that guide decision-making, and in aggregate, increase the efficiency and effectiveness of social relations. Instead, they are deeply contested precisely because they assign rights and responsibilities to different actors, and create distinctions between legitimate and illegitimate lending practices. As a result, their value is not only for markets to decide, but are also determined by the evolution of public expectations about what constitutes legitimate corporate behavior.

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<sup>9</sup> For a thorough review of norms literature, and a theoretical framework for analyzing and understanding international norm dynamics, see Finnemore and Sikkink (1998)

<sup>10</sup> For definitions of norms, see for example Axelrod (1986), p.1096-1097, Finnemore and Sikkink (1998), pp.891-893, and Klotz (1995), pp.13-16.

<sup>11</sup> Haas (1990), p.2. In this context, interests are not perceived as the opposite of ideals or values, but rather, 'interests cannot be articulated without values' and 'the interests to be realized by collaborative action are an expression of the actors' values.'

Whereas there is a general consensus across rational and constructivist approaches that norms matter in international relations, there is great disagreement about why actors follow them. As Nadelmann (1990) notes:

‘It is difficult and often impossible to determine whether those who conform to a particular norm do so because they believe the norm is just and should be followed, or because adherence to the norm coincides with their principal interests, or because they fear the consequences that flow from defying the norm, or simply because conforming to the norm has become a habit or custom.’<sup>12</sup>

The analysis attributes the emergence and widespread endorsement of the Equator Principles to a diffusion of norms, or standards that differentiate between legitimate and illegitimate forms of behavior for particular actors. As they give meaning to certain acts and forms of behavior, norms are central to understanding why some forms of corporate conduct are at one time acceptable, while later derided as irresponsible and illegitimate. The emergence of the Equator Principles reflects how the substantive and procedural norms that have come to define responsible project lending in multilateral financing have by virtue of their legitimacy and actions of norm entrepreneurs over time diffused across public to the private financial institutions. Understanding the economic, social and political developments that precipitated and perpetuated the expanding legitimacy of these norms and their integration into the profit narratives of commercial banks is therefore a critical objective.

In this context, the dramatic transformation in the policy positions of commercial banks cannot be disassociated from the long-term resilience and widening legitimacy of the World Bank’s environmental standards for project financing. Since the early 1970s, the concept of environmental review has been considered the institutional mechanism of choice for ensuring that project lending promotes sustainable development. First introduced at the World Bank by President McNamara in 1971, it rests on the assumption that the environmental and social costs of projects can be adequately mitigated by reviewing project proposals prepared by banking staff in collaboration with borrowers. In 1987, following a period of intense conflict between environmental NGOs and several allied governments, and the World Bank’s senior management defending its banking staff, environmental review became formalized, mandatory, systematic and fully funded, and subsequently, gradually adopted by other multilateral development banks as well.<sup>13</sup> And with the Equator Principles, a significant share of the commercial banking industry has pledged to adhere to the same substantive and procedural norms aimed at protecting the environment and extending certain rights to project-affected communities.

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<sup>12</sup> Nadelmann (1990), p.480.

<sup>13</sup> In 1996, the EBRD adopted its *Environmental Policy*, and two years later, the IFC formally adopted the World Bank’s framework, thereby extending the practice of environmental and social review to private sector projects. Subsequently, export credit agencies (ECAs) pledged their commitment to these norms in 2001 under the auspices of the OECD’s *Common Approaches on Environment and Officially Supported Export Credit*.



By placing an analytical focus on norms, the thesis provides a framework for understanding time-specific institutional developments, such as the emergence of the Equator Principles, within broader long-term transformations in the global political economy. Three parallel processes are of significance here. First, TNCs are increasingly defining their role in society in the context of the gradually emerging 'corporate social responsibility' paradigm, often in response to an increasingly vociferous corporate accountability movement that is demanding regulatory constraints on transnational business.<sup>14</sup> Secondly, international organizations are increasingly establishing institutional relationships with the private sector in order to induce private actors to voluntarily integrate a wide variety of public policy objectives into their business practices. In this context, state-based authority is increasingly being used to promote and legitimize voluntary business regulation at the transnational level. And third, forms of voluntary governance that depend on market-based mechanisms for their effectiveness are increasingly being challenged by a transnational movement for corporate accountability, which promotes well-recognized norms in areas such as environment, human rights and labor in an attempt to improve the public regulation of transnational business.

The transnational perspective on norms breaks with the common tendency to place states, state power and state interests at the center of institutionalization processes at the global level. Yet, it is still instructive to review alternative explanations of governance formation. The next section outlines the main approach taken in the thesis, and subsequently considers how the most common theoretical perspectives on international relations would explain the growth of private governance in world politics, and evaluates their usefulness in relation to this study.

## 1.2 Explaining the Emergence of Private Governance

With globalization, the rise of non-state actors and private governance at the transnational level has become an important feature of world politics.<sup>15</sup> Change-inducing decision-making, it is argued, increasingly takes place 'transnationally', by a variety of public and private actors operating at different scales across interdependent issue areas, guided by competing and conflicting interests and motivations.<sup>16</sup> In the field of environment in particular, much attention has been given

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<sup>14</sup> See for example Bendell (2004, pp.12-16), DeWinter (2003), Keck and Sikkink (1998) and Newell (2001) on the role of civil society in confronting transnational business, and Jenkins (2001), Sethi (2002) and Utting (2005) on corporate institutional responses to such pressures.

<sup>15</sup> This thesis identifies with the definition of globalization used by Gilpin (2001), using it as shorthand for the integration of the world economy. In more detail, the definition by Scholte (2005) of economic globalization covers the intended use of the term in full. He refers to three overlapping processes. First, increased cross-border movements between countries of people, goods, money, investment and ideas. Secondly, the growth in open-border transactions, in which the mobility of companies, trade, money, and finance is global rather than simply international. And third, increased trans-border transactions, whereby 'social relations acquire relatively distanceless and borderless qualities'. (Scholte 2005, p.605)

<sup>16</sup> Transnational relations is defined here as 'regular interactions across national boundaries when at least one actor is a non-state agent or does not operate on behalf of a national government or an inter-

to the proliferation of transnational networks and partnerships between and among civil society groups, inter-governmental organizations, business associations and TNCs existing largely independently of the formal treaties, conventions and agreements that are typically associated with inter-state relations. This trend is best captured by the phrase 'governance without government', which refers to the role that social institutions, rather than organizations or material entities, play in solving collective-action problems that pervade social relations under conditions of interdependence.<sup>17</sup> Examples may include voluntary codes of conduct, industry standards and guidelines that define norms and standards for corporate behavior in relation to a wide variety of public interest concerns, such as human and civil rights, environmental issues, corruption, and labor.<sup>18</sup>

As most of these new forms of private governance are not rooted in a formal or legal authority with sanctioning power, there is much uncertainty as to how and why they emerge. In the study of global environmental politics in particular, but also international relations more broadly, the growing role and influence of private governance is becoming an important aspect of the evolution of international organization and institutions.<sup>19</sup> In this context, TNCs are the most important private actors, as the central organizing entities of global business and the main agents of the transformation of the world economy, and to a certain extent, the state itself.<sup>20</sup> In many areas of environmental governance, TNCs no longer hold subordinate positions to states in the drafting of standards, but exert authority by virtue of their financial resources and technical knowledge. With their growing influence, the profit motive has become increasingly accepted as a legitimate, and in some cases, vital aspect of environmental governance, leading to institutional arrangements centered on addressing the environmental and social cost of business within the parameters set by the commercial interests of private enterprise.

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governmental organization.' (Risse 1995, p.3). This was the central thesis in the literature on 'transnational relations' that emerged in the 1970s (Keohane and Nye 1974; Kaiser 1971), and has in recent years been central to discussions regarding the elevated authority and influence of non-state actors in the context of 'governance' (Arts and Verschuren 1999; Cutler et.al 1999; Haufler 2000; Hall and Biersteker 2002; Hewson and Sinclair 1999; Rosenau and Cziempel 1992)

<sup>17</sup> Young (1994), p.16. The central point of emerging literature on 'governance' is that the absence of world government does not mean that governance is impossible beyond the level of individual states. (Koenig-Archibugi 2006, p. 4)

<sup>18</sup> For brief overviews, see Jenkins (2001), Lipchutz and Fogel (2002), pp. 125-129, Sethi (2002) and Utting (2005), pp.2-3.

<sup>19</sup> As per Falkner (2003), private governance 'emerges at the global level where the interactions among private actors, or between private actors on the one hand and civil society and state actors on the other, give rise to institutional arrangements that structure and direct actors' behavior in an issue-specific area.' (p.72)

<sup>20</sup> See Michelat (1994) on how TNCs are shaping government policy. In general terms, a TNC, or company, is one that is 'based in one country that has affiliates in at least one foreign country, which may be branches of a parent company, separately incorporated subsidiaries or associates, with large minority shareholdings. (Willets 2005, p.362) Drawing on Gilpin (2001), they expand overseas primarily through foreign direct investment (FDI), whose purpose is to achieve partial or complete control over marketing, production, or other facilities in another economy; such investments may be in services, manufacturing or commodities. (p.278)

By exploring the empirical case of the Equator Principles, the thesis aims to advance our understanding of how and why systems of private governance are increasingly emerging at the global level, and what they tell us about the changing nature of power and authority in the international system?<sup>21</sup> In relation to this particular case, the thesis finds that external pressures for accountability and transparency played an important role in inducing the commercial banking industry to develop a common industry framework for managing environmental and social issues in project investments. But more importantly, the pre-existence of a set of norms and rules in the multilateral system that defined why and how financial institutions could lend profitably and responsibly essentially constituted cooperation among commercial banks, by not only defining the problem they were facing, but providing the solutions for it.

Given the significance of public sector norms and the dual role of multilateral development banks and environmental NGOs in establishing and diffusing the norm, it is too simplistic to characterize the emergence of the Equator Principles as example of the 'privatization' of global governance.<sup>22</sup> Instead, the case reveals how globalization has enabled and induced different categories of public and private transnational actors to collaborate in new, innovative ways to facilitate the integration of environmental and social concerns into transnational business. In particular, new forms of relationships between states, international organizations, NGOs and TNCs are giving rise to a new form of transnational rule-making that is de-territorialized, decentralized and often constituted by a combination of public and private norms, producing rules that can conform to the commercial imperatives of transnational business while giving recognition to long-standing environmental and social norms in the international system.

The analysis is focused on advancing our understanding of private governance formation in issue areas with 'high value content and informational uncertainty', commonly attributed to environmental protection and labor standards, and human rights.<sup>23</sup> While perhaps a marginal aspect of the totality of world politics, these institutional processes are nevertheless redefining the purpose, content and design of a sub-set of global business regulation, potentially reshaping our understanding of the relationship between private sector development, environmental degradation and poverty. In these issue areas, transnational politics are characterized by conflicts between actors over the relevance and applicability of so-called prohibition norms, or norms that circumscribe the conditions under which actors can participate in and authorize activities.<sup>24</sup> Applied to transnational business, it entails the setting of standards that bar certain types of economic and financial practices for mostly moral and ethical reasons that have in the past been deemed both profitable and legitimate.

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<sup>21</sup> For a broader discussion of political institutions, see March and Olsen (1989), pp.1-21. Applied specifically to the study of international relations, see Ruggie (1998), pp.45-62.

<sup>22</sup> See Clapp (2005) for this argument.

<sup>23</sup> Keck and Sikkink (1998), p.2.

<sup>24</sup> As per Nadelmann (1990), 'prohibition norms' are absolute restrictions on certain types of activities, such as the condemnation of killing whales, elephants or other endangered species. (p.479)

Moreover, these restrictions often serve to give laws and norms institutionalized in Western democracies extra-territorial jurisdiction, by forcing private transnational actors to comply with them when they are doing business in developing countries, regardless of whether it is required by national laws and regulations.

In most cases, private governance concerning environmental and social issues emerge from deliberative processes involving both public and private actors in which different sources of legal, technical and moral authority are combined to integrate well-recognized international norms with existing transnational business practices. A theory purporting to understand why private actors are increasingly engaging in institutionalized cooperation over environmental and social matters needs to be able to explain these broader transformations that are reshaping the process, social purpose and impact of rule-making in world politics. What is clear is that compared to the most common manifestations of international cooperation, such as multilateral diplomacy, treaties and agreements, private governance does not easily fit with the prevailing assumptions about institutionalization in international relations, because of its decentralized institutional design, the absence of formal enforcement powers and the diversity of actors involved. In particular, the marginalization of states and nationally-bound actors within these rule-making processes seems to undermine the commonly held view that states are the primary actors in global governance.

### 1.3 Theoretical Perspectives

Notwithstanding the limitations of state-centric approaches, it is still instructive to briefly survey the most common theoretical perspectives on governance formation, and consider how they may explain these developments. In the study of international relations, governance formation has been traditionally studied within one of three analytical concepts; power, interests and knowledge. In a power-based theory, governance formation manifests the power and authority of dominant states, and is a function of their material resources and capabilities. For realists, the chief proponents of this view, the basic assumption that governs their understanding of governance is that the nature of relations between actors, whether cooperation or conflict, depends upon the structure of the international political system.<sup>25</sup> In this context, governance is supplied by powerful states in their effort to ensure stability and order in world politics. In turn, they assume that dominant states provide the conditions for processes of institutionalization to emerge and evolve, and also possess the capability to bring them to an end.<sup>26</sup>

In contrast, interest-based theories point us to the positive and negative incentives that actors (notably states) face in cooperating with each other, and the institutional

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<sup>25</sup> For example, Carr (2001), Gilpin (1971), and Krasner (1995).

<sup>26</sup> See for example Gilpin (1971) and Lipson (1984). As Haufler (1999) has noted, the literature attributing regime emergence and persistence to hegemonic power integrated hegemonic stability theory to the study of international institutions, and embedded it within a liberal concern for institutional cooperation.

conditions that encourage cooperation. For neo-liberal institutionalists, governance formation is a product of rational bargaining processes between actors in which the outcome is the most efficient solution to solving coordination problems or increasing the efficiency of interactions. In this context, governance is not necessarily an expression of state power, but triggered by the emergence of favorable institutional conditions which cause a demand for governance by inducing self-interest driven actors to favor cooperation over unilateral behavior.<sup>27</sup>

In contrast to the rational ontology of these perspectives, constructivist approaches assume the identities and interests of actors are not fixed, but are constituted by norms that define standards of behavior and particular ideas about the material world.<sup>28</sup> In turn, international institutions are seen as social constructions that attribute meaning and social purpose to different forms of behavior. By virtue of their constitutive role, institutions have significant distributional consequences by attributing legitimacy to different actors, forms of behavior and interests, at the detriment of others. In this view, power is inherently socialized, and is produced and exercised in social relations which define 'who are the actors and what are the capacities and practices they are socially empowered to undertake.'<sup>29</sup> As power is embedded in social structures, institutional development and the emergence of institutionalized behavior among actors is tied to the diffusion of norms and rules. Thus, rather than reflecting shifts in material capabilities or incentives, this perspective attributes governance formation to a shift in norms. As a result, understanding why and how norms emerge and diffuse in the international system becomes an important imperative to understanding processes of international institutionalization.

Based on the characteristics of transnational governance, conventional state-based approaches to understanding processes of institutionalization in world politics do not adequately account for how and why non-state actors engage in transnational rule-making processes.<sup>30</sup> As non-state actors are not vested with the same legal and formal authority as states, their sources of power are inherently different and more diffuse, yet may in some circumstances be equal or even superior to them. For example, norm entrepreneurs, such as environmental and labor groups, may exert social pressure on both governments and TNCs by advocating certain normative beliefs and moral

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<sup>27</sup> For example, global economic integration has increased interactions between states and interdependencies between them. To illuminate the distinction between institutionalist and structural realist accounts of international relations, using the analogy of a poker game, Keohane and Nye (1989) argue that 'at the process level, analysts are interested in how the players play the hands they have been dealt. At the structural level, they are interested in how the cards and chips were distributed as the game started.' (p.21)

<sup>28</sup> For brief overviews of constructivism in international relations, see for example Wendt (1995), Checkel (2001) and Finnemore (1996).

<sup>29</sup> Barnett and Duvall (2005), p.10.

<sup>30</sup> For the purpose of analysis, Josselin and Wallace (2001) offer a useful definition of non-state actors, namely actors which are 'at least in principle autonomous from the structure and machinery of the state, and of the governmental and intergovernmental bodies below and above the formally-sovereign state: transnational, rather than transgovernmental.' (pp.3-4)

claims that de-legitimize existing state or corporate practices.<sup>31</sup> Business may use their financial resources, technical expertise and market power to exert influence over governments and engage in both international and transnational rule-making processes.<sup>32</sup> And both sets of actors are frequently involved in the creation and implementation of private forms of voluntary regulation at the transnational level.

As private governance is more informal, fragmented and voluntary-based than conventional international agreements, treaties and conventions, an approach which regards institutions as formal structures is ill-suited to understand how and why they emerge, and what determines their institutional design and social purpose. In addition, apart from being unable to capture the influential role of non-state actors in private governance, state-centric approaches also tend to bypass what seem to be the most interesting questions. For example, whereas establishing the significance of private governance requires an assessment of how states impact, or are impacted by, institutional processes at the transnational level, the arguably more interesting question is how and why non-state actors are able to legitimately project authority in ways that are commonly assumed to be limited to states. As such, this requires a theoretical perspective that does not take state power, interests or inter-state relations as a starting point. Similarly, a contrarian's view that elevates the role and influence of non-state actors over states can be equally inappropriate, and be vulnerable to the same kinds of criticisms.

Before discussing this theoretical approach more in detail, the next section will explain why the framework will be influential in the global project finance market, and more broadly, in shaping environmental and social governance in global finance.

#### **1.4 Why the Equator Principles Matter**

The analysis suggests that an in-depth study of the Equator Principles can provide many clues as to why private governance emerges and gives rise to institutionalized behavior in the private sector. The adoption of the Equator Principles is not legally binding, and compliance with them is not formally monitored or enforced. By implication, they could be easily dismissed as yet another code of conduct that does not impact core business practices in any significant way. Yet, notwithstanding their voluntary nature, corporate codes of conduct have the effect of forcing TNCs to consider the environmental and social impacts of their business practices and publicly justify their actions (and inactions) to broader constituencies, including shareholders, consumers and civil society more broadly.<sup>33</sup> As such, private governance gives birth to new forms of dialogue and authority, mobilizing intellectual energy towards reconciling commercial interests with a wide variety of public concerns. In addition,

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<sup>31</sup> On the role of norm entrepreneurs in institutional processes at the global level, see for example Finnemore and Sikkink (1998), pp.896-902, Keck and Sikkink (1998), Nadelmann (1990), and Wapner (1995).

<sup>32</sup> See Levy and Newell (2005), pp. 1-21, and Strange (1996).

<sup>33</sup> Newell (2001a), p.89.

one of the virtues of international law is the extent to which non-binding norms and principles, so-called 'soft law', can be given formal expression and hardened into binding rules that give rise to specific duties and obligations.<sup>34</sup> Therefore, in cases where voluntary guidelines are recognized by public bodies as 'best practice', there is a distinct possibility that they become legally binding in the future, which is what justifies a closer examination of them.<sup>35</sup>

Beyond this aspect, the framework has several specific characteristics that suggest it may significantly influence corporate practices and broader governance structures.

First, the mere fact that a vast majority of leading commercial banks that provide project loans in developing countries have adopted the Equator Principles suggests that the framework may significantly influence the market. As Figure 1.1 illustrates, the original ten commercial banks have since been joined by more than forty financial institutions, representing over 85 percent of the global project finance market in financing volume. As project finance is commonly provided in loan syndications, the reach of the framework goes beyond the number of signatories. When debt financing is pooled together in syndications, a leading bank arranges the debt financing and conducts risk assessments on behalf of all the banks. In this context, if the arranging bank applies the Equator Principles, all the debt financing provided through the syndication is compliant with the framework. In this way, the influence of the framework is not limited to those banks that have adopted it, but also includes those that participate in syndications arranged by Equator banks.

According to one study, the total debt amount for Equator Principle debt financing in developing countries in the first half of 2006 was roughly £14 billion, or more than 90 percent of the market.<sup>36</sup> Furthermore, only three percent of projects in developing countries were arranged and financed by non-Equator banks. According to some legal experts, this impressive market penetration means the framework may significantly inform the future development of lender liability in developing countries by setting a global benchmark for what constitutes acceptable and responsible financing practices.<sup>37</sup> This notion is backed by anecdotal evidence that some TNCs in environmentally-sensitive industries are expecting that compliance with the Equator Principles may in the future be a condition for accessing long-term capital.<sup>38</sup> As a result, a new industry of consulting, training and legal advisory services is emerging to meet the demands from commercial banks and TNCs for support in interpreting and implementing the framework.

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<sup>34</sup> See Boisson de Chazournes (2000), Clapp (2005) and Hurrell (1993). As Drahos and Braithwaite (2000) note, 'today's voluntary code secretariat provides a contractual environment and a framework that can become tomorrow's treaty when the right kind of disaster supplies the catalyst. (p.274)

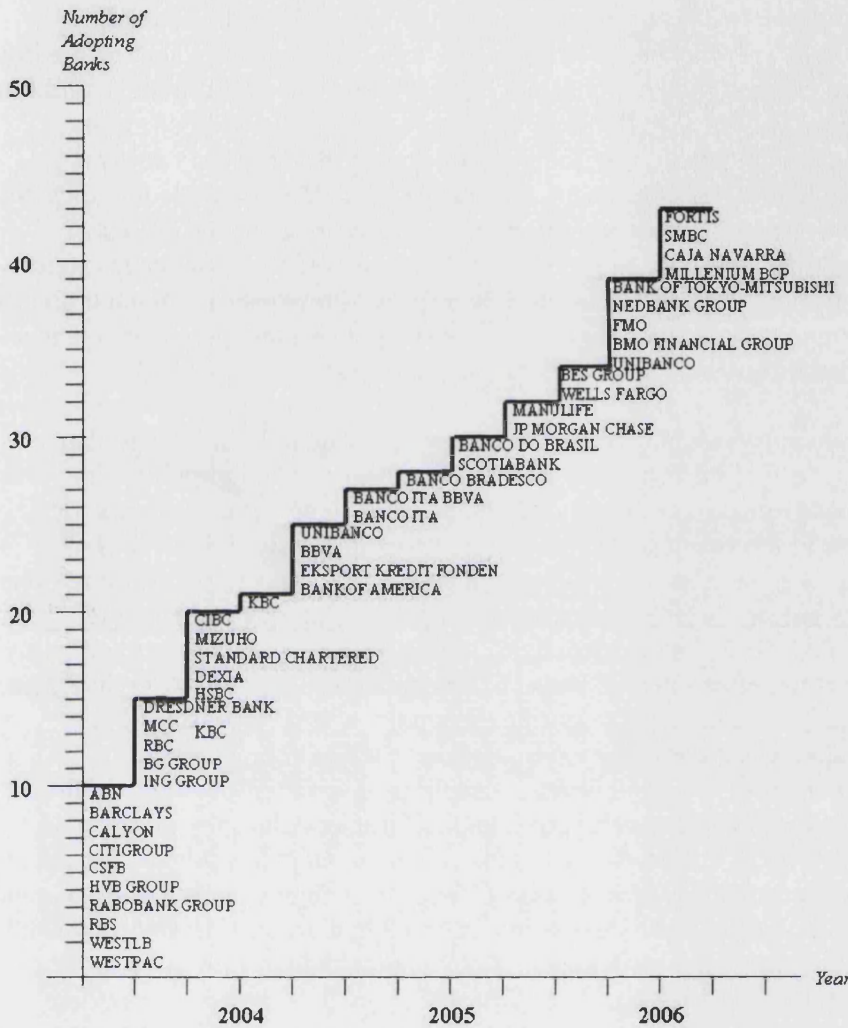
<sup>35</sup> Clapp (2005).

<sup>36</sup> 'IJ first half review: Equator Principles financing', Infrastructure Journal, August 17, 2006.

<sup>37</sup> Boisson de Chazournes (2000) and FBD (2005).

<sup>38</sup> FBD (2005), pp. 118-121 and Lazarus (2004).

**Figure 1.1 Adoption of the Equator Principles**



Second, by being based on the IFC’s environmental and social standards, the Equator Principles give affirmation to well-recognized norms and rules in the international system, such as human rights, protection of sensitive ecosystems and public access to information and decision-making. In theoretical terms, the framework not only advances and legitimizes need to protect the environment and the rights of local communities, it also reaffirms the validity of particular norms, or standards of behavior, that prescribe for lenders how they should act on these values. As such, they have raised public expectations about investment practices, and the moral responsibilities that investors have. As a result, the framework has significantly empowered the IFC in the global project finance market, by effectively making its own environmental and social policy framework the recognized industry standard.



Third, by placing an inter-governmental body of rules and standards at the center of the framework, the Equator banks all but ensured that it would enjoy international support among states. The World Bank's environmental and social standards significantly inform the practices of national environmental agencies and the lending policies of other international, regional and bilateral financial institutions. In addition, as the IFC's Board of Directors formally approves changes and additions to its operational policies and procedures, the Equator Principles effectively enjoy a multilateral endorsement. By extension, this makes it much more likely that they be recognized by governments as an acceptable standard for responsible project financing, rather than a competing framework that undermines or challenges state governance. In turn, given this conformity, the Equator Principles are much more likely to be integrated into international agreements, policies and procedures than a framework built entirely upon standards devised in the private sector.

And fourth, while most voluntary codes of conduct provide only limited guidance as to how individual companies should implement norms, rules and principles in particular business contexts, the Equator Principles define specific standards for a very narrow area of the financial sector, project financing. This high level of specificity is likely to increase its influence on corporate conduct for several reasons. First, precise prescriptions relieves commercial banks of interpreting how the framework should be translated into practice, reducing the likelihood that ambiguity and uncertainties cause commercial banks to implement the framework in divergent ways, and thereby impeding harmonization. Secondly, specificity raises public expectations and makes it easier for external observers and competitors to demonstrate instances of non-compliance. And third, given that specificity both removes uncertainties and increases accountability, it may reduce the problem of free-riding by helping to ensure that only those commercial banks prepared to act on their commitments decide to adopt the framework. As such, it is more likely to induce high levels of compliance, and by extension, succeed in harmonizing environmental and social risk management practices across commercial banks with those of the World Bank and the IFC.

The next section will outline the methodological approach and research design that will be employed in the thesis.

## **1.5 Methodology**

As many new forms of transnational rule-making are not rooted in a formal or legal authority with sanctioning power, there is much uncertainty as to how and why they emerge. The aim of this research is two-fold; to provide an-depth analysis of the Equator Principles as a means to advance our understanding of how and why private actors are increasingly cooperating to create rules for governing corporate environmental and social practices in transnational markets, and related, to test the explanatory power of existing theoretical perspectives on governance formation in international relations against an atypical case. In doing so, the research is focused on

generating insights into six aspects of private governance formation; why norms emerge, timing, main initiators, sources of influence, governance structure, and why norms are adopted. In turn, the findings generated by this thesis can contribute to refining existing theories of governance formation so as to better explain the emergence of transnational rule-making.

### *Case Study*

Drawing on George and Bennett (2007), the research is based on a ‘within-case analysis of a single case’. The case study approach can be defined as a ‘detailed examination of an aspect of a historical episode to develop or test historical explanations that may be generalizable to other events.’<sup>39</sup> For example, within the study of politics, case studies often observe particular nation-states at a single point in time or over some period of time, in order to make inferences about certain features of nation-states more generally.<sup>40</sup> It is typically characterized as an exercise in process-tracing, in which the researcher attempts to identify links between possible causes and observed outcomes. The research method relies on qualitative methods, such as interviews, participatory observations, and field studies, and tends to focus on the properties of a single phenomenon or event.<sup>41</sup>

Given that a case study approach entails the study of an instance of a class of events, it is necessary to narrowly define which classes of events the case is drawn from and assumed to be comparable to. Table 1.1 presents a useful typology for distinguishing different forms of global governance mechanisms. In this typology, Pattberg (2004) categorizes global governance mechanisms based on three different purposes and actor constellations. Based on this typology, the Equator Principles can be categorized as either a hybrid or private rule-making mechanism, depending on what level of public involvement is necessary to qualify for the ‘hybrid’ level. (identified in Table 1.1 in bold print). By extension, the findings generated by this study of the Equator Principles is presented as an example of, and therefore assumed to be comparable to, transnational rule-making processes involving either a combination of public and private actors, or private actors only. Whereas hybrid rule-making processes involve the active participation of at least one state or international organization in the rule-making process, actor constellations of private forms are limited to non-state actors only.

The impetus for this research is based on the observation that transnational rules are increasingly emerging from within the private sector to govern the environmental and social impacts of transnational corporate practices. As such, private actors engaged in such rule-making can no longer be considered merely intervening variables in the

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<sup>39</sup> George and Bennett (2007), p.5.

<sup>40</sup> For definitional issues related to the case study approach, see Gerring (2007), pp.19-26.

<sup>41</sup> For an overview of the case study approach, see Gerring (2007), pp.1-15, Hamel et.al (1993) and Stark and Torrance (2005).

international system, but possess the capability and interest in establishing their own transnational system of rules.<sup>42</sup> Furthermore, rule-making is for this purpose assumed

**Table 1.1 Examples of Global Governance Mechanisms**

Actor Constellation	Public	Hybrid	Private
Purpose			
<b>Provision of Goods and Services</b>	UNEP	Global Reporting Initiative (GRI)	Privatization of water services
<b>Implementation</b>	GEF	Global Network on Energy (GNESD)	Cement Sustainability Initiative
<b>Rule-Making</b>	Johannesburg Summit	<b>World Commission on Dams (WCD)</b>	<b>Marine Stewardship Council (MSC)</b>

Source: Pattberg (2004), p.12.

to resemble standard-setting, or the making of voluntary, expertise-based structural, procedural or substantive regulation for corporate practices.<sup>43</sup> The key distinction between public rule-making and hybrid or private forms, is that the former is typically backed by state power and often embedded in structures of public regulation, while the latter are commonly voluntary and depend on non-state forms of enforcement. The definition of rule-making does not only include processes that involve the creation of new rules that conflict or differ with existing rules. Rule-making that is based on applying existing rules to new institutional contexts, for example drawing on international environment law to formulate obligations for TNCs operating in environmentally-sensitive industries, are also included in this definition.

This methodological approach for understanding how and why the Equator Principles emerged was chosen because of its advantages over alternative approaches. First, while sampling a greater number of cases may be better able to reveal the distinguishing characteristics of each, the advantage of focusing on one case rests on the opportunity to conduct an in-depth analysis.<sup>44</sup> In this respect, it is particularly useful for identifying and measuring the significance of attributes and characteristics that are commonly aggregated in studies with more cases. Secondly, case studies lend themselves to samples that are new, reveal themselves for the first time, or are

<sup>42</sup> Pattberg (2004).

<sup>43</sup> Kerwer (2002), p.298.

<sup>44</sup> As Hamel et.al (1993) demonstrate, it is the depth of the description of the object of study that determines and drives the case study's explanatory power. (p.48-50)

identified as unusual cases. A method that is based on original data of one case enables the heuristic identification of new variables and hypothesis in ways that statistical methods drawing on existing databases are less able to. And third, by limiting the study to a single case, rather than many, the approach lends itself to identifying and evaluating the range of intervening variables that can cause particular outcomes. By extension, it is conducive to testing competing theoretical explanations and identifying the preconditions for different theoretical perspectives to have explanatory power by considering whether independent variables emphasized in particular theories matter in explaining the outcomes of a particular case.

Apart from describing the empirical developments that led to the launch of the Equator Principles, the thesis aims to test the explanatory power of the main theoretical perspectives on governance formation in international relations. Given that theories in international relations have been developed to explain state-based governance and not rules created by and for private actors, assessing their explanatory power against this particular case also provides an opportunity to test their scope and relevance to studying new forms of global governance. By exploring their validity in reference to a single case, the research findings can inform future studies of other similar cases and facilitate theory refinement and development.

### *Case Selection*

The thesis is a heuristic case study of the Equator Principles that seeks to answer broader questions about how and why private and hybrid transnational rule-making processes emerge, and what they tell us about the nature of institutional change in world politics. Given the limited empirical data available about recent private and hybrid transnational rule-making processes and the limited knowledge about their emergence, the selection of the Equator Principles as the subject of a single-case study was driven by two criteria. First, its unique characteristics, notably the specificity of the rules, the interactions between public and private actors, and the high level of uptake in the market, make it an intriguing case for testing the validity of existing theories of governance formation. In turn, the case will be used to identify relevant variables that influence the emergence of similar transnational rule-making processes, and suggest how existing theories can be refined to better explain outcomes. And secondly, in addition to being an ‘outlier’ case among global governance mechanisms, the framework has become recognized as the most influential and ground-breaking case within the financial sector, despite not having been subject to an in-depth academic analysis. Therefore, beyond its theoretical contributions, the aim of the thesis is to provide historical data for future studies of the Equator Principles.

The influence of the Equator Principles in the financial sector manifests itself in several ways. First, following the adoption of the framework, numerous commercial banks have invested in environmental risk management training for project finance staff, reorganized credit risk processes and in some cases, used the Equator Principles

to inform the integration of environmental and social considerations into other forms of corporate finance. Secondly, in terms of process, a core group of commercial banks have organized working groups to discuss policy matters related to the Equator Principles, that regularly consult with the IFC and transnational advocacy groups. Issues that have thus far been discussed include enhancing reporting requirements, establishing a secretariat, and encouraging more commercial banks in developing countries to adopt the framework. Third, at the project-level, environmental advocacy groups have used the framework as leverage for demanding that commercial banks reject financing certain projects on the basis of their adverse environmental and social impacts, and numerous commercial banks have publicly stated that they have rejected particular projects because they did not comply with the Equator Principles. Fourth, the framework has become the focal point for civil society engagement with the financial sector and has provided a new social purpose and meaning to interactions between commercial banks and environmental advocacy groups. And finally, the IFC has used the Equator Principles to demonstrate its technical expertise in environmental and social risk management, and show shareholders how it is helping to integrate environmental and social practices into financial markets. More broadly, the IFC has drawn on its experience with facilitating the emergence of the framework to increase its engagement with corporate responsibility initiatives through partnerships with international organizations and business networks, including the U.N Global Compact and the Global Reporting Initiative (GRI)

### *Data Requirements and Collection*

In order to establish why the Equator Principles emerged and why commercial banks decided to adopt it, the thesis is based on information gathered from individuals directly involved in the negotiations of the framework, and privy to the decision-making processes within adopting banks. To collect data, the research depended heavily on interviews with key decision-makers, cross-examining them on the specifics of particular events, including the causal relationships they believed existed between different phenomena. In turn, information was analyzed using the method of 'process-tracing' which draws on multiple types of evidence for the verification of a single inference.<sup>45</sup> It often involves presenting and analyzing long causal chains, and considering whether the sequence of events and variables conform to what various theories predict, and if variance is detected, use the empirical material to suggest how they could be refined to increase their explanatory power relative to particular cases.

The main objective was to interview project finance executives from all of the ten commercial banks that endorsed the Equator Principles at the launch in 2003, along with IFC staff that were closely involved in the policy discussions. By asking different interviewees the same sets of questions, it would in principle be possible to reconstruct the events and discussions that preceded the framework, and map the different rationales and expectations that negotiating parties had. By way of

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<sup>45</sup> See Gerring (2007), pp.172-185 for a broader definition of process-tracing, examples of how it has been used, and its strengths and weaknesses. Also, see George and Bennett (2005), pp. 205-232.

interviews, the research could also identify the circumstances that led project finance professionals to attribute positive values to these norms, after long having dismissed them as irrelevant or prohibitive to their social purpose as commercially-driven organizations.

In this context, the structuring of interviews, the selection of interviewees, and the manipulation of interview data, becomes a central determinant of research quality. As noted by Barbour and Schostak (2005), the unavoidable dilemma facing interviewers is what status to attribute information given by others. In truth, interviewees may have a wide variety of reasons for providing false information, particularly in answering sensitive questions about their interests and motivations, which may place their respective employers in a bad light. Indeed, given the central role that corporate communication plays in the formulation of corporate environmental strategies, interviewers in this field necessarily need to approach the interviews with a certain amount of skepticism, without prejudging the interviewees.<sup>46</sup>

To address the problem of information accuracy, a concerted effort was made to only interview project finance executives that had been party to the policy deliberations preceding the launch of the Equator Principles, rather than public relations staff charged with promoting the framework in the aftermath. In turn, by gathering multiple sources of evidence, irregularities could be identified and discarded. Furthermore, the quality of interview data was also enhanced by promising interviewees that data would be considered strictly confidentiality.<sup>47</sup> By making this declaration prior to the interview, the expectation was that they would be more inclined to answer questions truthfully and admit knowledge gaps. But some element of subjectivity is of course inevitable, and the quality of the research then falls back on the knowledge base and the analytical judgement of the researcher.

In addition to interviews, the research draws on content analysis of corporate reports, media clippings and personal observations. In considering corporate reports and news items, biases were understood and considered when incorporating them into this research. In terms of personal observations, the researcher benefited from attending numerous meetings and conferences as an NGO employee, an academic researcher, and a freelance journalist.<sup>48</sup> For example, in February 2005, the author attended a multi-stakeholder dialogue between members of Banktrack and a selection of Equator

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<sup>46</sup> As an example, in a survey of the German financial sector on corporate environmentalism, the most important benefit of developing an internal environmental policy cited by German financial institutions was the positive effect it had on the motivation of employees. However, closer scrutiny revealed that only one financial institution in the survey actually reported having asked its employees about this directly. BMU (2002).

<sup>47</sup> Thus, in later empirical chapters, names of interviewees are replaced by codes. In turn, examiners will be provided a separate interview sheet that associates these codes with particular individuals. (See Appendix 2)

<sup>48</sup> From June 2003 to June 2005, the author was an external consultant for the International Financial Flows and the Environment (IFFE) Project at the World Resources Institute (WRI). Since January 2006, the author has been a freelance journalist, writing for The Ecosystem Marketplace and Ethical Corporation Magazine.

banks, held at the offices of Credit Suisse near Zurich. Such experiences did not themselves directly inform the research, but broadened the knowledge base of the author and thereby improved the quality of analytical and methodological judgements.

### *Process*

Based on anecdotal information sampled through personal observations and informal conversations with individuals close to the subject matter, a preliminary questionnaire with in-built hypothesis was produced. Then, during the course of the interviews, the questionnaire was amended several times, reflecting new information and knowledge gathered interviews, and document analysis conducted alongside. The sample questions were shared with interviewees prior to the interview. However, in the vast number of interviews, the depth of conversation went beyond what the questions would suggest, and the length of the interviews also often exceeded the time commitment that was asked for.

In sequencing the interviews, a deliberate choice was made to approach the least important and informed decision-makers first, in order to identify the key decision-makers and be best prepared for the most important interviews. Following the completion of preliminary analysis, almost exclusively based on policy literature and media reports, the author conducted the first round of interviews with IFC staff that were either first-hand observers of the policy discussions, or directly involved as technical advisors. At this stage, he also interviewed several staff of transnational advocacy groups that had campaigned against commercial banks. What followed was an extended period of research and writing, before a second round of interviews with commercial banks of secondary significance. These interviews honed in on the central research questions, while recognizing that interviewees may only have cursory information about some parts of the policy discussions. Yet, following this round of interviews, the analysis sharpened and a phase of document analysis and writing followed. In the last round of interviews, the most significant decision-makers were formally approached, and in-depth interviews with these individuals followed. In a final stage, earlier drafts were revisited and updated to produce the final draft of the thesis.

### *Limitations of the Research Design*

Notwithstanding the arguments in favor of using a case study approach to understand how and why the Equator Principles emerged, the research method has limitations that influence the quality of findings.<sup>49</sup> First, a case study approach, and single-case research designs even more so, invariably raises questions about the extent to which findings can be generalized. Given that findings are drawn from a few or a single

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<sup>49</sup> See Gerring (2007), p.5-8, for an outline of the standard positivist critique. See also Hamel et.al (1993), p.23.

case, they can necessarily only be extrapolated to cases that have similar characteristics. As a result, while an in-depth analysis of a small number of cases based on large amounts of original data can in principle generate more insights than a cross-comparison that draws more heavily on secondary data, the findings may not be generalizable to a large population of cases given the unrepresentativeness of the single case. As such, it is not guaranteed that findings about the significance of particular dependent variables or the interactions between variables generated by a single case study can be generalized to other cases.

Secondly, a single-case study approach runs the risk of failing to unearth sufficient evidence to assess the validity of competing theoretical explanations. Given the limited scope of investigation, the researcher may assume that the range of independent variables thought to be significant in explaining the dependent variable are present in the single case, even in cases where they are not. For example, it is unclear whether public, private, and hybrid transnational rule-making processes have more in common than different forms of mechanisms with the same actor constellations. Yet, when assumptions about the scope of cases determine case selection, they may influence inferences about causal mechanisms and thereby suffer from systematic error. In turn, researcher may draw erroneous conclusions and extrapolate these to other cases.

And third, a case study approach, even if it involves several cases, is often criticized because the objects of research are not sufficiently distanced from the subjects researching them. Given that the case study approach depends largely on qualitative data collected through interviews and ethnographic studies, and researchers deliberately mix the descriptive and the analytical aspects of the research, critics have questioned whether findings are sufficiently objective to be generalized. This can be particularly problematic in cases where the researcher chooses a case study on the basis of his/her prior familiarity with the issue area.

In terms of data collection, the method and process had several limitations that should influence how the findings are interpreted and used in future research. First, as one of the primary aims was to document the series of meetings and workshops that preceded the launch of the Equator Principles, the research was primarily based on interviews with banking executives that were heavily involved in the negotiations and in the aftermath, have a large stake in its success and reputation. Meanwhile, banks that had not adopted the framework and were under heavy criticism for not doing so were less likely to agree to an interview, given the sensitive nature of the questions. As a result, data gathered from interviews would be biased in favor of the framework, and the research is unable to adequately reveal motivations that banks may have for not adopting the framework. Yet, while interviews with consultants, environmental activists and lawyers that engaged with a broad array of banks somewhat made up for this shortfall, it is nevertheless a limitation that should be recognized when considering the main findings.



Secondly, as the thesis aims to make a set of theoretical claims about why private actors adopt norms, it is important to recognize what the material and social costs of non-compliance are, as an aspect of understanding how private actors define their interests. Given the voluntary nature of the framework, and the lack of independently verified information on actual compliance, it is somewhat difficult to assess whether adopting the framework also leads to changes in corporate behavior. While the investments in resources and staff, the reform of credit risk processes, and the emergence of consulting industry around the Equator Principles suggests that the framework has led to material changes within adopting banks and in the way project risks are managed, data on compliance across financial institutions is currently not available. As a result, the study of norm adoption is necessarily limited to understanding why commercial banks would publicly commit to applying the Equator Principles to their project finance operations, and is less able to make claims about what they actually intend to do so.

## **1.6 Thesis Outline**

The thesis will seek to place the emergence of the Equator Principles within broader structural and normative changes in the global political economy and global environmental governance. It will attempt to provide an integrated analysis of the social, political and economic developments that induced commercial banks to favor a common industry standard for the project finance market, and thereby led to the emergence of the Equator Principles.

Following this introduction, chapter two will provide a comprehensive overview of the existing literature on international norms in the study of international relations. In doing so, it will highlight how rational-materialist perspectives exogenize norms to identities and interests, and therefore subordinate the independent significance of norms in governance formation. While both power and interest-based approaches recognize the role of the norms in governance, neither assumes behavior is entirely rule-governed. In contrast, alternative cognitive approaches, notably constructivism, focus on how norms not only inform the behavioral decisions of actors, but also constitute their identities and interests. In conclusion, it will identify examples from the growing body of research on international norms that illustrate how behavioral variations have been persuasively attributed to social institutions, rather than material capabilities or incentives.

Chapter three outlines the theoretical framework that will shape the analysis of the emergence of the Equator Principles. Drawing on the preceding literature review, this chapter first considers how the three dominant theoretical perspectives in international relations – realism, neo-liberal institutionalism, and constructivism – expect governance to emerge in world politics. By comparing these perspectives across six aspects of governance formation, it provides a framework for testing the explanatory power of each in relation this case. Subsequently, by drawing on existing research in the field of international norms, the chapter proposes a theoretical model

in which norm entrepreneurs, notably transnational advocacy groups, advocate particular norms and principles in the corporate sector. In explaining successes, it argues that norms that have been legitimized by states in the international system are more likely to diffuse further in the corporate sector than those that are not.

Chapter four introduces the project finance market and the concept of 'risk', which is the conceptual lens through which project finance executives understand their professional roles and responsibilities. This is important, as biases grounded in their professional training and commercial orientation influence how they interpret environmental and social impacts generated by a particular project, and make judgements about how to manage them. The chapter identifies project finance as a financial structure ultimately aimed at reducing projects risks to a level that is financially acceptable. In this context, adverse environmental and social impacts, such as water pollution or the disruption of local livelihoods, are primarily understood as potential risk to the ability of the borrower to service debt. Yet, the integration of environmental and social norms into project risk management both reinforced this conceptual view, whilst also expanded it in important ways.

Chapter five discusses the question of norm emergence, and traces the origins of the Equator Principles to the World Bank, and more specifically, to the introduction of environmental review of projects in the early 1970s. Furthermore, it highlights how the continuous contestation of operational policies and their application to particular projects was instrumental to the evolution of these norms, and ultimately, their widespread legitimacy in the international system. Overall, it identifies how the contentious relationship between the World Bank, and later the IFC, and transnational advocacy groups reflected differences in their understandings of what constitutes the origins of underdevelopment and environmental degradation, and what should be the social purpose of development finance in addressing this. In the end, the analysis finds that the environmental and social review procedures of the World Bank reflect these differences, by legitimizing and promoting large-scale infrastructure lending while recognizing the need to protect the environment and the rights of local communities.

Following this analysis of the emergence and institutionalization of environmental and social norms in multilateral financing, chapter six addresses the question as to how these norms diffused into the private sector. In identifying one of the two principal drivers of norm diffusion, the analysis discusses the significance of transnational networks of advocacy groups and local community activists and their role in gradually increasing the public scrutiny of commercial project financing in the 1990s. By campaigning against both multilateral and commercial lenders involved in controversial projects, they helped to de-legitimize the notion that the latter were not equally responsible for ensuring that projects they financed did not generate significant adverse environmental and social impacts. As such, they helped narrow the gap between public expectations of multilateral and commercial lenders by holding them both to the same level of standards. In turn, this resulted in the de-

legitimization of project financing practices that did not adhere to particular environmental and social norms.

In turn, chapter seven provides an in-depth study of the drafting process of the Equator Principles, identifying how and why commercial banks decided to collaborate on creating a common industry standard, and why they settled on the IFC's policy framework as a blueprint. It identifies the IFC's critical role as a convener and facilitator of cooperation, allowing commercial banks to overcome collective action problems. However, with regards to determining institutional content and design, the commercial imperatives of the banks themselves, and the structure of the project finance market, proved more decisive than the IFC's influence.

And finally, chapter eight identifies the main conclusion that can be drawn from the case study, and discusses how they can advance our understanding of the emergence of private governance in international relations. It revisits the comparison of theoretical perspectives on governance formation outlined in chapter three, and argues that while realism can best account for why norms get institutionalized in the multilateral system, constructivists are best able to explain their diffusion, and neo-liberal institutions their adoption by private actors. It concludes that a collective concern for reputational risk prompted commercial banks to negotiate and launch the Equator Principles and thereby effectively adopt the IFC's policy framework. In doing so, they enjoyed significant discretion in designing a framework that conformed to their commercial objectives in the marketplace.

## ***2. Perspectives on Governance Formation***

### **Introduction**

The introductory chapter suggested that emergence of the Equator Principles can be usefully investigated using an analytical focus on norms. Specifically, an analysis of how norms emerge and diffuse within particular institutional contexts, and why and under what conditions they are adopted by actors, can shed light on why private governance emerges in areas of significant public interest, such as human rights and environmental protection. By employing this analytical angle, the thesis refutes the notion that the emergence of the framework should be narrowly viewed as a function of state power and hegemony, or in purely functionalist terms, as a response to a demand among private actors for standards that help coordinate investment practices. Instead, both the emergence of and the perceived need among private actors for a common approach and their choice of particular standards should be seen in the context of norms emerging and diffusing across policy spaces, which created the impetus for cooperation between private actors and determined the institutional design and content of the framework. As such, norms not only informed behavioral choices, but also defined the problem that cooperation ultimately sought to address and solve.

It is common for literature on private governance to dismiss existing scholarship on international institutions because of its state-centric and rational biases. However, given the central roles that states and state-based institutions play in global processes of institutionalization, lending significance to international norms requires an appreciation for how these have attained legitimate status in world politics. In turn, a central contention put forward here is that private governance is deeply embedded in well-recognized international norms that gained legitimacy because of their inclusion into international constitutive law, notably the U.N Charter and the articles of agreement and mission statements of various multilateral institutions. Therefore, in cases where governance, whether public or private, induces behavioral convergence around such norms, an analysis of governance emergence necessarily needs to focus on processes of institutionalization at the global level, and how these impact the emergence and diffusion of norms across institutional contexts.

This chapter reviews the literature on norms in international relations, surveying the dominant theoretical perspectives on the study of international institutions in international relations. In this context, the thesis uses regime analysis as a departure point for understanding how neo-realists and neo-liberal institutionalists explain the emergence of governance within issue areas, and the significance they attribute to norms in this process. While the regime concept is not particularly useful for studying private forms of cooperation, the literature on international regimes does provide insights into how dominant perspectives in international relations understand the emergence of governance at the global level.

Subsequently, the broader cognitive view is introduced, and used to provide a contrasting perspective to the rational-materialist theories of institutional change. Broadly, this literature argues that in order to explain the emergence of governance, it is necessary to understand how technical standards and procedures acquire particular normative meanings, how and why these meanings may shift over time and diffuse across institutional contexts, and ultimately, acquire legitimacy among actors so as to inform behavioral choices. In turn, understanding why some norms gain prominence while others do not, and to what extent these inform the identities, interests and behavioral choices of actors, emerges as a critical objective.

The chapter will be structured as follows. The first section will seek to conceptualize the concept of 'norms' by reviewing how they are defined and understood in constructivist approaches to international relations. This will include an overview of their main properties and functions, and how they give rise to institutionalized patterns of behavior. The second section reviews the theoretical literature on international regime formation, and the third offers a cognitive critique of this. And finally, the fourth section will survey recent literature that demonstrates the significance of norms in constituting shifts in institutional behavior among states in a wide variety of policy areas, including security, economics, development aid and human rights.

## 2.1 Defining International Norms

The literature on international norms employs a variety of broadly similar definitions. In Finnemore (1996), norms are defined as 'shared expectations about appropriate behavior held by a community of actors.'<sup>50</sup> In their discussion of international norm dynamics and political change, Finnemore and Sikkink (1998) define norms as 'standards of behavior for actors within a given identity.'<sup>51</sup> In another oft-cited definition, Jepperson et.al (1996) refer to norms as 'collective expectations about proper behavior for a given identity.'<sup>52</sup> Common to all of these definitions is the sense that norms induce convergence among actors, thereby mobilizing interests and behavior around particular notions of appropriateness. It is behavioral convergence that manifests the power of a particular norm, and represents the true test of successful norm diffusion and adoption.

In this regard, norms should be differentiated from rules, which are much more targeted and precise.<sup>53</sup> Whereas norms loosely define the boundaries of appropriateness without directly clarifying for actors what norm compliance may entail in particular circumstances, rules provide explicit guidance in language for particular actors, such as 'private property – no trespassing.' Relative to international

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<sup>50</sup> Finnemore (1996), p.22.

<sup>51</sup> Finnemore and Sikkink (1998), p.891.

<sup>52</sup> Jepperson, Wendt and Katzenstein (1996), p.54.

<sup>53</sup> This distinction between norms and rules is made by Kratochwil (1989), p.73. See also Dessler (1989), pp.454-458.

cooperation, norms tell us why states collaborate, which is ultimately based on an agreement on the character and value of the subject singled out for regulation, whereas rules tell us what the collaboration is about. That is why rules of privacy differ between cultures, based on how the commonly-held understanding of the 'the right to privacy' norm is understood and interpreted. Therefore, complying with rules can be said to be a discrete choice, and actors can exempt themselves from rule compliance by arguing that prohibitions do not apply to them. In contrast, actors may adhere to norms without knowing they are doing so, by virtue of engaging in certain forms of behavior that respect certain norms. In this context, they are more unconsciously bound to norms than rules, as the former identify for actors their identities and interests as members of a social community.

As an element of prescribing behavior, norms operate as 'collective social facts' embedded in shared understandings that define bonds between actors belonging to a social group.<sup>54</sup> As such, norms, in contrast to some specific rules, are collectively held, by prescribing appropriate acts for actors that share particular identities or belong to particular social communities. This perspective presupposes that states (or other actors) have a normative identity, and do not simply embody interests and make behavioral choices like functional bodies.<sup>55</sup> Therefore, norm compliance defines group membership, as an actor conveys a sense of belonging by making appropriate and legitimate behavioral choices. As Kratochwil (1989) notes, 'by directing actors to act in specified ways, rules and norms link individual autonomy to sociality.'<sup>56</sup> More broadly, they define, reinforce and strengthen bonds between actors, as behavioral convergence sustains group cohesion and reinforces their shared, collective identities.

By implication, norms are intimately tied to governance, as they are a powerful source of behavioral convergence, or more specifically, the harmonization of practices. Norms may induce and explain convergence in expectations among a group of actors in cases whether they seemingly lack a clear long-term motivation to do so.<sup>57</sup> According to Bernstein (2001), three functions are commonly attributed to norms in the constructivist literature on global governance. First and foremost, norms have an important constitutive function, as they define the identities and interests of actors, including their perspectives of the natural world and the knowledge and ideas that inform them. By extension, norms do not simply provide solutions to predefined problems, as rational institutionalists would hold. Instead, they give meaning and legitimacy to particular identities and courses of action, thereby defining for actors what constitutes a problem and which behavioral responses are deemed appropriate to mitigate or prevent it.<sup>58</sup> In fact, if an actor violates constitutive norms, other actors with similar identities are unable to understand or comprehend the action, as it falls outside of what is perceived as meaningful social action.<sup>59</sup>

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<sup>54</sup> Katzenstein (1996), p.17.

<sup>55</sup> Finnemore (1996), pp.5-7.

<sup>56</sup> Kratochwil (1989), p.70.

<sup>57</sup> Kratochwil 1989, p.58

<sup>58</sup> Finnemore (1996), pp.22-28.

<sup>59</sup> Dessler (1989), p.455.

Secondly, norms regulate social behavior by setting standards of appropriate conduct. As outlined by Kratochwil (1989), norms define the scope of prohibitions, which rules out certain methods of individual goal-seeking that are in principle available to actors.<sup>60</sup> They do so by restraining actors from even contemplating certain behavioral choices, as they perceive them as antithetical to their identities. Moreover, within the range of permissible objectives and strategies, norms create 'separation-schemes' which minimize interference and channel conflict. This quality, stressed by neo-liberal institutionalists, means norms contribute to regulating conflict between actors that compete over scarce resources, by inducing behavioral shifts that help actors realize joint gains.<sup>61</sup>

And third, as Bernstein (2001) notes, norms perform a deontic function, by 'expressing values that create rights and responsibilities and thereby empower actors by providing reasons and justifications for particular actions.'<sup>62</sup> This means norms can be prohibitive, by circumscribing the conditions under which actors can participate in and authorize certain activities, as well as enabling, by providing actors with a moral license to undertake certain actions.<sup>63</sup> In either case, norms can have significant distributional consequences that ultimately empower certain actors over others.<sup>64</sup> In this context, the discussion in Kratochwil (1989) on the normative origins and impacts of 'rights' becomes very relevant. As rights embody claims about why the demands of certain actors should be socially protected, they impose obligations and duties on other actors, even if these actors are not specified.<sup>65</sup> Accordingly, they confer entitlements to 'right holders', whilst barring others from making particular arguments and engaging in certain practices that infringe on those rights.

In summary, as norms help mobilize actors around particular goals and strategies, and may indirectly induce redistributions of power and wealth, they are directly relevant to some of the most poignant research questions in the study of international relations. In particular, norms can be useful focal points for analyzing abrupt shifts in collective behavior among a set of actors that are unexpected and counterintuitive. Before considering the important questions about how and why particular norms emerge and diffuse in the international system, the chapter will review the literature on international regimes as a proxy for understanding how the mainstream traditions in international relations consider international norms in explanations of governance formation. Subsequently, it will draw on this discussion and identify how norms have

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<sup>60</sup> Kratochwil (1989), p.70.

<sup>61</sup> See Axelrod (1986) for an illustration of this example. This limited view on the significance of norms is captured in the following statement; 'When coordinated behavior takes place without the intervention of a central authority to police the behavior, we tend to attribute the coordinated behavior and the resulting regulation of conflict to the existence of norms.' (p.1096)

<sup>62</sup> Bernstein (2001), p.5.

<sup>63</sup> The former are referred to by Nadelmann (1990) as 'prohibition norms', and may include condemnations of killing whales, elephants or other endangered species, or human rights violations and (p.479)

<sup>64</sup> Katzenstein, (1996), p.27.

<sup>65</sup> Kratochwil (1989), p.155. Accordingly, he distinguishes between positive rights, or 'non-actions' that give others rights, such as no trespassing, and negative rights, or those upon which all others depend.

been used to understand the recent political mobilization of private actors in global environmental politics, and the emergence of new forms of transnational governance.

## 2.2 Regime Analysis and the Study of International Norms

The concept of 'international regimes' originated within the institutionalist tradition in social theory, and provided a theoretical tool for considering how shared norms, values and principles can provide the basis for cooperative and coordinated behavior in the international system.<sup>66</sup> Regime analysis was the first comprehensive attempt within the mainstream traditions of international relations to explore the role of international institutions in shaping political change in the international system. In the most oft-cited definition, international regimes are defined as institutional arrangements that 'encompass principles, norms, rules and decision-making procedures around which actors' expectations converge in a given issue area.'<sup>67</sup> The regime literature that proliferated in the 1980s provides a useful insight into how neo-realists, neo-liberal institutionalists and sociological institutionalists explain the emergence, diffusion and adoption of international norms.<sup>68</sup> As norms are conceptualized as important building blocks of international regimes by identifying standards of appropriate behavior for regime members, the research on the formation, maintenance and decline of international regimes sheds light on how different perspectives conceptualize the relationship between actors, norms and governance.

In the study of how and why international regimes emerge, scholars typically outline three generic approaches, each resting on different understandings of international norm dynamics centered on either power, interests or knowledge. (see Table 2.1)<sup>69</sup> As discussed by Hasenclever et.al (1997), within both power- and interest-based approaches, behavior is largely explained in instrumental terms, as a function of either hegemony or interactions, respectively. In this context, norms are understood as exogenous variables that enhance material power or form part of the decision environment in which actors make rational choices. In both cases, actors are depicted as self-interest actors, continuously analyzing the material costs and benefits of different courses of action, and choosing those that conform to the interests of dominant states, or maximize their own utility. More generally, their perspective on the emergence and diffusion of international norms is strongly influenced by the

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<sup>66</sup> Vogler (2003), p.26.

<sup>67</sup> Krasner (1983), pp.1-2. In this widely used definition, principles are 'beliefs of fact, causation and rectitude', norms are 'standards of behavior defined in terms of rights and obligations', and rules are 'specific prescriptions and proscriptions for action.'

<sup>68</sup> For Oran Young's discussion and critique of the consensus definition, see Young (1986), pp.105-108. Because of the ambiguity surrounding the Krasner's definition, Strange (1983, p.342) famously labeled the 'international regime' concept 'woolly', whereas both Finnemore (1996, p.16) and Kratochwil (1984, p.685) have argued the principles, norms, rules and decision-making procedures that represent the building blocks of international regimes need to be conceptually developed further to avoid being too vague for constructive scholarship.

<sup>69</sup> For example, Young (1986) differentiates between three behavioral models, realism, which depicts states as 'status-maximizers', neo-liberal institutionalism, which depicts states as 'utility-maximizers', and a Rawlsian perspective, in which state behavior is constituted by rules. (pp.118-120)



assumption that the international system is based on a state of anarchy between competitive states, an institutional context characterized by uncertainty and risk.

The theoretical perspectives embedded in regime analysis were shaped by economic and political developments in the international system. As a result of the proliferation of international regimes since World War II, the actions and interests of states were increasingly embedded in a complex array of institutions and rules. While the most prominent international regimes arose in the areas of economic and security relations, institutionalized international cooperation and coordination emerged in many areas, including communications, transportation and the environment.<sup>70</sup>

**Table 2.1 Three Theoretical Perspectives on International Institutions**

	Neo-Realism	Neo-Liberalism	Cognitivism
Central variable	power	interests	knowledge
“Institutionalism”	weak	medium	strong
Meta-theoretical orientation	rationalistic	rationalistic	sociological
Norm dynamics determined by	hegemony	rational competition	discursive practices

Loosely adapted from Hasenclever, Mayer and Rittberger (1997), p.6

For example, domestic trade, economic and financial policy was increasingly embedded in a variety of overlapping and mutually reinforcing international regimes, notably the General Agreement on Tariffs and Trade (GATT) and the financial stability and development aid regimes of the Bretton Woods institutions, which gradually facilitated the liberalization and integration of the global economy. In turn, within many issue areas, state practices were increasingly rule-governed, drawing their purpose from multilateral organizations, agreements, and treaties, and giving rise to new kinds of responsibilities and obligations.

The use of regime analysis has been particularly popular in studying the creation and persistence of international institutions in the international political economy. As an example of how Krasner’s definition is applied to a particular case study, Cohen (1983) posited that the International Monetary Fund (IMF) was established in response to a fundamental *principle* that emerged out of the inter-war experience, namely that all nations should have assured access to supplementary balance-of-

<sup>70</sup> See for example chapters by Robert Jervis, John Ruggie, Oran Young and Ben Cohen in Krasner (1983).

payments deficit financing.<sup>71</sup> Furthermore, this principle was combined with the *norm* that granted members access to IMF resources based on pledges to avoid certain distortionary policies. In turn, the IMF charter, its Articles of Agreements, contains specific *rules* for actions in relation to enforcing its prerogative of policy conditionality. And finally, the application of these principles, norms and rules are organized in a set of administrative *decision-making procedures*, including formal voting, which determines the amount of available financing to member states, and the set of conditions that form part of the loan. Moreover, as Haas (1990) notes, the creation of the IMF effectively led to an internationally-recognized monetary issue area, in which previously separate monetary management issues related to inflation, exchange rates, and growth were brought together in negotiations.

The next three sections will identify the different perspectives on international regimes that are commonly found in international relations literature.

### *Regimes Reflect State Power*

In a power-based theory, international norm dynamics are intimately tied to broader shifts in material power between states within issue areas, which lead to the promotion of particular norms to the detriment of others.<sup>72</sup> As norms are simply viewed as building blocks of international regimes, they are seen as instruments through which powerful states exert influence in the international system, and therefore embedded in broader explanations about the sources of state power. As such, norms emerge in a given issue areas because dominant actors decide to change their strategies and place their power behind new norms, or because interactions between powerful states cause a shift in the balance of power between them which allow them to project their power in ways that they have not been able to do before. Moreover, norm diffusion among actors or across issue areas is then a function of the exercise of that power, and the institutionalization of norms into systems of rules the govern relations between actors. This means that the emergence and diffusion of norms is mediated principally by states, and more specifically, powerful states, as part of a process of 'hegemonic socialization'.<sup>73</sup>

An illustration of how neo-realists understand the creation and persistence of international regimes further elucidates how norms are understood in a rational perspective where power is the central variable. Given the overarching emphasis on power, neo-realists attribute much less independent significance to institutions than neo-liberal institutionalists in explaining the creation and persistence of international regimes.<sup>74</sup> For neo-realists who are generally pessimistic about the prospects of

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<sup>71</sup> Cohen (1983), p.323.

<sup>72</sup> For a lengthier discussion of this perspective, see Hasenclever et.al (1997), pp.83-135.

<sup>73</sup> Finnemore and Sikkink (1998), p.896.

<sup>74</sup> In fact, since realists most often do not accord international norms even limited autonomy and simply view them as manifestations or products of interests, many scholars conceptualize neo-realism as a theoretical alternative to regime theory in understanding international institutions, rather than one of several perspectives. For example, Keohane (1998) juxtaposes 'rational' and 'reflectivist'

international cooperation, the basic assumption that governs their understanding of international economic regimes is that the nature of international economic relations depends upon the structure of the international political system.<sup>75</sup> As a result, international institutions are not given much significance independently of powerful states, which means realism does not have an independent theory of international norm dynamics. Given this perspective, a central area of investigation in the regimes literature was to the extent international regimes merely reflected broader distributions of power in international relations, and in particular, the interests of hegemonic powers. In this context, states are inherently 'status-maximizers', seeking to climb the hierarchical ladder of power in the international system by exercising influence over other states in order to acquire more power.<sup>76</sup> As power is the most important variable, dominant states are assumed to provide the conditions for processes of institutionalization to emerge and evolve, and are assumed to possess the capability and power to bring them to an end.<sup>77</sup> By extension, neo-realists understand international regime formation as a function of the overall distribution of power among states in the international system

### *Regimes Regulate Inter-State Conflict*

Given that the explanatory power of realism depends on a near correlation between power of states and the emergence and purpose of international institutions, observations in the late 1970s that international economic cooperation had persisted under conditions of waning hegemonic dominance posed a real challenge. After the signs of U.S hegemonic decline in the global economy, a research program raised the question as to how international economic regimes established in large part by U.S political might in the post-1945 period were surviving without their chief architect maintaining a hegemonic position in the global economy. As Kratochwil (1989) noted, realism was slightly 'embarrassed' by this development, as it suggested that power-based theories of international institutionalization alone could not fully account for the persistence of international regimes.<sup>78</sup> In fact, this was perceived as evidence that existing constellations of power alone do not determine the nature of international cooperation.<sup>79</sup> Thus, they recognized that adherence to particular norms among states was not entirely dependent on the threat of force, and that international

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approaches to studying international institutions, with the former resembling neo-liberal institutionalism, whereas Klotz (1995) distinguishes between neo-realism and neo-realist institutionalists, with the latter accepting that international regimes may attain limited autonomy. (pp.20-21)

<sup>75</sup> See for example Gilpin (1971) and Krasner (1995).

<sup>76</sup> The distinction between states as 'status-maximizing' agents in realism and 'utility-maximizing' in neo-liberal institutionalism, is from Young (1986), p.118.

<sup>77</sup> As Haufler (1999) has noted, the literature attributing regime emergence and persistence to hegemonic power integrated hegemonic stability theory to the study of international institutions, and embedded it within a liberal concern for institutional cooperation.

<sup>78</sup> Similarly, Keohane (1982) argued hegemonic theories of international regimes fail to explain the lag between changes in power structures and changes in international regimes. (p.326)

<sup>79</sup> One common alternative explanation offered by neo-liberal institutionalists was that fluctuations in demand for international regimes, rather than shifts in the balance of power between states, induce international regimes to emerge and decline. (Keohane 1982, p.326)

norms could in fact develop their own limited autonomy if institutionalized in international organizations and regimes. In turn, the acceptance that an active hegemonic power was not necessarily a precondition for an international regime to emerge triggered a new research program that sought to identify the wide range of institutional conditions that facilitate and encourage international cooperation.

In contrast to neo-realists, neo-liberal institutionalists viewed norms as sources of regulation which served as focal points for sets of actors and facilitated the harmonization of interests and behavior among them.<sup>80</sup> Therefore, while neo-realists study norms within the context of the evolving balance of power between states in the international system, neo-liberal institutionalists emphasize how norms can contribute to favorable conditions for international cooperation.<sup>81</sup> Or as Keohane and Nye (1989) argue, using the analogy of a poker game, whereas neo-realists emphasize the structures that determine the distribution of chips in explaining outcomes, neo-liberal institutionalists focus on the process that determines how different players make strategic betting choices through interactions. Rather than being an instrument of power, norms form part of a broader opportunity structure that determines the range of choices available to actors, and the costs and benefits associated with different types of behavior. In this context, actors strategically invoke or advocate norms that reinforce their fixed interests, or alternatively, norms may inform the decisions that actors make to maximize their own welfare. In these cases, norms are understood as tools or mechanisms that individual actors can deploy at will, or road maps that guide behavior and regulate conflict.

In the microeconomic logic that governs neo-liberal institutionalist understandings of the relationship between agents and structures, the focus shifts from the supply of international regimes, as provided by hegemons, to the demand for international regimes among states in a given issue area. In this context, norms are not instruments of state power, but informational devices that help actors identify their common interests and achieve collective benefits.<sup>82</sup> Rather than constituting identities and interest, they simply help remind actors of their common, often hidden, material interests, and provide a framework for bargaining and negotiating cooperation.<sup>83</sup> As such, norms emerge because there is a demand among actors for better coordination and cooperation in a given issue area. The diffusion of such norms is then a function of their inherent efficiency in meeting the evolving interests of actors. In this context, utility, rather than power, is the overarching variable that explains how and why norms emerge and diffuse among a group of actors. If successful, norms play a role in consensus-building, by providing compelling ethical or moral motivations for actors to pursue certain courses of action. In doing so, norms do not express power in and of

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<sup>80</sup> Reflecting this perspective, Axelrod (1986) says 'norms provide a powerful mechanism for regulating conflict in groups' in cases where a central authority is lacking. (p.1095).

<sup>81</sup> For a lengthier discussion of this perspective, see Hasenclever et.al (1997), pp.23-82.

<sup>82</sup> For a broader neo-liberal institutionalist definition and perspective of 'international institutions', see Keohane (1998), pp.389-389.

<sup>83</sup> Young (1994), p.26

themselves, but rather facilitate cooperation and the convergence of interests among actors and help them realize joint gains.<sup>84</sup>

A brief outline of the neo-liberal institutionalist perspective on international regimes illustrates how actors interact with norms in a purely utilitarian framework. Whereas neo-realists identified power as the central variable for understanding the creation and persistence of regimes, neo-liberal institutionalists argued that the collective interests of states and the efficiency of formal institutional structures determined the fate of international institutions.<sup>85</sup> For neo-liberal institutionalists, the puzzle that the emergence of international regimes presented is why inherently self-interested actors choose to cooperate in an international system of anarchy.<sup>86</sup> In this context, regimes do not emerge spontaneously, but are outcomes of 'political entrepreneurs' that see a clear benefit in organizing collaboration.<sup>87</sup> As such, they focused on identifying the conditions under which states cooperate and coordinate behavior in policy areas otherwise characterized by discord, and the factors that explain the persistence of such collective action. In turn, these positivist assumptions mean interactions between states can be examined through employing game-theoretical models, such as the game of the Prisoner's Dilemma.<sup>88</sup>

In this context, hegemonic rule was not the overarching explanatory variable, but identified as one of many factors that made cooperation much more likely.<sup>89</sup> Therefore, neo-liberal institutionalists found it necessary to identify institutional conditions specific to the issue area in question, and the opportunities and obstacles for cooperation embedded within them.<sup>90</sup> Given the predicted decline of U.S. hegemony in the 1980s, a popular line of inquiry centered on identifying the conditions that encouraged self-interested states to cooperate with each other in the absence of a hegemonic power.<sup>91</sup> For Keohane and Nye (1989), an important explanatory factor was the post-war expansion of free trade and investment, which was underpinning evolving relationships of 'complex interdependence' between states in the international system.<sup>92</sup> In turn, regime formation and persistence was

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<sup>84</sup> Keohane (1984).

<sup>85</sup> To illuminate the distinction between institutionalist and structural realist accounts of international relations, using the analogy of a poker game, Keohane and Nye (1989) argue that 'at the process level, analysts are interested in how the players play the hands they have been dealt. At the structural level, they are interested in how the cards and chips were distributed as the game started.' (p.21)

<sup>86</sup> Hurrell (1993).

<sup>87</sup> Keohane (1982), p.339.

<sup>88</sup> For a description of this game, and an application of it to economic and security matters, see Lipson (1984)

<sup>89</sup> Some scholars, such as Keohane (1984), suggest that a hegemon is critical, whereas others, such as Young (1986), demonstrate that a dominant actor is not necessary to facilitate cooperation between competing states.

<sup>90</sup> For a useful discussion of rational institutionalist perspectives on compliance with international regimes, see Zürn (2005), pp.20-22.

<sup>91</sup> In the context of the Prisoner's Dilemma game, cooperation was assumed to be more likely under conditions of 'ongoing reciprocal exchange', which occur in cases where interactions are infinite or linked to a wide variety of other games with the same players. (Lipson 1984)

<sup>92</sup> Keohane and Nye (1989).

attributed to the growing economic integration of domestic economies, which deepened interactions between states and increased the relative gains of cooperation, and conversely, the relative cost of defecting from international agreements.<sup>93</sup>

For neo-liberal institutionalists, regimes are viewed as vehicles that provide a framework within which actors can realize joint gains through cooperation. So rather than merely reflecting instrumental acts or single agreements between states, international regimes manifest a convergence among states around particular norms, rules and principles, which provide the basis for sustained institutionalized cooperation between them.<sup>94</sup> This view is most succinctly spelled out in Keohane (1984), in which the emergence of regimes reflects the existence of 'political market failure' in which actors demand international institutions to solve collective problems.<sup>95</sup> Thus, in the absence of supranational authority, regimes as systems of norms and rules were perceived as important and effective sources of governance that facilitated cooperation between self-interest driven states. In turn, actors are willing to accept constraints on their behavior if it maximizes their benefits.

This perspective assumes that international regimes have fixed optimal outcomes, in which the volume and distribution of benefits across actors is maximized. Once established, they define common rules of behavior that incentivize cooperation over non-cooperation, thereby solving collective action problems caused by unaligned incentives and interests between individual actors. Their persistence depends on the extent to which instructive rules and sanctioning mechanisms effectively discourage non-compliance. This could result from changes in the distribution of capabilities among participants, where gainers may reassess the benefits of cooperation in the face of new power dynamics. So not only do utilitarian arguments assume that actors are inherently non-cooperative and driven by conflicting material self-interests, they also presuppose that action is always intentional, and that the costs and benefits of rule-compliance are pre-established rather than continuously interpreted and resolved.<sup>96</sup>

In this context, the content and structure of international economic regimes was seen as a product of broader bargaining processes between self-interest driven states over global trade and investment rules. Furthermore, bargaining outcomes did not simply reflect the distribution of power among states, nor did it require the active

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<sup>93</sup> Keohane and Nye (1989). But given these constraints, realists do recognize that cooperation is more likely on economic matters than over matters of security, because of the greater possibility of institutionalizing stable expectations. (Lipson 1984)

<sup>94</sup> In this context, regimes differ from single agreements or acts of cooperation, in that they go beyond the formal letter of international law by institutionalizing compliant behavior over the long-term based on a set of collectively held norms and principles (Vogler 2000). Their relationship may also be depicted as hierarchical, in which (higher order) regimes facilitate the making of substantive agreements by providing a framework of rules, norms, principles and decision-making procedures for negotiation. (Keohane 1982, p.337) As Hurrell (1993) notes, engaging in cooperation presumes the existence of a basic moral community among states, resting on a basic compatibility of major values and common conceptualization of basic concepts, such as order, justice, state, law, contract etc.

<sup>95</sup> Keohane (1984), p.85.

<sup>96</sup> Kratochwil (1989).

participation of a hegemonic power, as realists would contend. Instead, they also depended on the extent to which underlying institutional conditions induced states to favor cooperation over unilateral behavior.<sup>97</sup> By extension, the central objective was to understand what kinds of institutional conditions were likely to give rise to cooperation between inherently self-interested states, and induce them to comply with institutional arrangements. Given this motivation, studies of international regimes tended to focus on the formal structures of cooperation within international institutions, such as agreements, treaties and conventions, and how these allowed states to act collectively and manage conflicts amongst themselves.<sup>98</sup> For example, Mitchell (1994) argued that whether a regime elicits compliance depends not entirely on hegemonic power or the economic interests of regime members, but instead, on the agreed upon compliance system, and in particular, levels of transparency, the inclusion of potent and credible sanctions, the reduction of compliance costs and a focus on preventing violations rather than deterrence.<sup>99</sup>

In relation to the environment, some regime analysis has tended to be less rigid, as scholars have loosened the state-centric, rational-material assumptions that dominate regime analysis to give recognition to the significance of the growing ecological interdependence between states and the influence it affords non-state actors in environmental policy-making processes. While a utilitarian logic still dominates the literature on international environmental regimes, research has to a large extent accepted the post-realist consensus that international institutions have real implications for states and the formation of interests, and investigated the origins of institutionalized cooperation by looking beyond the role of converging interests or favorable distributions of power among states.<sup>100</sup> In particular, the instrumental role of scientific communities in identifying the origins of environmental problems and placing them on the international agenda has been of particular interest to some scholars of international environmental regimes.<sup>101</sup> The argument is that in place of domestic interest groups, transnational scientific alliances could influence state identities and interests by creating and diffusing new categories of knowledge and information that induce a convergence in policy among states, thereby laying the foundation for institutionalized cooperation between them. By attributing significance to transnational scientific or technical networks, non-state actors are given an influential role in the formation of international environmental regimes, and norms rather than fixed material preferences determine both the purpose and content of governance.

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<sup>97</sup> Keohane (1984), p.76. For an example of an interest-based institutional bargaining model developed to understand international regime formation, see Young (1989).

<sup>98</sup> See for example Keohane (1984). For a review and critique of Keohane (1984) and the contractual theory of international regimes, see Hasenclever et al (1993), pp.27-44.

<sup>99</sup> These observations were made with reference to two international oil pollution control regimes, the first governing tanker discharges, and the second governing equipment to prevent oil spills, such as segregated ballast tanks. (See Mitchell 1994)

<sup>100</sup> Vogler (2000).

<sup>101</sup> Haas (1992).

Yet, despite the emphasis on norms, rules and principles as defining characteristics of international regimes, the emergence of regime theory served to extend the use of positivist methodologies to study the emergence and impact of international norms and institutions. When confronted with the persistence of international cooperation in the face of hegemonic decline, regime theory did not re-examine the basic ontological and epistemological assumptions of realist and liberal theory. Instead, the challenge of regime analysis has largely been to explain the emergence and persistence of international cooperation given rigid rational-materialist assumptions.<sup>102</sup> In particular, as Vogler (2000) notes, the adherence to a utilitarian logic centered on rational-materialist explanations of political change has led to the integration of regime analysis into the main positivist theoretical traditions of international relations theory, largely leaving the sociological dimensions aside. In fact, the interest in international institutions as potential sources of political change was limited to understanding how they may complement existing rational explanations.<sup>103</sup> Therefore, neither realists nor neo-liberal institutionalists used regime analysis to develop a theory of international norm dynamics that is independent of either the material power or interests of actors.

The next section will review the alternative cognitive perspective for understanding institutional change in world politics that questions the ontological and epistemological basis of conventional rational approaches. By departing from the notion that actors have fixed identities and interests, this perspective attributes a much greater significance to norms in the international system, and therefore places norm shifts at the center of governance formation within given issue areas.

### 2.3 Cognitive Perspectives on International Norms

The central contribution that cognitive approaches bring to the study of international relations is that social institutions do not only affect behavioral choices, but also constitute the identities and interests of actors.<sup>104</sup> In international relations theory, cognitive perspectives that focus on the role of ideas, norms and forms of knowledge have been most prominent in constructivist literature on state behavior. In their view, constitutive norms should be recognized as a crucial element in explaining stability and change in the study of international relations and institutions, alongside political and economic advantage.<sup>105</sup> Norms encode appropriate actions for actors with

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<sup>102</sup> Briefly, these are 'that states are inherently self-interested actors competing in a world of anarchy, that cooperation need not depend on altruism, and that it can develop from the calculations of instrumentally rational actors.' (Hurrell 1993, p.56)

<sup>103</sup> As Katzenstein (1996) notes in the context of discussing the extent to which national identity influences the security policy of states, 'cultural explanations may be acceptable [to realists] as a last resort, but only if all other styles of analysis have failed.' (p.17) As an example of this, Goldstein and Keohane (1993) argue that examining the role of ideas in foreign policy-making might be able to shed light on the 'empirical anomalies' of rationalist approaches.

<sup>104</sup> For an overview of this perspective on regimes, see Hasenclever et.al, pp.136-210.

<sup>105</sup> Klotz (1995), p.17. As Nadelmann (1990) notes, while international regimes tend to reflect the economic and political interests of the dominant members of international society, moral and



particular institutional identities, who in turn comply with norms to fulfill their institutionally-defined obligations and duties. As norms organize and structure the cognition of actors, they give rise to routinized and habitualized forms of behavior. And crucially, such rule-guided behavior does not depend on the threat of external sanctions, as actors have internalized the duties and obligations that define their institutional identity. As such, the behavior of actors is communitarian, rather than instrumental, as the identities and capabilities of actors cannot be understood in isolation of their membership and position within a social community.<sup>106</sup>

While the prevailing epistemological position of regime analysis became almost entirely positivistic in orientation, the concept originated within the institutionalist tradition in social theory. In contrast to power- and interest-driven perspectives, constructivist approaches assume that the identities and interests of actors are not fixed, but are constituted by social structures, defined by 'shared understandings, expectations or knowledge.'<sup>107</sup> This alternative cognitive perspective, also labeled 'reflectivist' (Keohane 1998), 'interpretivist' (Klotz 1995), and a model of 'social learning and policy diffusion' (Underdal 1998), emphasizes how the production and reproduction of knowledge does not only constrain and enable behavior, but also constitutes identities and interests.<sup>108</sup> In turn, the sharing of knowledge can facilitate a convergence in modes of thinking, and produce a common understanding of what constitutes a problem of common concern, in effect defining the issue area.<sup>109</sup>

As such, constructivists are interested in the foundational origins of identity and interest formation. This means not taking for granted how the decision environment is organized, but recognizing that the delineation of issue areas and linkages between public policy problems is socially constructed, and constitute actors and agency.<sup>110</sup> A central assumption is that interests are redefined as the dynamic between knowledge and goals evolves in deliberations between actors.<sup>111</sup> In this view of governance, human behavior is predominately rule-governed, and can only be understood against the background of ideas and norms that give inter-subjective meanings to different behavioral choices. As Kratochwil (1989) notes, an actor must refer to rules in order to make a choice, and the observer must understand the normative structure

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emotional factors also play a crucial role in the creation and evolution of international regimes, including religious beliefs, humanitarian sentiments, faith in universalism, compassion, conscience, paternalism, fear, prejudice, and the compulsion to proselytize. (p.480)

<sup>106</sup> March and Olsen (1989), p.161.

<sup>107</sup> Wendt (1995), p.73.

<sup>108</sup> For sociological critiques of the conventional regime approach, see Checkel (2001), Kratochwil (1989), pp. 45-60, Kratochwil and Ruggie (1986), Klotz (1995), pp.13-39, Risse (2000), pp.1-14, and Schimmelfennig (2000), pp. 111-112.

<sup>109</sup> See Haas (1990) for a discussion on how knowledge creation and diffusion is central to the development of issue areas, and the formation of individual and collective interests in the context of international regimes.

<sup>110</sup> Haas (1990). As an example, whether greenhouse gas emissions cause global warming have objective answers, but the degree of certainty that warrants mitigative actions and the nature of those actions are for actors to decide, and depends on their interpretation of the problem. (Bodansky 1990, p.621)

<sup>111</sup> See Chayes and Chayes (1993).

underlying the action in order to interpret and appraise that choice.<sup>112</sup> As such, norms are central to the deliberative processes of assessment, justification and criticism, as they identify and establish for actors what has normative value and moral purpose.

Employing this approach means depicting regimes as inherently social structures that inform the evolution of state identities and interests, with no meaning or existence apart from the ongoing behavior of actors.<sup>113</sup> Moreover, material capabilities, so central to neo-realist approaches to understanding institutional change, explain nothing by themselves, as their effect presupposes shared knowledge that is not reducible to capabilities.<sup>114</sup> By extension, the analytical focus of constructivists is as much on informal institutions, such as norms of behavior, conventions, and self-imposed codes of conduct, as the formal institutions that rationalists commonly emphasize, such as codified rules, laws and constitutions.<sup>115</sup> In turn, meanings are not fixed in material structures, but mediated through social interactions and embedded in social practices. In this context, interaction does not follow rational negotiations between actors with fixed preferences, but is characterized by persuasive and argumentative acts aimed at adjusting interests toward particular ideas and norms.<sup>116</sup> By extension, as Kratochwil and Ruggie (1986) argue, the significance of international institutions goes beyond what the utility calculations of rational actors would address, as they manifest shared understandings that inform members about the boundaries of appropriate conduct in certain situations.

Before reviewing constructivist research on the emergence and diffusion international norms, it is instructive to briefly review an alternative cognitive approach that places hegemonic forces coalescing around an agenda of capital accumulation at the center of analysis. This perspective, while post-positivist, associates institutional change with historical structures centered on accommodating capital and encouraging capital accumulation, thereby providing an interesting take on the relationship between the state, transnational business and civil society, so central to the emergence of private governance.

### *Critical Cognitive Approaches: The Neo-Gramscians*

In contrast to constructivists, critical perspectives on international regimes argue they consistently favor certain norms and principles that facilitate and perpetuate the dominance of particular states and actor constellations over others. As such,

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<sup>112</sup> See Kratochwil (1989), pp. 69-94.

<sup>113</sup> Young (1983).

<sup>114</sup> Wendt (1995), p.73.

<sup>115</sup> This distinction is made by North (1990).

<sup>116</sup> As Risse (2000) argues, if identities and interests are fixed, there is no room for argumentation. In place of a rational ontology, he suggests that actors engaged in the international public sphere constantly have to explain and justify their behavior, and in case where actors are uncertain about their own identities, interests and views of the world, communicative processes centered on argumentation and persuasion become very important. (p.21-23)

international regimes do not only reflect material power structures, but also produce and reproduce hegemonic discourses that constitute the identities, interests and behavior of actors. These contentions are embedded in the Neo-Gramscian framework for understanding international political economy, in which Gramsci's theory of hegemony is drawn on to advance a historicist method of studying international relations. In this context, a *long durée* perspective is employed to illuminate how particular historical structures are produced by collective human action and come to characterize the social material world during particular periods of history.<sup>117</sup> According to Cox (1987), these historical structures define a collective consciousness, which present themselves to subjects as objective reality. Yet, in actuality, they are a historically specific subjective understanding of the social world. Within them, ideas, material capabilities and institutions reciprocally interact and collectively form a complex reality, and operate within three spheres of activity; social relations of production, forms of state, and world orders.<sup>118</sup>

The historicist perspective manifests itself in the contention that the past shapes current and future historical structures, which provides for the possibility that different time periods are shaped by different historical structures, and that within given time periods, different historical structures confront each other in concrete social situations in a struggle over hegemony. As such, these structures are not given, but continuously produced and reproduced by human agency and interaction, and a dialectic between normative and material dimensions. This gives 'precedence to practice' in explaining the nature and content of broader structural change, and identifies hegemony as a product of process, rather than material capabilities. In turn, the notion of truth is historically specific and inter-subjectively produced by social relations, conventions and discursive practices.

The most significant argument that Neo-Gramscians contribute to the study of international institutions is that the modern incarnation of the state has always been associated with the growth of integrated capital markets.<sup>119</sup> Likewise, inter-governmental institutional arrangements have evolved over time to accommodate capital, as it depends on the creation and maintenance of regimes of capitalist accumulations.<sup>120</sup> These arguments are embedded in Gramscian perspectives on the relationships between the state and civil society, or the state and business, which sees them not as antagonistic, but reciprocal and mutually reinforcing, nested in a deeper shift towards new institutional forms. By extension, neo-liberalism is transforming

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<sup>117</sup> For good overviews of the theoretical assumptions of this perspective, see Amin and Palan (2001), Bieler and Morton (2001) and Gill and Law (2001). For its application to understanding international economic and environmental regimes, see Levy and Newell (2005), and Paterson et.al (2003).

<sup>118</sup> In this context, ideas are understood as 'inter-subjective meanings, or shared notions of social reality, material capabilities are 'more tangible resources', whereas institutions are 'amalgams of the previous two elements.' (Bieler and Morton 2001, p.22)

<sup>119</sup> Gill and Law (2001).

<sup>120</sup> These regimes often take the form of 'regimes of accumulation', directly or indirectly governing 'the mode of life, composition of the labour force, its political organization, the technical, organizational and human aspects of the labour process and legal regulations at work.' (Gill and Law 2001, p.95)

the state into corporation-like actors, by being driven by competition and adopting corporate techniques and practices, and corporations into states, evident in CEOs perfecting political and diplomatic skills.<sup>121</sup>

By extension, business influence on world politics not only manifests itself in lobbying and bargaining with individual states, and the consequences of capital allocations, but also as part of a transnational hegemony that exerts institutional and ideological influence on social relations in world politics.<sup>122</sup> Since the normative and material dimensions of social change mutually reinforce each other, 'world hegemony is a social structure, an economic structure, and a political structure, it cannot simply be one of these things, it must be all three.'<sup>123</sup> This understanding of world order corresponds to Gramsci's concept of 'civil society', defined as a realm within which social structures of accumulation are consolidating while continuously being challenged.

So rather than depicting hegemony in the international system as a function of state economic or military power, or as a consequence of private structural power, Neo-Gramscians point to the networks generated by elite interactions between business, state officials, bureaucrats, and members of international organizations, that force a broad consensus around neo-liberal ideas and forms of governance.<sup>124</sup> As Cox (2001) notes, hegemony at the international level is not merely an order among states, but closely associated with the dominant mode of production, post-Fordist capitalism, which penetrates into all countries and subordinates other modes of production. As such, the global economy is integrated into the international system, not as a sub-structure driven by the power and interests of states, but as the central arena of hegemonic power and socio-economic reproduction of structural relations of inequality.

In this view, the post-Second World War international regimes depicted by realists as products of U.S hegemonic leadership, and by liberals as reflections of sustained legitimacy of liberal ideas and values in the international system, are interpreted quite differently. Rather than focus on the power capabilities or strategic interests of the U.S, or the incentives among states for international economic cooperation, critical perspectives see this period as the consolidation of economic, social and political forces around a configuration of power based on market capitalism. According to Gill and Law (1993), these regimes encompassed a wide range of actors that shared class interests and were united behind the perpetuation of neo-liberal norms, including financial firms on Wall Street, elements of the state apparatus, centrist political parties and organized labor in the major capitalist nations. Their leading element was the international expansion of capital-intensive, mass-consumption accumulation, and

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<sup>121</sup> Amin and Palan (2001) and Cerny (1995).

<sup>122</sup> For example, see Sell (2000) and Williams (2001) on organized business lobbying of multilateral trade negotiations at the WTO.

<sup>123</sup> Cox (2001), p.62

<sup>124</sup> See Bieler and Morton 2001, p. 29, for examples of how transnational hegemony is manifested in current international economic regimes.

broadening global investment opportunities for exports and FDI in manufacturing and natural resource extraction, particularly oil.

While this perspective has gained a growing following, particularly among scholars researching the relationship between global environmental politics and the broader institutional structures of global capitalism, it has yet to significantly engage with the literature on social movements and account for how these are able to induce both states and private actors to pursue policies that seem to conflict with a pure capital accumulation agenda. The next section will review how constructivists typically understand the emergence and diffusion of norms in the international system, and the role they attribute actors and strategic agency in this process.

#### **2.4 Norms and State Behavior: A Survey of Literature**

During the last two decades, literature on international norms conducted outside the confines of regime theory has flourished. Rather than assuming that the influence of norms in international relations is limited to formal structures created and adopted by states, these perspectives identified broader social structures and normative changes as constitutive of the international system itself. In a wide variety of policy areas, including those that have traditionally been the exclusive domain of power- or interest-based approaches, scholars identified how state behavior could be traced to the emergence and diffusion of particular norms, either domestic or international. Moreover, these norms were central to explaining the character of relations between states, and the broader evolution of international organization and cooperation.

Perhaps the first real challenge to the rational-materialist assumptions of neo-realism was the English School, which placed shared norms and values at the center of explanations of stability and order in international relations. While broadly accepting the overarching assumptions of neo-realism that world politics is anarchical, this alternative view rejected the notion that it was populated by ego-centric, self-interest driven states left to defend themselves in the absence of supranational rules and norms. Instead, they perceived relations between states to be predominately norm-governed, sustained by common institutions, norms and practices, in particular international law and diplomacy. In turn, instead of an international system of anarchy, there exists an international society of states, in which relations between states are competitive, yet take place within a common normative framework that places certain social constraints on state conduct.<sup>125</sup> According to Bull (1979), the principles, norms, rules and values that constitute the international society govern both which states are considered a member and how those states behave.

By extension, the English School identified social structures as central to identity and interest formation, and by extension, as the basic foundation for the generation of

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<sup>125</sup> For the seminal publication on the concept of 'international society', see Bull (1977). For a brief comparison of the neo-realist and English School understanding of international relations, see Brown (2007).

alliances, and more generally, for cooperative interactions between states. According to this view, many international regimes that identify certain state practices as immoral and unacceptable can be traced to the ideational consensus that represents the foundation of international society.<sup>126</sup> Subsequently, problematizing identities and interests became a common theme in the constructivist literature in international relations, as a means to understand sustained patterns of behavior of particular states, or groups of states with a shared cultural or normative heritage. For example, in his analysis of the Cuban missile crisis, Kratochwil (1989) argues that it was not the competitive buildup of military capabilities *per se* that precipitated the infamous Cold War standoff, but rather how both the United States and the Soviet Union interpreted each other's military ambitions.<sup>127</sup> In this context, the distribution of military capabilities was not a sufficiently accurate predictor of why the conflict occurred or what the outcome would be. Instead, what mattered was the meaning that both parties attributed to particular policies pursued by the other side, and in turn, how these meanings were reaffirmed or contested in the context of interactions between them.<sup>128</sup>

Constructivist approaches to regime analysis have convincingly argued that regimes have a compliance pull of their own. Specifically, what binds members together and produces a sense of obligation are not simply the functional benefits that they provide states, or the extent to which they reflect broader relationships of power between them.<sup>129</sup> Rather, as Ruggie (1983) argues, norms embedded in international regimes produce a consensus among states around what constitutes legitimate social purposes towards which state power is expected to be employed at the domestic level. In his oft-cited example, he argues states complied with the international economic regime that emerged after the Second World War because it sought to integrate domestic welfare demands into an international neo-liberal world order.<sup>130</sup> This balance between international and domestic objectives, captured in the phrase 'embedded liberalism', gave recognition to the desire among states to manage the domestic costs of a liberal international economy. The widespread acceptance of this concept gave the international economic regime a 'legitimate social purpose' that meant neither overwhelming power or the existence of clear, short-term benefits was necessary to induce states to comply with norms.

By recognizing that norms can give rise to stable behavioral patterns over time, Ruggie (1983) illuminated how institutional continuity and change in the international political economy had been driven by the persistent or changing legitimacy of particular norms related to international trade and capital.<sup>131</sup> This

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<sup>126</sup> Nadelmann (1990), p.483.

<sup>127</sup> Kratochwil (1989), pp.49-52.

<sup>128</sup> In a similar example, Wendt (1995) notes that '500 British nuclear weapons are less threatening to the United States than 5 North Korean nuclear weapons, because the British are friends of the United States and the north Koreans are not, and amity and enmity is a function of shared understandings.' (p.73)

<sup>129</sup> Hurrell (1993).

<sup>130</sup> Ruggie (1983).

<sup>131</sup> Finnemore and Sikkink (1998).

perspective attributes governance formation to a shift in norms, which reconstitutes the identities and interests of actors, and by extension, the duties they feel obligated to fulfill. As a result, understanding why and how norms emerge and diffuse in the international system become important imperatives for explaining why governance emerges in particular issue areas. In particular, whereas state power and interests may determine *form*, such as the institutional design of the regime, it is the rise and fall of norms that explains the *content*, notably the regime's social purpose. By extension, constructivists argue that disassociating norm dynamics from power and interests in the rational-material sense helps explain why fluctuations in power among states may not influence the social purpose of international regimes, and conversely, why institutional continuity and change may result despite the absence of shifts in the balance of power.

Apart from problematizing behavioral decisions beyond the utilitarian logic, norm research has also taken issue with the homogenization of state identities that is prevalent in realist analysis. Katzenstein (1996) features a selection of case studies that refer to norms, identities and social realities to explain state interests and behavior in security politics, including weapons acquisition patterns, positions on humanitarian interventions, and the choice of military postures in relations with other states. A common assumption that runs counter to rational approaches is that the social purpose of individual states is not fixed, but is greatly informed by domestic political and cultural traditions that (re)constitute their identities. In turn, state behavior is not conceptualized as a means to an end, but instead, an end in itself as it serves to affirm state identity. In a similar vein, Finnemore (1996) considers the reasons why states adopted the Geneva Conventions, a set of four treaties concerning the treatment of non-combatants and prisoners-of-war in military conflict. She argues that states did not adopt them principally because they expected it to bring strategic advantages to themselves in times of war, but as an end in itself, as 'affirmations of value about the kind of world people wanted and the kind of behavior that was acceptable.'<sup>132</sup>

With regards to explaining the emergence and diffusion of norms, constructivists often point to the instrumental actions of particular 'moral agents'. In the areas of environmental protection, labor and human rights, a burgeoning literature has documented how advocacy groups have become influential political forces in world politics, pressuring states, international organizations and TNCs to integrate public interest concerns into their activities. In the literature, these non-state actors are identified as 'norm entrepreneurs', collectively manifesting a 'global civil society' that is becoming a growing source of global governance.<sup>133</sup> Their activities and policy positions are primarily motivated by an ideational commitment, and that have defined political strategies based on raising awareness of particular issues and framing their

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<sup>132</sup> Finnemore (1996), p.129.

<sup>133</sup> For a discussion of the term 'global civil society' and its role in global governance, see Mathews (1997), Newell (2001a), and Wapner (2000).

moral causes in persuasive ways.<sup>134</sup> As part of making moral demands, norm entrepreneurs question the utility of certain activities that are considered entirely legitimate, and often protected either by law or political prudence.<sup>135</sup> By doing so, they not only advocate particular remedies to widely recognized problems, but actually define the problems themselves, including who bears responsibility. According to Finnemore and Sikkink (1998), as this involves challenging existing norms, they may have to explicitly act in ways that are deemed 'inappropriate' by existing normative standards, such as engaging in organized civil disobedience. By doing so, in-compliant behavior may over time become accepted if it leads to outcomes deemed by other actors to be favorable and preferable.

In turn, by promoting shared values, norm entrepreneurs mobilize 'social energy' to trigger broader social transformations in favor of human equality and social justice. If they overcome initial resistance and denial of accusations of wrong-doing, they may be successful in institutionalizing new norms in inter-state structures. For example, the norm may become embedded in domestic regulations, either as 'soft' or 'hard law', and inform the creation of new policies among states and international organizations in issue-specific areas. As noted by Risse and Sikkink (1998), at this stage states consistently argue in favor of the norm, regardless of whether the audience is generally hostile or favorable to it. And in cases where they have not been integrated internationally, international organizations may develop new organs, subunits, and administrative practices that are designed to improve some new measure of organizational performance.<sup>136</sup> In turn, as these policies become precedents that inform the development of subsequent domestic legislation or international agreements, the norm contributes to narrowing the policy space for alternative understandings and increases the pressure on states that remain defiant in their opposition to the norm.

And finally, apart from conceptualizing the purpose and impact of social movements, norm research has been used to problematize the role of international organizations in world politics by demonstrating how they are instrumental in not only diffusing domestic norms across countries, but also producing shared understandings of international problems and conceptualizing institutional responses to them. In this context, they are neither instruments of power, as neo-realists argue, nor simply functional responses to state problems, as neo-liberal institutionalists contend. As Haas (1990) notes, while states may create international organizations to solve particular coordination problems, the exact definition and understandings of those problems shift as part of being embedded within the organizational and professional culture of the international organization. In turn, the coordination function of international organizations also acts like a knowledge filter, in which domestic policy

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<sup>134</sup> For a theoretical discussion of 'framing', see Payne (2001) and Stone (1989). For examples of its application to understanding the influence of transnational advocacy groups, see Keck and Sikkink (1998) and Nadelmann (1990), and Price (1998).

<sup>135</sup> As an example, see Price (1998) for the role of such 'norm entrepreneurs' in changing attitudes among states towards land mines.

<sup>136</sup> Haas (1990), p.86.



preferences are amended to harmonize with existing policy agendas, and in accordance with the professional and technical biases of the international organization.

As such, international organizations engage as semi-autonomous actors in world politics, interpreting mandates and state policy preferences in unanticipated ways, commonly shaped by their internal organizational and professional culture and the rational-legal character of decision-making.<sup>137</sup> Given these biases, they should not be conceived as passive and objective actors simply serving their principals as international problem-solvers, but instead, as conveyors of forms of knowledge and categories of action that shape common understandings of development in very particular ways.<sup>138</sup> Moreover, this means the authority of international organizations does not only stem from their association with dominant states, but also their discursive power as knowledge producers and brokers, and by extension, influential forces in the emergence and diffusion of norms. For example, St.Clair (2006) provides a critical assessment of the World Bank's self-proclaimed transformation into a 'Knowledge Bank' and argues it is not promoting knowledge as an educational institution would, but instead advocating a significant bias in favor of development economics as the theoretical and normative foundation for understanding and discussing human aspirations for welfare. This perspective is advanced through formulating conference agendas, providing capacity-building and professional training courses, and most of all, generating enormous amounts of policy-oriented academic research that 'frames' the development problematique in very specific ways.<sup>139</sup>

By representing member states, whilst also peddling policy agendas that reflect their organizational and professional biases, international organizations provide collective legitimization of particular policy preferences, and by doing so, signal approval and disapproval of the claims, policies and behavior of states.<sup>140</sup> As an example, Barnett and Finnemore (2004) survey the evolution and influence of the IMF as an international bureaucracy, and argue that many of the roles and functions taken on by the international organization cannot simply be explained by broadening demands among states for international coordination and policy advice. Rather, the staff of the IMF itself have been leading many new initiatives and broadening the scale, scope and depth of technical advice on monetary policy matters given to member countries, greatly expanded its ability to regulate economic life and in many ways constituting those systems in need of regulation.<sup>141</sup> As an example, they discuss the IMF's move from a limited focus on balance-of-payments lending to ever more sweeping structural interventions in members' economies and societies in an attempt to control activities that might contribute to stabilization. This move, they argue, was not purely

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<sup>137</sup> Barnett and Finnemore (2004), p.10-12. For a similar discussion how the internal features of the World Bank and IMF effect their respective behavior, see Woods (2006).

<sup>138</sup> See St.Clair (2006), Woods (2006) and Stone and Wright (2006), pp. 9-17,

<sup>139</sup> On the 'framing' role of the World Bank, see Bøås and McNeill (2004).

<sup>140</sup> This argument was originally presented by Claude (1966) in reference to the political function of the United Nations.

<sup>141</sup> See Barnett and Finnemore (2004), pp.45-72.

‘technical and value-neutral’, but aimed to ‘reconstitute these economies to conform to the market-dominated models that have become known as the Washington Consensus.’<sup>142</sup>

The cases of the World Bank and the IMF demonstrate how the legitimizing effects of expert knowledge created and diffused by international organizations empowers certain actors over others, thereby having real distributional consequences. While such views are most common in the context of multilateral financial institutions and international economic regimes, they can also be useful in studying norm diffusion in other policy areas. As an example, Finnemore (1996) attributes the proliferation of state-science bureaucracies in countries to the work of the United Nations Educational, Scientific and Cultural Organization (UNESCO), rather than an administrative need that emerged and diffused among member-states. She finds that many states that developed these bureaucracies to manage domestic scientific research actually had no substantial domestic scientific communities. Therefore, this development has to be understood in reference to a desire among governments to signal a commitment to advancing modern science, as part of reinforcing their identities as members of a socially constructed international community of which UNESCO is an anchor organization.<sup>143</sup>

Thus, symbolic acts play a role in international relations, as states may pursue courses of action that conform to well-recognized moral principles even in cases where this entails confronting a dominant state or absorbing material costs. As an example, Klotz (1995) observes that the emergence and widespread support for trade sanctions against South Africa was a product of the growing legitimacy of the norm of racial inequality, which reconstituted the identity and social purpose of states, and prompted them to support policies that in many cases conflicted with their immediate short-term economic interests as major investors and trading partners. Similarly, numerous case studies in Risse, Ropp and Sikkink (1998) illustrate how the quest for international legitimacy, respect and affirmation explains why states declare a commitment to human rights norms. In both cases, widespread legitimacy of particular norms empowered weak states and non-state actors, allowing them to confront and circumvent the initial opposition of dominant states.<sup>144</sup>

In these observations, collective behavioral changes that manifest governance within an issue area are attributed to norm shifts, which are conceptualized as outcomes of normative struggles among various networks of power and knowledge.<sup>145</sup> In this context, behavioral changes are not primarily due to shifts in material power or resources, but changes to the meanings that actors attribute to different courses of action.<sup>146</sup> Thus, actors follow new courses of actions not because they stand to gain in

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<sup>142</sup> Barnett and Finnemore (2004), p.47.

<sup>143</sup> Finnemore, (1996), p.12

<sup>144</sup> Klotz 1995, p.24. On the sources of power of transnational advocacy groups, see also Keck and Sikkink (1998) and O’Brien et al (2002).

<sup>145</sup> Litfin (1994).

<sup>146</sup> Elaborating on this point, Risse (2000) argues that rational bargaining models that seek to explain processes of institutionalization should more forcefully recognize that human interactions are

power or wealth, but because doing so corresponds to their identity as members of a particular social group. In turn, the characteristics and properties of norms themselves hold many answers as to why governance emerges, and the selection of norms around which actors cooperate. In particular, an approach that assumes behavior is norm-guided can be useful in shedding light on the diffusion of environmental and social management standards in transnational markets, as these are neither backed by a legal authority nor significantly influenced by states. Instead, the transnational policy realm is dominated by transnational actors, whether they be businesses, voluntary organizations or even international organizations operating semi-autonomously from their principal states, with recognized technical expertise that is assumed to be equally (if not more) valuable to solving policy problems across national jurisdiction.

## Conclusion

The debates between neo-realists and neo-liberals in the 1980s over the creation, persistence and effectiveness of international regimes triggered the first investigation into the exogenous effects of international institutions on state behavior. As Hurrell (1993) notes, these debates were shaped by the acceptance of three rigid assumptions about international relations; that states are inherently self-interested actors competing in a world of anarchy, that cooperation need not depend on altruism, and that it can develop from the calculations of instrumentally rational actors.<sup>147</sup> For neo-realists, the rise and fall of international institutions is intimately connected to the power and interests of states, whereas for neo-liberal institutionalists, they could not be understood within a purely utilitarian logic of political change that elevated agents over structures. The debate between them and sociological institutionalists provided a useful starting point for understanding the significance that mainstream theoretical perspectives in international relations attribute to norms in explaining institutional change.

While the state-centric nature of regime analysis suggests that it may not be particularly useful for understanding how and why private governance emerges at the global level, the central role of state-based authority in processes of institutionalization suggests that inter-state regimes and institutions do matter. This contention has been validated in the growing literature on international norms and state behavior, which has highlighted the role that powerful states and international organizations play in the emergence and diffusion of norms in the international system, alongside more traditional norm entrepreneurs. In turn, as many forms of private governance draw on well-recognized norms in the international system and incorporate references to international environmental law, it is instructive to consider private governance as an outgrowth of existing international regimes, organizations and institutions, rather than a separate system of rules that are either supplementing or

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characterized by communicative acts, such as persuasion and argumentation, rather than rational exchanges of material concessions in which the interests of the parties remain fixed throughout. (pp.14-34)

<sup>147</sup> Hurrell (1993), p.56.

rivaling those created by states.

Building on this literature review, the next chapter will discuss in more detail how the three dominant theoretical perspectives on governance formation would explain the emergence of private governance. By comparing the perspectives across six aspects of private governance formation, the chapter will provide a framework for organizing the empirical case study and the summary of findings in the concluding chapter. In addition, the next chapter will provide a hypothesis for how norms emerge and diffuse in transnational markets by drawing extant norm research in international relations.

### ***3. Theoretical Framework: Norms and Private Governance***

#### **Introduction**

This chapter will argue that understanding the emergence of private governance in transnational markets is best achieved by placing the growing legitimacy of environmental and social norms in the private sector at the center of the analysis. Specifically, given that private governance relies on the voluntary acceptance and adherence to particular procedural and substantive norms, compliance is less a consequence of formal enforcement than a desire among private actors to adhere to evolving norms that dictate what constitutes legitimate and acceptable behavior. As such, social sanctions, such as being excluded from a social group or losing one's reputation, are much more significant in explaining compliance than the threat of legal sanctions. By implication, an analysis of institutionalized behavior in the transnational policy realm, where formal state authority is diminished, directs our attention to how certain norms initiate and sustain behavioral patterns among actors.

The previous chapter reviewed the literature on governance formation and established that norms matter in understanding state behavior. While all three generic approaches to understanding institutional change – power, interests and knowledge – attribute significance to norms, only cognitive approaches endogenize them in the identities and interests of actors. Furthermore, neo-realists, and to a lesser extent neo-liberal institutionalists, downplay the role that non-state actors can play in influencing international norm dynamics and broader institutional change. By extension, the challenge for this chapter is to take the key insights from the previous chapter and consider how and why they apply to the case study at hand. Specifically, an important objective is to present a framework that explains the emergence of private governance within the broader existing system of international norms and rules. Implicit in this is an assumption that private governance may have significant associations with existing international regimes and organizations, and that these ties are most often discursive and evident in the diffusion of norms from and between states to non-state actors.

This chapter will consider competing theoretical explanations and outline a framework for understanding private governance formation that centers on understanding how and why environmental and social norms emerge and diffuse in transnational markets. The first section will define the institutional context produced by the globalization of world politics that took place in the 1990s, and identify its implications for understanding governance formation. The second section will build on the previous chapter and outline three contending hypotheses for explaining private governance formation built on realism, neo-liberal institutionalism and constructivism, and more specifically, identify the explanations that each of these would have for the emergence of the Equator Principles. And finally, the third section will make the case for a synthesis approach to propose an analytical model for

studying private governance formation that combines insights from the three theoretical perspectives.

### 3.1 Setting the Context: From 'International' to 'Transnational' Governance

Given the need to understand norm emergence and diffusion in transnational policy processes, it is necessary to move beyond the confines of regime analysis, which fails to fully recognize the direct roles that non-state actors can play in world politics. Whereas states are the principal units of analysis in the study of multilateral environmental agreements, TNCs stand at the center of the vast array of intra-industry codes of conduct, guidelines, labeling and certification schemes that have emerged in the last decade. The growing role of private actors epitomizes the increasingly liberal orientation of global environmental politics, towards institutional responses that rely on 'market-friendly' norms and principles that allow them to be integrated into existing neo-liberal economic regimes.<sup>148</sup> In many cases, private governance manifests itself in standards and guidelines for environmental management practices in a given industry in the form of eco-labeling schemes or codes of conduct.<sup>149</sup> While voluntary, the growing diffusion of these schemes and their growing influence on the practices of states and international organizations suggests that these initiatives could potentially transform the institutional relationships between public and private actors.

This section will argue that the conventional focus on formal rules created and implemented by states, for states, fails to recognize the increasingly complex set of institutional arrangements that govern the transnational policy arena, in which decision-making is guided by states and a variety of non-state actors with competing and conflicting interests and motivations.<sup>150</sup> Figure 3.1 depicts the differences between an 'international' and a 'transnational' perspective on governance, in which the latter provides a more comprehensive account of the interactions between public and private actors that characterize world politics today. In the 'international' perspective, governance is assumed to be whatever international organizations do, and their formal attributes, such as their charters, voting procedures, and committee

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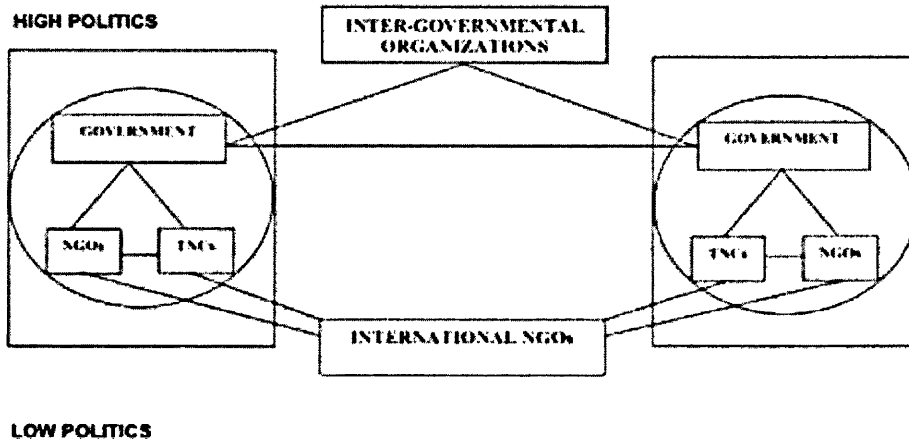
<sup>148</sup> The rise of environmental management as an overarching policy paradigm is significant in this regard. (Williams 2001) This conception arises from positivist understandings of environmental problems, and an optimistic belief in technocratic solutions to environmental problems. See also Bernstein (2001), Clapp (2005), Falkner (2003), and Graham and Woods (2006).

<sup>149</sup> See Cutler et.al (1999) and Pattberg (2004) for overviews of different institutional types of private governance.

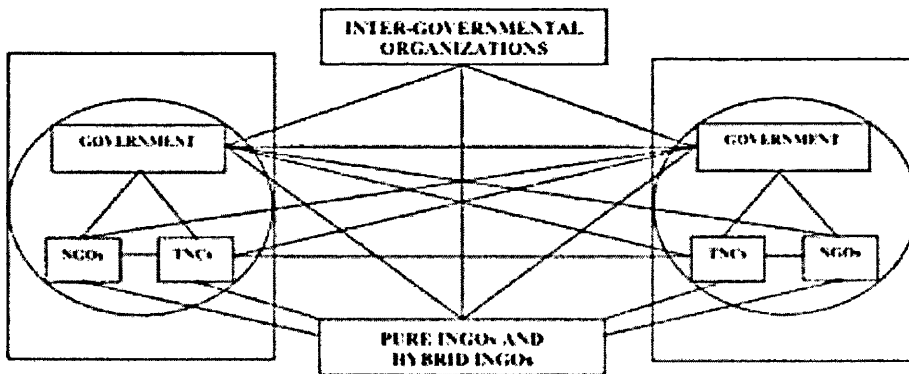
<sup>150</sup> Cerny (1995) argues the structural transformation is of such magnitude that it has 'transformed the way that the basic rules of the game work in politics and international relations.' (p.596)

**Figure 3.1 Two Perspectives on World Politics**

**‘International’**



**‘Transnational’**



Source: Willetts (2005), p.379.

structures, account for their behavior.<sup>151</sup> In this perspective, characteristic of regime analysis, the influence of non-state actors is largely confined to lobbying governments at the domestic level and providing scientific input into international negotiations.<sup>152</sup> In contrast, a transnational perspective recognizes the full range of interactions between states and non-state actors, and more broadly, the growing integration of domestic, international and transnational policy spaces. These interactions take place in an international public sphere that is broadly open and

<sup>151</sup> Kratochwil and Ruggie (1986), p.758.

<sup>152</sup> As per Strange (1991), this perspective is deeply rooted in the assumption that the power to create and disrupt international order rests exclusively with states, which naturally relegates non-state actors to merely informing rule-making, or being forced to obey rules created by states.

inclusive, rather the closed nature of many multilateral and bilateral policy-making processes.<sup>153</sup>

As part of outlining an analytical framework for understanding how norms emerge, diffuse and become institutionalized in transnational policy spaces, it is instructive to survey the institutional features of transnationalism that shape international norm dynamics. First, the growth of transnational relations among actors reflects the culmination of broader structural changes in the international system, in which private actors and interests increasingly shape the configuration of the international political economy.<sup>154</sup> Secondly, as a result of the political mobilization of private actors in policy areas traditionally driven by the state, institutional design in global governance is becoming increasingly diverse, ranging from conventional inter-governmental agreements backed by state-based authority to non-binding rules and certification schemes created and implemented by different kinds of non-state actors.<sup>155</sup> Third, and related, by not being directly associated with states or state-based institutions, the purpose and scope of governance is increasingly de-territorialized, away from rules defined by and for national jurisdictions, to frameworks that can be applied and implemented transnationally.<sup>156</sup> And fourth, as both a precursor to and a product of the transnationalization of governance, authority is increasingly diffused or delegated to transnational non-state actors, placing them in a position to directly determine the institutional design and content of governance that penetrates into domestic policy spaces.<sup>157</sup>

In general terms, these institutional conditions have proved politically favorable for transnational actors, including international organizations, relative to those whose interests and influence are limited to particular states. In shaping institutional development, transnational actors are not always beholden to state interests and actions, but can play a direct and independent role in deciding the purpose, institutional design and implementation of new forms of transnational governance. For example, as demonstrated in numerous case studies in Cutler, Hauffler and Porter (1999), Hall and Biersteker (2002), and Levy and Newell (2005), non-state actors are capable of acquiring and projecting authority in the international system that is perceived by those subjected to it as both legitimate and credible. In particular,

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<sup>153</sup> Risse (2000), p.22.

<sup>154</sup> Strange (1996) defines authority in political economy as 'the power to alter or modify the behavior of others by using incentives and disincentives to affect the choices and range of options.' (p.133)

<sup>155</sup> See Koenig-Archibugi (2006), pp.12-19. For examples of new forms of transnational governance, see selected chapters in Hall and Biersteker (2002), Cutler et.al (1999), Higgott et.al (2000), and Josselin and Wallace (2001).

<sup>156</sup> However, as Scholte (2005) notes, apart from supranational governance beyond states, the growing interdependence between states has also induced the emergence of sub-state governance, in which local authorities in different states interact and formulate policy independently of their respective national governments.

<sup>157</sup> In recognition of this, literature identifying and examining new forms of private governance typically rejects the assumption prevalent in the regime literature that states and state-based institutions hold a monopoly on legitimate and authoritative power in world politics. For a broader philosophical discussion about the nature of legitimate authority and its relationship with power in the context of non-state actors, see Hall and Biersteker (2002), pp.3-22.



private actors are increasingly cooperating on overtly political matters that go beyond the coordination of market behavior commonly associated with cartels, to form self-regulatory private regimes.<sup>158</sup> By doing so, private actors can no longer be considered merely intervening variables in the international system, but possess the capability and interest in establishing a parallel transnational system of rules.<sup>159</sup>

As an example, the most influential standard-setting framework for environmental management is the ISO 14000 standard series of the International Standards Association (ISO). The standard is intended to provide guidance for adopting firms to integrate environmental considerations into their business operations by establishing environmental management systems and other operational guidelines.<sup>160</sup> The international standard for Environmental Management Systems (EMS), ISO 14001, was based on the British Standards BS 7750, and also driven by the voluntary charter for business drafted by the ICC.<sup>161</sup> While dominated by industry, the ISO standards are formally negotiated between national industry bodies of member governments, collectively supported by a large network of some 180 technical committees, 550 subcommittees, and 2,000 working groups.<sup>162</sup> The process of standard-setting is decentralized, with different national standards bodies taking the lead in different technical areas, in close consultation with national and international stakeholders.<sup>163</sup>

Alongside the rise of private actors, the information and communications technology revolution has allowed advocacy groups in different countries to form transnational networks that have become an increasingly powerful force against transnational business and the neo-liberal policies of the Bretton Woods institutions.<sup>164</sup> Rather than simply acting through states and international organizations as domestic or transnational advocacy groups, these networks have become central to the diffusion of knowledge and information about environmental and social problems, and become directly involved in articulating and implementing policy responses to them. As an example, the World Wildlife Fund played a crucial role in the creation of the Forest Stewardship Council (FSC), a standard-setting and certification scheme devised by logging companies, forest managers, international NGOs, and a wider range of local community groups and trade unions.<sup>165</sup>

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<sup>158</sup> See Drahos and Braithwaite (2000) and Falkner (2003). As per Cutler et.al (1999), private regimes are 'integrated complexes of formal and informal institutions that are sources of governance for an economic issue area as a whole.' (p.13)

<sup>159</sup> Pattberg (2004).

<sup>160</sup> According to one proponent, the purpose of the ISO 14000 series is to 'move organizations from a compliance-based orientation to the level of integrated environmental management.' (Feldman 1999, p.5)

<sup>161</sup> Feldman (1999).

<sup>162</sup> Clapp (2005), Falkner (2003), pp. 76-77, and Mattli and Bühte (2003).

<sup>163</sup> Haufler (2000).

<sup>164</sup> See selected chapters in O'Brien et.al (2000), as well as Keck and Sikkink (1998), Kobrin (1998), Nadelmann (1990), Price (1998) and Wapner (1995).

<sup>165</sup> Pattberg (2004). The first two types of standards are certified by independent certification bodies. Since the establishment of the FSC secretariat in 1994, over 78 million hectares of forest in more than 82 countries have been certified according to FSC standards while several thousand products are produced using FSC certified wood and carrying the FSC trademark.

In broad terms, the new transnational politics in the international political economy of the environment has produced a policy realm that is largely independent of domestic political structures, and is underpinned by a deepening institutional relationship between international organizations, TNCs and transnational advocacy groups.<sup>166</sup> In turn, decentralized consultations between them are leading to the creation of new systems of rules in which traditional inter-state bargaining is no longer the locus of global decision-making.<sup>167</sup> In turn, this emerging realm of social relations is dominated by transnational actors whose identities are tied to ideas and norms that are not nationally-defined or bounded, but derive from a universal vision of world politics. By implication, the social purpose of interactions is frequently the harmonization and coordination of state and non-state practices across national jurisdictions, in areas such as environmental policy and management, financial accounting and risk reporting.

### **3.2 Hypothesizing Private Governance Formation**

Before outlining the analytical framework that will be used to explain the emergence of the Equator Principles, it is instructive to review how the three main theoretical perspectives on governance formation in international relations would explain the emergence of private governance. Table 3.1 identifies six dimensions of governance formation – why norms emerge, timing, main initiators, their sources of influence, governance structure, and why norms are adopted - for which the three before mentioned theoretical perspectives have competing explanations. First, the question as to why norms emerge concerns what factors determine the influence of a particular norm on actors' behavior. Secondly, timing concerns the reasons why norms begin to inform corporate behavior in a particular market at a particular time, as a precondition for governance. Third, main initiators refer to the actors that are each theoretical perspective assumes will take the lead in creating private forms of governance. Fourth, sources of influence refers to on what basis the main initiators have attained their dominant role and exert power in the governance process. Fifth, governance structure concerns what the level of formalization and the kind of institutional design that the respective theories would predict a private governance initiative to have. And finally, why norms are adopted concerns the explanations the different theories have for why private actors adopt norms.

Overall, the analysis will develop three general hypothesis about how the dominant perspectives in international relations on institutional change may explain the emergence of private governance generally, and the Equator Principles in particular. While these perspectives have commonly been deployed to explain the emergence of international regimes negotiated by and for states, it is nevertheless instructive to consider their explanatory power relative to transnational governance of this kind. In

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<sup>166</sup> Börzel and Risse (2002) and Ruggie (2004), p.504.

<sup>167</sup> Pattberg (2004).

turn, the concluding chapter will return to these hypothesis and consider the explanatory power of each in relation to this case.

**Table 3.1 Three Perspectives on Private Governance Formation**

	<b>Realism</b>	<b>Neo-Liberal Institutionalism</b>	<b>Constructivism</b>
<b>Why norms emerge</b>	Hegemony	Efficiency	Legitimacy
<b>Timing</b>	Shift in balance of power between states	Change in institutional conditions and interest structure	Rise and fall of international norms
<b>Main initiators</b>	States (and international organizations)	States, international organizations and transnational actors	Norm entrepreneurs (both states and non-state actors)
<b>Sources of influence</b>	Economic resources	Economic resources / technical expertise	Knowledge / legitimate moral claims
<b>Governance structure</b>	(Inter)national, state-based	Transnational, market-based	Global, society-based
<b>Why norms are adopted</b>	Response to coercion	Convergence in interests and response to incentives	Effect of persuasion

### *Realism and Private Governance Formation*

Early literature on the role of non-state actors in world politics frequently lamented the fact that the core assumptions of realist perspectives on institutional change do not readily lend themselves to exploring private governance as an institutional phenomenon separate from states. The state-centric dimension of realism, in which states and state power are elevated over non-state actors and forms of authority, has been seen as a significant limitation in studying emerging forms of global governance. Yet, the inclusion and testing of a realist hypothesis of institutional change in this thesis is based on a contention that the validity of theory should be empirically tested rather than simply assumed.

Within realism, states, and hegemonic states in particular, hold primary significance in the analysis of institutional change. As Haufler (1999) notes, the early literature on regime analysis more or less integrated hegemonic stability theory to the study of international institutions, embedding it within a liberal concern for institutional

cooperation.<sup>168</sup> In this regard, explanations of broader long-term structural stability and change in the international economic system are associated with the rise and fall of hegemonic states.<sup>169</sup>

**Why norms emerge:** Realists argue that state-based institutions remain resilient even in an age of globalization where the mobility and financial strength of transnational private actors have grown considerably. Whether a particular norm exhibits a high level of conformity with existing international institutions (and by extension the interests of powerful states) is the primary factor in determining its legitimacy in world politics and its influence on behavior and broader institutional change. By implication, realists would predict that only those norms that conform to the interests of powerful states would emerge and diffuse in transnational markets, because they are backed by state power. As a result, they would expect that rules predominately negotiated and implemented by non-state actors nevertheless do not directly confront or undermine state power and state-based institutions. Instead, private governance would be expected to extend the power of states by legitimating and promoting the interests of powerful states, and diffusing norms embedded in domestic policies and state-based regimes. Given this prediction, a realist hypothesis would be invalidated if norms that conflict with and undermine the interests of powerful states are institutionalized in transnational markets.

**Timing:** A realist perspective would explain the emergence of institutionalized cooperation between private actors within a broader context of inter-state relations and competition. (see Box 3.1) The timing of a process that leads to a specific private governance outcome is closely linked to the consequences of state behavior and the exercise of state power. Thus, to understand why norms and rules emerge and induce behavioral convergence among market participants, realists would find it necessary to consider the national and international structures and institutions within which market transactions take place, and within which private actors are forced to operate and make decisions. In particular, they would predict that governance reflects changes in the balance of power between states, which places state power behind a new set of norms. More broadly, realists would predict a direct link between the emergence of private governance and shifts in the wider inter-state competition over trade and finance in the global political economy.

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<sup>168</sup> While predominately applied to international economic regimes, hegemonic stability theory has been loosely attributed to other issue areas as well. For example, Little (2005) argued that states observed the humanitarian principle that prohibited the international slave trade not because of its inherent moral or ethical properties, but because it was expected that Great Britain intended to enforce the regime and had the capacity to do so.

<sup>169</sup> For example, Kindleberger (1973), a lead proponent of this view, suggested that the existence of mutually beneficial economic exchange between states at the international level has historically depended on the presence of a dominant economic and political power that has the capacity and willingness to supply and support the necessary infrastructure, including stability and order. As an example, Carr (2001) argued that international free trade in the 19<sup>th</sup> century did not organically emerge, but came into existence and was maintained by British economic and military power. Similarly, Gilpin (2001) states that the creation of a multilateral system of trade and economic relations after World War II reflected the material and security interests of the emerging hegemonic power, the United States.

**Main initiators:** Realists assume states are the primary actors in international relations by virtue of possessing a monopoly of force within their given territory. They explain the behavior of non-state actors and institutional cooperation between them within the broader struggles for power and influence among states in the international system. The significance of non-state actors is subordinated to that of states because of the legal authority that the latter enjoy within their territorial jurisdiction and in relations with other states. Moreover, international organizations are considered to be mechanisms through which states act, rather than autonomous agents in international affairs. As states, independently or collectively, determine the rise and fall of particular institutions, they ultimately provide the institutional context for non-state actors to act and engage with each other. Therefore, in terms of explaining the emergence of private governance, realists would predict that powerful states, either directly or through international organizations, would drive any initiative in order to ensure that its purpose, structure and influence would correspond to their interests. They would expect the membership of any initiative to include states and/or international organizations, as non-state actors are not viewed to be capable of creating institutions that rival or challenge those of states.

### **Box 3.1 Realism and Private Governance Formation**

#### Hypothesis

General: Private governance is supply-driven, conceptualized as a set of norms expressive of hegemonic state power and coercively imposed on private actors.

Specific: The Equator Principles reflect the strategic interests and values of dominant economic powers by encouraging the imposition of particular terms and conditions on project finance loans given to developing countries.

**Source of influence:** As power is the main factor in determining the outcomes of negotiation processes that lead to governance, states are the primary actors in the international political economy by virtue of their sovereign powers and economic resources and capabilities. States can exercise power structurally, in the sense of creating and enforcing the structures within which market actors are forced to operate, or relationally, by directly using their legal authority and economic power to punish those that violate law through national or international courts or using other coercive measures. Within negotiations between private actors, state power manifests itself in the creation and enforcement of international institutions that constrain and enable international business. Whereas realists may admit that growing economic

interdependence has increased the influence of transnational private actors, the scope of corporate power and interests is still assumed to be restricted by rules and regulations defined and enforced by states and international organizations. In fact, the growing financial and economic interdependence between states, reflected in the transnationalization of markets and corporations, as a manifestation of state power and not a reflection of its decline.

**Governance structure:** Given these assumptions about norm evolution and state power, the overarching purpose of various regimes, even of those created and implemented by non-state actors, would be to institutionalize norms that encourage stability and order in a particular domain in the international system that would ultimately be beneficial to powerful states and their survival. As realists assume only the exercise or threat of state power can guarantee compliance, they would predict that state authority is present in the governance structure. The validity of this argument would be strengthened by evidence that states or international organizations hold privileged negotiating positions and are directly involved in both setting rules and overseeing their implementation. But state power could also be exercised structurally, in the sense that negotiations conducted amongst non-state actors could be nested within broader structures of inter-governmental relations, such as the U.N or the OECD. In either case, the explanatory power of a realist perspective would depend on the presence of state authority in the governance structure of private regimes, in some form.

**Why norms are adopted:** As realists believe non-state actors are forced to operate within the constraints created and upheld by state-based institutions, norm-following behavior is ultimately assumed to be a function of state authority. As markets follow, rather than lead states, private actors continuously adapt their behavior to the changing nature of market structures, which themselves are products of state power and competition between states. In this regard, realists would explain private governance as a response to state power and the coercive pressures generated by state-based institutions. A failure to align their market behavior with the interests of powerful states may not necessarily result in direct punishment, but would place them in a disadvantaged position within market structures created and maintained by states. As a function of coercion rather than consent, adoption is then a defensive act, meant to ensure commercial survival by adjusting behavior according to the rules set by powerful states.

Applied to the Equator Principles, a realist hypothesis would be boosted by evidence of significant state representation in the negotiations, either in the form of direct participation or through international organizations. Moreover, the soundness of a realist interpretation seemingly rests on evidence that commercial banks, despite their increased mobility and financial strength in an age of financial globalization, are nevertheless forced to devise rules for themselves that conform to those created and enforced by powerful states. Thus, realists would predict that private governance does not institutionalize norms and rules that rival those embedded in state structures, but serves to reinforce them. In this regard, they would expect the Equator Principles to

promote the diffusion of norms that emerged from inter-state cooperation to govern investments in a way favorable to states. As such, the framework could be characterized as an extension of state power in global finance that structures financial transactions in ways favorable to powerful states and the stability of capital markets.

### *Neo-liberal Institutionalism*

The rise of private actors and authority in world politics, and the growing significance of transnational relations between non-state actors across national boundaries, has been the root of a reconsideration of many realist assumptions within the study of international relations. Neo-liberal institutionalists argue that realists overemphasize the significance and impact of state power in world politics, and related, underemphasize the extent to which states are inclined to engage in cooperation. The transnationalization of politics and markets has deepened interactions between states and increased the necessity of multilateral cooperation to solve problems that affect individual states, manifested in areas such as the environment, migration, trade and finance. Integration has increased the benefits of peace, and thereby produced favorable conditions for transnational institutions to emerge and diffuse.

**Why norms emerge:** For neo-liberal institutionalists, norms emerge because of a demand among actors for problem-solving or better coordination. (see Box 3.2) The process whereby governance emerges depends to some extent on the compatibility of interests among actors, and their relative success in bargaining processes.<sup>170</sup> Such a perspective would hypothesize that the content of governance, manifested in the standards around which actors coalesce and the structure that governs implementation, reflects an efficient response to a collective problem. As neo-liberal institutionalists conceptualize governance as problem-solving rather than outcomes of battles for power between conflicting parties, norms emerge and become institutionalized through a process akin to Darwinian natural selection; norms that gain widespread acceptance do so because they have proven to be more efficient and effective at solving collective action problems than other norms.<sup>171</sup> Just like successful companies in a market are credited with superior business models to those that are less successful, so are dominant norms assumed to have superior qualities compared to those that are less influential in informing behavioral choices. In this

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<sup>170</sup> Reflecting such a utilitarian perspective, Axelrod (1986) proposes to use game-theoretic methods to study norm dynamics, in which actors select norms on the basis of their utility. While conceding that actors do not always make choices about the future by way of rational calculations, he still subscribes to a utilitarian logic in which norm selection is based on the principle that 'what works well for a player is more likely to be used again.' (Axelrod 1986) p.1097). For an outline of his evolutionary approach to studying norm dynamics, see pp. 1096-98.

<sup>171</sup> Three principle mechanisms determine the rise and fall of norms in a utilitarian perspective. First, the more effective players, or those that are most successful in attaining their goals, are more likely to survive and reproduce, by virtue of making more efficient choices. Secondly, a similar process of natural selection takes place with regards to norms, in which those that are frequently 'selected' by players gain prominence in favor of those that are most often bypassed. And third, by way of perfect information, players that suffer from making poor choices may start to imitate the norm selections of the players that have gained from making better choices. (Florini 2003)

context, norms function primarily as informational devices that reduce uncertainty and solve conflicts between actors, by for example establishing rules of conduct that increase the efficiency of transactions.

**Timing:** In this view, the emergence of private governance is a product of the rational choices that private actors make in pursuit of their own self-interests. The timing of governance formation is attributed to changes in institutional conditions

### **Box 3.2 Neo-liberal Institutionalism and Private Governance Formation**

#### Hypothesis

**General:** Private governance is demand-driven, and emerges as a consequence of changes to institutional conditions and interest structures in which the benefits actors derive from cooperation outweigh the costs.

**Specific:** The emergence of the Equator Principles manifests how changing institutional conditions meant commercial banks could better realize their fixed, rational interests in the project finance market by engaging in cooperation and harmonizing environmental and social risk management practices.

which create a new demand for order among actors in a particular policy domain. Neo-liberal institutionalists therefore place much more significance than realists in the evolution of state interests, and how it impacts the qualitative character of relations between states, and in particular, the opportunities for cooperation. For example, they would contend that in an era of growing interdependencies between states, transnational governance has become much more possible and desirable. They would therefore predict that private governance emerges when institutional conditions, notably market changes that alter the distribution of costs and benefits of different forms of behavior, make cooperation more desirable for private actors.

**Main initiators:** Similar to realists, neo-liberal institutionalists also believe that states are primary actors in international relations and hold a privileged position relative to non-state actors by virtue of having a monopoly of force within their territorial jurisdiction. However, they contend that global economic and political integration has created opportunities for many non-state actors to develop and strengthen relations with other states and non-state actors through transnational activities. These transnational linkages, alongside deepening relations between sub-national actors, including bureaucracies and municipalities, means state power in an era of global integration is more diffuse and open to contestation. Thus, in particular policy areas, governance formation does not entirely depend on the exercise of state



power, as non-state actors may be able to take on 'state-like' functions by drawing on their resources and expertise.

**Sources of influence:** Instead of simply assuming that the emergence of governance is an expression of state power and coercion, neo-liberal institutionalists are more inclined to consider it a reflection of interests, in particular shared interests. Thus, interest, rather than power, is the ontological starting point for neo-liberal institutionalists to understand governance formation. Actors promote their fixed interests in rational bargaining processes, and a governance outcome, for example a joint acceptance of particular standards, reflects the fact that actors have individually considered cooperation to be preferable to defection in achieving their aims. In turn, the influence of individual actors is reflected in the leverage they have in negotiations, their relative bargaining positions, and the strategies they choose to pursue. The basis for bargaining power is thus a combination of economic resources and technical expertise, as well as strategic competence and skill. In this context, states hold a privileged position, but neo-liberal institutionalists argue non-state actors, including scientific organizations and TNCs, can exert influence by virtue of scientific knowledge and technological expertise that other actors depend on for understanding problems and solving them.

**Governance structure:** The choice of governance structure would follow a similar logic. A neo-liberal institutionalist perspective would hold that a governance structure reflects the interests of private actors, and optimizes the efficiency of governance by ensuring that the benefits of cooperation outweigh the costs. In a transnational market, this perspective would predict that a market-based structure, which affords maximum flexibility and discretion to private actors while ensuring that harmonization in practices takes place, is the optimal outcome. As markets are believed to lead to a more efficient distribution of costs and benefits than that which would result from a publicly created and enforced system, neo-liberal institutionalists would predict that private governance is market based, and driven by voluntary compliance. In fact, the growing role and influence of private actors in transnational governance would be interpreted as an efficient response to the kinds of problems and inefficiencies caused by parallel processes of growing global integration combined with the persistence of nation-based politics and regulation.

**Why norms are adopted:** Neo-liberal institutionalists would explain private governance using a micro-economic logic in which the decision to adopt is based on rationally weighing the relative costs and benefits of different strategies for achieving fixed objectives. Actors differ in their market strength and position, as well as the institutional environment within which they operate, which explains patterns of adoption. Adoption would therefore be a discrete choice of action that would be measured against a decision to not adopt. It is therefore possible to ascertain that those private actors that adopt a particular voluntary framework do so because they expect to derive more benefits from doing so than failing to do so. The outcome of such a rational calculation both reflects the constraints and opportunities produced by the institutional environment, as well as the actors' own interests and capabilities.

Applied to the Equator Principles, neo-liberal institutionalists would view the framework as an outcome of rational bargaining processes between commercial banks faced with a collective incentive to better manage the environmental and social impacts of project finance investments. Similar to realists, they primarily understand the actions and interests of private actors to be a function of international and national structures of governance created and maintained by states. Yet, relative to global finance, they would stress that growing economic and financial interdependence between states has created new transnational policy spaces and markets in which national boundaries are less significant in determining the structure and content of governance. This has not only increased the commercial opportunities and autonomy of transnational investors, but made the capabilities and resources of transnational actors more influential. The Equator Principles, as a voluntary framework negotiated by transnational investors, would be an expression of the economic and financial interdependence between states, and the growing influence of investors as intermediaries between national markets.

### *Constructivism*

While both realist and neo-liberal institutionalist perspectives emphasize material factors, such as resources and capabilities, in explaining governance formation, cognitivist perspectives attribute governance formation to a shift in norms. In international relations theory, cognitive perspectives are most commonly associated with constructivism, a theoretical orientation that departs from a rational-material ontology based on an assumption that ideas, meanings and understandings in the social world are socially constructed. In this regard, behavioral changes occur because norms reconstitute the identities and interests of actors and by extension, the duties they feel obligated to fulfill. Norms are understood as neither informational devices exogenous to interests, nor expressions of state power. They are viewed as central to identity and interest formation, and more broadly, governance. As a result, the study of norm emergence and diffusion must be disassociated from material power and interests in order to explain why fluctuations in power among states may not influence the social purpose of international regimes, and conversely, why institutional continuity and change may result despite the absence of shifts in the balance of power. In this regard, the interests of actors are not fixed around rational self-interest, but conceived to be more fluid and produced and reproduced through social interactions.

**Why norms emerge:** For constructivists, governance is socially constructed through social interactions between many actors, rather than being a consequence of the actions of one class of actors, whether they be states or TNCs. In turn, a shift in norms is a precondition for institutional change. A constructivist explanation for why norms emerge would emphasize the role of discursive practices in social interactions between actors, rather than the legal characteristics and material capabilities of individual actors. Norms become influential because actors consider them legitimate,

and define their interests around them. An important determinant of whether a new norm is legitimate is the extent to which it conforms to existing norm structures. This means norms may redefine how actors understand problems, allocate blame, and evaluate solutions. In turn, the emergence of governance in an issue therefore reflects how particular norms come to define what constitutes appropriate behavior as a result of persuasion and argumentation, and give meaning and social purpose to collective action. As norms constitute the identities and interests of actors, norm emergence can be associated with a deeper transformation of the social purpose of agency. Once institutionalized in governance frameworks, norms attain a force of their own as they are embedded into the identities and interests of actors and frame policy discussions in ways that reinforce the legitimacy of the norm.

**Timing:** Constructivists argue that understanding the timing of governance formation necessitates an inquiry into how and why some norms gain prominence and legitimacy among a group of actors at a given time, while others do not. (see Box 3.3) In global governance, norms emerge and diffuse because of norm entrepreneurs who actively promote them in social interactions. By implication, constructivists would expect private governance to coincide with the behavior of norm entrepreneurs, and by extension, the rise of particular norms, which made certain corporate practices illegitimate and gave meaning to cooperation between private actors. Norms are produced and reproduced by social interactions between actors that are wedded to conflicting ideologies and moral claims, and clash over how particular problems should be understood and who is responsible for solving them. When a norm gains prominence over others, it changes the appropriateness of certain types of corporate behavior and thereby creates interests around achieving particular normative outcomes. In this context, the decision of private actors to cooperate with each other and commit to following certain norms should not be understood as an instrumental reaction to either power or incentives, but a reflection of a deeper convergence in identities and interests across private actors.

**Main initiators:** While most constructivists agree that the state is the central organizing entity in international relations and thereby exerts considerable discursive influence, they do not always share the view that states are primary actors simply by virtue of having a monopoly of force within a given territory. Instead of arguing that the influence of individual actors is a function of their legal and material properties, constructivists point to their legitimacy in social interactions, the moral authority of their normative claims, and the ability to argue and persuade. More broadly, actors are not viewed as either power- or interest maximizers. Instead, they are conceptualized as norm entrepreneurs, embedded in social structures while promoting particular ideas, understandings and standards of conduct that may alter those same structures.

As constructivists do not assume that possessing a legal right to sovereign rule is the only source of power, they would contend that governance can be traced back to norm entrepreneurs that frame policy problems and promote particular solutions. Norm entrepreneurs can be states as well as non-state actors. This means that while

the discursive influence of state-based institutions in defining problems, allocating responsibilities among actors and shaping policy discourses is in most cases formidable, states' actions do not alone decide the rise and fall of international norms, and in turn, the emergence of institutions. In particular, champions of norms that conform to well-recognized principles constitutive of international law, such as respect for human rights, non-violence and non-discrimination, are often more influential than those that challenge these. For example, a human rights organization may therefore be more influential in negotiations than a state that routinely violates human rights, by virtue of its legitimacy and moral standing among a particular group of actors.

**Sources of influence:** For constructivists, power structures and the distribution of

**Box 3.3 Constructivism and Private Governance Formation**

Hypothesis

General: Private governance is norm-driven, and reflects how the identities and interest of private actors have become redefined by new norms, which in turn triggers behavioral changes that conform to those norms.

Specific: The emergence of the Equator Principles reflects the diffusion of particular international norms in commercial project finance, which reconstituted the identities and interests of commercial banks through a process of socialization.

power among actors is socially constructed and a function of inter-subjective understandings of problems and solutions, which provide legitimacy to actors with certain identities and interests over others. In contrast to the rational-materialist ontology of both realist and neo-liberal institutionalist perspectives, constructivists assume behavioral changes, and governance formation more generally, reflect processes of socialization whereby the identities and interests of actors are reconstituted around particular norms.<sup>172</sup> Influence in global governance is much more a consequence of discursive practices, in particular acts of persuasion, the legitimacy of moral claims and the extent to which norms promoted by actors conform to existing norm structures. By implication, influence is not limited to states, or even financially powerful TNCs, as non-state actors with legitimate moral standing can overturn the power of those that have superior material resources. Over time, the repetition and routinization of certain types of behavior reinforces them, thereby maintaining the foundation for continued institutionalized cooperation.<sup>173</sup>

<sup>172</sup> See Meyer (2002), pp.532-542 and Schimmelfennig (2000), pp.111-112.

<sup>173</sup> Rosenau and Cziempel (1992).

**Governance structure:** Constructivists would expect a governance structure for harmonizing market practices to be more inclusive and multi-level than what is commonly predicted in the literature on international regimes. It is based on a society-based understanding of international relations in which a multitude of public and private actors influence the form and content of governance by participating in public discourse. Therefore, they would predict an inclusive governance structure in which roles and responsibilities are divided across public and private actors as part of ensuring its legitimacy. Moreover, neither power nor positive incentives are seen as requirements for a particular framework to induce compliance. It is legitimacy-seeking behavior, rather than fear of coercion or response to positive incentives, that drive institutional change. Therefore, legitimacy of the process and the outcome of governance – input and output legitimacy – is the main determinant of compliance. This means constructivists would not necessarily expect private governance to be formalized and backed by state power, as the legitimacy of voluntary principles ensures compliance.

**Explaining norm adoption:** In terms of explaining why private actors adopt a particular norm, constructivists would argue that it is not a function of state coercion or new incentives that make private actors prefer cooperation over unilateral actions. Instead, the roots of behavioral changes are much deeper, caused by processes of socialization which reconstitute the identities and interests of actors around particular norms.<sup>174</sup> Once such a transformation has occurred, norm compliance becomes a natural act embedded in the consciousness of actors as ‘the right thing to do’. This means the compliance pull of norms is inherently a social mechanism, where norm-following behavior is not motivated by rational calculations of the costs and benefits associated with compliance, but pursued because it is meaningful and considered legitimate, or proper in the normative sense.<sup>175</sup> When norms have attained that level of legitimacy, breaching them would require actors to make a deliberate choice to act in ways they know is illegitimate and inappropriate. By implication, governance formation is then a reflection of collective norm-following, as norms define actors’ identities, their view of the world as well as their own moral and social purpose relative to other actors.

Applied to the Equator Principles, constructivists would focus on the growing compliance pull of environmental and social norms among commercial banks, reflected in a transformation of their identities as lenders. They would view the framework as evidence of the emergence and diffusion of particular norms in the global project finance market which redefined what constitutes responsible lending practices, and by extension, redefine the identities and interests of lenders. The analysis would then hone in on social interactions between actors, and why actors promoting particular norms succeeded in persuading others of their moral superiority over others. Constructivists would predict that successful norm entrepreneurs were

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<sup>174</sup> See Meyer (2002), pp.532-542 and Schimmelfennig (2000), pp.111-112.

<sup>175</sup> Dessler (1999), p.454-458 and Zürn (2005). As per Hurd (1999), legitimacy refers to ‘the normative belief by an actor that a rule or institution ought to be obeyed.’ (p.381).

both superior in arguing their moral claims and framed them according to existing norm structures. In this regard, the Equator Principles reflect how norm entrepreneurs were able to shift the parameters for what constituted responsible business conduct, and thereby make a concern for environmental and social impacts of project loans central to the identities and interests of commercial banks as responsible 'corporate citizens'.

The next section will make the case for a theoretical framework which incorporates elements of each of the perspectives reviewed above. In turn, this will provide a context for outlining an analytical approach to understanding the emergence of private governance in transnational markets.

### **3.3 Understanding Private Governance Formation: A Synthesis Approach**

As suggested by Hasenclever et.al (2000), rather than consider which of the stylistic representations of regime formation applies to this case, it is more constructive to assess the validity of their core assumptions relative to various phases and aspects of a particular regime, thereby integrating them into a synthesis framework. A basic premise of this approach is that the three perspectives, while different in their epistemology and core assumptions, are not necessarily mutually exclusive. For example, a focus on international norm dynamics does not necessarily conflict with a state-centric view of international relations. As Ruggie (1983) demonstrates, hegemonic power significantly influences the rise and fall of international norms, and more generally, states often serve as norm entrepreneurs in the international system. Likewise, constructivists often accept that social institutions are often influenced by the rational calculations of actors, and that norm entrepreneurs make strategic choices about how they build and diffuse their ideas. Finally, neo-liberal institutionalists often recognize that the social dimension of agency, including trust, expectations and legitimacy, often explain behavioral choices of actors.

An emerging tendency in the literature dealing with norm emergence, diffusion and adoption is that a dichotomous conception of theory that favors either an instrumentalist or sociological perspective is neither accurate nor particularly constructive. To bridge the fault line, several scholars have sought to explore a synthesis of the two dominant positions of the third debate - rationalism and constructivism - by seeking to understand which logic of social action dominates the various stages of norm evolution.<sup>176</sup> For example, as Checkel (2001) notes, 'softened' rationalists accept that norms do constrain behavioral choices, and that sociological imperatives such as prestige, reputation and esteem are sometimes significant factors in explaining why actors make certain decisions and follow particular courses of

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<sup>176</sup> For attempts at this, see Finnemore and Sikkink (1998), which place human agency in the form of 'norm entrepreneurs' and strategic calculations at the center of norm emergence, as well as Risse (2000) and Risse et.al (1999), which outline an analytical framework that includes both rational bargaining and argumentative processes. See also Checkel (2001) for a comparison of rationalist and constructivist methodologies.

action.<sup>177</sup> Likewise, as illustrated in the previous chapter, constructivist approaches to understanding international norm dynamics commonly explain the actions of norm entrepreneurs in near instrumental terms, as ideationally committed and motivated actors strategically weighing the costs and benefits of different advocacy strategies and carefully selecting targets.<sup>178</sup>

At the heart of this matter is the relationship between social structures and agents. As Risse and Ropp (1999) note, research on the effects of ideas need to specify the causal mechanisms through which ideas affect actors' identities, interests and behavior. Yet, given that actors identities and interests are constituted by and conform to dominant norms, cognitive approaches do tend to have a structural bias. Therefore, while such a 'logic of appropriateness' helps explain how institutions constitute agency and why stable behavioral patterns persist over time, it is less able to identify how such rule-guided behavior may be altered. As Sending (2002) notes, the regulative properties of rules place severe constraints on individual interpretation, whereas the constitutive properties of rules define the identity of actors and the social community they belong to.<sup>179</sup> Accordingly, this perspective assumes that actors are 'more or less 'hermeneutically-programmed' by the institutions in which they are located', as they are not given much room to interpret compliance with rules in divergent ways.

This structural bias in constructivism poses problems for understanding the emergence of new forms of behavioral patterns among a group of actors, as this entails explaining why actors break with prevailing norms and align their behavior with new norms that redefine what are considered appropriate and legitimate actions. To explain norm shifts, constructivists commonly draw on an ontology of mutual constitution resembling Giddens' structuration theory, in which social structures such as market exchange, classes, or political processes do not exist or evolve by themselves, but are embedded in social interactions between actors.<sup>180</sup> Therefore, social structures should be viewed as systems of human knowledge that are produced and reproduced by social interactions, and can be altered if actors amend their

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<sup>177</sup> Most rational regime theorists that depart from an orthodox contractarian view of international cooperation fall into this category. For example, Axelrod (1986), whilst advancing a game-theoretic model for explaining norm evolution, argues that the power of membership makes defection as a strategy less attractive because 'it would tend to lower one's self esteem.' (p.1105) Similarly, Keohane (1988) recognizes that rationalistic theories of international institutions need to be historically contextualized in order to recognize that specific institutions are embedded in practices that cannot be fully explained through rationalistic analysis. (p.393)

<sup>178</sup> For example, Finnemore and Sikkink (1998), in describing the role of norm entrepreneurs, argue that the utilities of actors can be both 'material' and 'social', and claim norm entrepreneurs 'engage in 'strategic social construction' by making detailed means-end calculations to maximize their utilities' in order to 'change the utility function of other players'. By implication, they argue the first half of the process fits with a rational game-theoretic framework, whereas the latter half does not, as it involves reconstituting identities and interests. (p.910) Similar combinations of rational and constructivist ontologies are used in the 'spiral model' outlined by Risse et.al (1999)

<sup>179</sup> Sending (2002), p.452.

<sup>180</sup> See Giddens (1984).

conduct, either consciously by abrupt deviance, or unconsciously through incremental adjustments.

This duality of structure provides an explanation for how norms constitute identities and interests, yet persist only if actors reaffirm their legitimacy through their behavioral choices. As Wendt (1995) argues, in most cases social structures contain some 'slack' that allow actors to diverge from institutional directives and thereby contribute to altering them. In this context, actors are not slavishly programmed to follow norms, but are inclined to break with entrenched institutions in certain circumstances by pursuing forms of behavior that conflict with their institutionally-defined identities and interests. In explaining how a particular normative context may be replaced by another, constructivist approaches often resort to action-oriented explanations that emphasize actors and their individual ideational and instrumental motivations.<sup>181</sup> For example, whilst arguing that social structures constitute the identities and interests of actors, Wendt (1995) also notes that 'what happens in the future depends on what actors *do* with the structures they have *made* in the past.' (emphasis added)<sup>182</sup> As Sending (2002) argues, this assumes that actors 'are always in a position to evaluate, reflect upon and *choose* regarding what rules to follow and how to act.' (original emphasis)

Yet, the notion that actors can affirm and undermine norms by making certain behavioral choices does not mean their behavior should be examined purely within an instrumental logic. Because it is collective action, not discrete rational acts, that ultimately cause a transformation in normative contexts. Thus, the rise and fall of norms is not for individual actors to decide, but is instead a consequence of collective action. As such, the way in which individual actors perceive the costs and benefits of different choices, and how these perceptions may change, is deeply shaped by their interactions with other actors. In fact, it is through interactions between actors that different courses of action gain meaning and social purpose, and become recognized as either preferable or counter-productive.

To account for the importance of strategic behavior for understanding the emergence of international norms, the perspective outlined here will resemble what Hurrell (1993) refers to as 'weak cognitivism', or an attempt to fill a gap in interest-based theorizing by recognizing that the demand for international institutions among actors depend on actors' perceptions of international problems, which is in part produced by causal and normative beliefs.<sup>183</sup> There are two reasons for choosing an approach that

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<sup>181</sup> For example, in discussing a 'logic of arguing' as a mode of social interaction, Risse (2002) notes that the interplay between agents and structure in the real world usually combines several modes of social interaction. Furthermore, as both rational choice and social constructivism encompass both rule-guided behavior and deliberative behavior, the debate is really about 'how far one can push on logic of action to account for observable practices and which logic dominates a given situation.' (p.3)

<sup>182</sup> Wendt (1995), p.80, fn.28.

<sup>183</sup> Hurrell (1993), pp.139-154. As such, the focus on international norms in explaining behavioral changes is predominately designed to supplement, rather than replace, existing rational theories of institutional change and behavior. This perspective conforms more or less to what Checkel (2001) brands 'the modernist branch of constructivism', in which 'scholars combine an ontological stance



does not entirely depart from instrumental logic. First, norm entrepreneurs that deliberately and strategically invoke well-recognized norms to push particular political agendas are central to the emergence of private governance in transnational markets, particularly with regards to explaining the proliferation of business activities relative to environmental protection, poverty reduction and human rights. And secondly, when private actors are the targets of norm entrepreneurs, they make decisions about social pressures primarily in their capacity as market participants, weighing the costs and benefits of different behavioral changes. As such, the characteristics of markets, including the level of integration and concentration and how products and services are produced and sold, has a bearing on how private actors understand, interpret and respond to calls for greater responsibility and accountability.

On the other hand, norms matter. In imperfect market conditions, norms can influence how private actors respond to uncertainty. While they are driven by profit-motives, private actors frequently make value judgements about profit-margins, risk and opportunity, all of which are based on ideas and understandings about their roles and responsibilities relative to shareholders and society as a whole. Such decisions are predominately informed by the professional norms that govern market transactions, embedded in language, methodologies, and decision processes. But with respect to environmental and social impacts of business practices, behavior is also, and increasingly so, informed by norms institutionalized in international law, agreements and institutions. In private environmental governance, environmental and social norms, such as the precautionary principle and respect for human rights, become interwoven with the professional norms that elevate commercial justifications above all other moral or ethical claims. This means that with regards to prohibition norms, such as a ban on child labor or bribery, they often conflict with the professional norms that govern transnational business. In turn, a successful diffusion of the norm would manifest itself when particular business activities are no longer deemed legitimate or appropriate, and the adoption of new norms acquires a commercial justification.

More broadly, with regards to the debate between rationalist and constructivist accounts of international institutions, exploring possible synergies between the two perspectives is the most fruitful approach to advancing our understanding of how and why new forms of private governance are emerging at the transnational level. This is predicated on the assumption that it is useful to explore the wide middle-ground that exists between instrumental approaches based on purely rational-materialist logic of agency, and deeper constructivist perspectives that assumes identity and interest transformation is a precondition for any substantive behavioral change. This means combining the research questions that dominate the two approaches. On the one hand, the primary challenge for a normative theory of interest formation is to identify under which social and material circumstances actors violate dominant norms in favor of

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critical of methodological individualism with a loosely causal epistemology', in which 'norms matter in a constitutive, interest-shaping way not captured by rationalist arguments.' (p.554)

complying with other conflicting norms.<sup>184</sup> As it is assumed that behavior conforms to existing social structures, it is necessary to understand how social interactions cause actors to shift their allegiances between norms, or related, why particular norms succeed others as dominant within a given issue area. On the other hand, the primary challenge for a rational theory of social choice is to identify the material incentives that prompt shifts in behavior, often related to changes to the underlying institutional conditions. In the context of private actors, this would entail analyzing how norms inform market decisions, and how they influence the choice of and justification for different business activities. Combining these research questions means identifying both the normative and material circumstances that give rise to new forms of institutionalized behavior among actors engaged in a given issue area.

### **3.4 Norm Emergence and Diffusion in Markets: An Analytical Framework**

Based on the preceding discussion of rationalist and constructivist approaches to studying governance formation, this section will present an analytical framework that purports to demonstrate how environmental and social norms may emerge and diffuse in markets so as to lead to substantive behavioral changes. Pursuant of the issues discussed in the previous section, the framework hypothesizes in which phases of the norm emergence, diffusion and adoption process, different logics of social action – instrumentalist or constructivist - explain the behavior of actors. And secondly, it needs to establish the relationship between public and private actors, and their relevant roles and sources of influence, and how this is significant to causing or enabling the emergence of private governance. In turn, the end result would be an analytical model that incorporates a theoretical explanation of private governance formation within the broader, existing literature on institutional change in world politics.

In comparison to the existent frameworks that seek to explain the emergence and diffusion of international norms, the analytical framework put forth to explain norm emergence and diffusion in transnational markets is more complex. First, whereas both Finnemore and Sikkink (1998) and Risse and Sikkink (1999) employ a wide definition of ‘norm entrepreneur’ that in principle may encompass domestic, international and transnational actors, the analytical focus of the norm emergence stage in both cases is predominately on domestic politics, and interactions between ‘domestic movements’ and national governments.<sup>185</sup> In the proposed model for private actors, the stage within which norms emerge and diffuse in the private sector is characterized by complex interactions between states and non-state actors at the domestic, international and transnational levels.

And secondly, whereas the process whereby norms emerge, diffuse and get adopted by states is largely depicted as a one-way process that may or may not succeed,

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<sup>184</sup> Sending (2002), p.458.

<sup>185</sup> Finnemore and Sikkink (1998), p.902. As they say, ‘up to the tipping point, little normative change occurs without significant domestic movements supporting change.’

depending on the norm entrepreneur and the intrinsic characteristics of the norm, the framework for norm evolution in markets is described as much more complex. In particular, state-based governance, such as government policy, multilateral agreements and international organizations, inform norm emergence in the private sector alongside transnational advocacy networks that actively promote particular norms. As such, the way in which norms have been institutionalized within states and international organizations has a bearing on how they are institutionalized in private governance initiatives. In fact, the standards and procedures that manifest institutionalized norms in international organizations do not only provide private actors with technical solutions to integrating the norms into existing practices, but in actuality constitute the problem itself.

Table 3.2 outlines the main phases of the ‘spiral model’ that Risse and Sikkink (1999) used to explain the variations in the extent to which national governments move along the path towards improvement in human rights conditions.<sup>186</sup> As such, it is an evolutionary framework that seeks to explain how norm entrepreneurs, notably transnational advocacy networks advocating human rights, gradually gain influence over national governments. Over the course of the norm emergence, diffusion and adoption process, the dynamic between norm entrepreneurs and target states moves from being very confrontational to reconciliatory, and ultimately, mutually supportive. In this regard, it complements Finnemore and Sikkink (1998) nicely by identifying the dominant mode of social interaction that characterizes different phases of norm evolution, specifically, instrumental adaptation, arguing and institutionalization.

**Table 3.2 Norm Evolution and State Behavior**

	<b>1. Repression</b>	<b>2. Denial</b>	<b>3. Tactical Concession</b>	<b>4. Prescriptive Status</b>	<b>5. Rule-Cor Behavior</b>
<b>Main Actors Moving Process to Next Stage</b>	Transnational Advocacy Networks	Transnational Advocacy Networks	Transnational Advocacy Networks and Domestic Opposition	National Governments and Domestic Society	National Government Domestic S
<b>Main Mode of Interaction</b>	Instrumental Rationality	Instrumental Rationality	Instrumental Rationality / Argumentative Rationality	Argumentative Rationality and Institutionalization	Institutional and Habitua
<b>Main Target Actors</b>	States and International Organizations	States and International Organizations	States and International Organizations	States and International Organizations	States and International Organizati

**Source:** The table is featured in Risse and Sikkink (1999:32) as an illustration of how human rights norms among states in the international system.

<sup>186</sup> Risse and Sikkink (1999), p.18.

Table 3.3 outlines the hypothesis of the thesis in the form of an amended ‘spiral model’ aimed at explaining the emergence, diffusion and adoption of environmental and social norms in transnational business. Whereas the former concerns the cases where states are target actors, the latter concerns the integration of environmental and social norms in transnational business activities. By extension, it makes claims about how, why and under what conditions environmental and social norms emerge, diffuse and are adopted in transnational markets.<sup>187</sup>

The framework seeks to combine and build on two of the most influential frameworks for understanding international norm dynamics presented in the scholarship on social movements in world politics. First, as discussed previously, the norm ‘life-cycle’ model by Finnemore and Sikkink (1998) provides a useful way of distinguishing between the separate stages that characterize how a norm may gain prominence and legitimacy in world politics, and become adopted by actors. It places norm entrepreneurs at the center of international norm dynamics, and associates their initial instrumental actions with a clear cognitive transformation on the part of states, in which norm diffusion and internalization are not the result of tactical concessions, but rather, reconstituted state identities and interests. -

**Table 3.3 Norm Evolution and Corporate Behavior**

	<b>1. Repression</b>	<b>2. Denial</b>	<b>3. Tactical Concession</b>	<b>4. Prescriptive Status</b>	<b>5. Rule-Consistent Behavior</b>
<b>Main Actors Moving Process to Next Stage</b>	Transnational Advocacy Networks	Transnational Advocacy Networks	Transnational Advocacy Networks, Home Country Consumers, and Shareholders	TNCs and Home Country Society	TNCs and Home Country Society
<b>Main Mode of Interaction</b>	Instrumental Rationality	Instrumental Rationality	Instrumental Rationality / Argumentative Rationality	Argumentative Rationality and Institutionalization	Institutionalization and Habitualization

**Source:** This table is an amended version of Risse and Sikkink (1999:32), hypothesizing how norms emerge, diffuse and get adopted in transnational markets.

The framework assumes that international norms related to the prohibition of particular economic or political activities, such as logging in virgin forests, the use of child labor, or development in sensitive ecosystems, emerge on the international stage primarily because of the activities of norm entrepreneurs, notably transnational advocacy networks. As Finnemore and Sikkink (1998) note, norms are actively built by these agents who construct cognitive frames, which in cases where they are successful, resonate with broader public understandings and replace old ways of understanding and talking about issues.<sup>188</sup> As per Stone (1989), this entails

<sup>187</sup> This section draws heavily from Risse and Sikkink (1999), pp.22-35.

<sup>188</sup> Finnemore and Sikkink (1998), p.897, and Keck and Sikkink (1998), p.199.

‘composing stories that describe harm and difficulties, attribute them to actions of other individuals or organizations, and thereby claim the right to invoke government power to stop the harm.’<sup>189</sup>

However, the existence of norm entrepreneurs, and more specifically, actors who champion environmental and social causes, does not in itself guarantee that private actors adopt these norms and alter their behavior. What follows is a phase-by-phase description of how a norm may emerge and diffuse among private actors. The framework builds on previous theoretical literature on norm emergence, diffusion and adoption, and seeks to explain the case of environmental and social prohibition norms in transnational business. In this context, the assumption is that the target actors are TNCs that are based in OECD countries, yet active in non-OECD countries as financiers, producers or retailers. Indeed, because of domestic institutional pressures, this subset of private actors are most likely to develop corporate responsibility policies, engage in transnational rule-making and join voluntary initiatives, including codes of conduct. Therefore, understanding how environmental and social norms emerge and diffuse among market participants in these transnational markets is both topical and timely.

### *Repression*

In many cases, norm entrepreneurs seek to enhance the governance of collective goods in issue areas that most international relations scholars would not predict cooperation, because of excessive political cost, collective action problems, or most often outright hostility. Thus, in the early phases of the model, public information on norm violations is very scarce, as private actors ignore or deliberately suppress criticism. Therefore, as noted, the active promotion of a prohibition norm is initially met with *repression*, as norm entrepreneurs are denied political space to make their moral claims, and receive scant attention in the media. Furthermore, the norm is delegitimized by both states and private actors because it does not affirm the legitimacy of existing norms, understandings and linguistic practices that dominate transnational business. In turn, it is not simply a failure to integrate the norm into existing business activities, but private actors are unable to understand how and why the moral claims put forward by norm entrepreneurs is even relevant to their identities and roles in society.

Relative to private actors, norm entrepreneurs have several mechanisms available for promoting norms, which can be usefully categorized as either ‘liberal’ or ‘critical’ forms of governance.<sup>190</sup> In terms of the former, it involves a strategy of engagement, in which the constraints that the norm places on existing business practices is readily acknowledged and accepted. In this context, norm promotion becomes an exercise in problem-solving, or overcoming conflicts between norms or social purposes. For example, this may include educating the public on the environmental and social costs

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<sup>189</sup> Stone (1989), p.3

<sup>190</sup> See Newell (2001a), pp.91-100.

associated with producing or consuming certain products, and conversely, educating the targeted TNCs on the existence of potential niche market in which consumers are willing to pay a premium for 'ethical' products. Another option is forging partnerships with TNCs at the project level, by for example finding ways to ensure that particular business transactions benefit a local community, to policy-level collaborations that may include the drafting of industry guidelines or codes of conduct based on a consensus among market participants in consultation with civil society groups.

Yet, given the resistance to prohibition norms that exist in transnational markets, norm entrepreneurs most often resort to more confrontational strategies, especially during the initial stages of norm evolution. For example, they may organize consumer boycotts or demonstrations that are meant to stimulate adverse media publicity, and essentially shame targeted TNCs into responding to specific accusations of wrongdoing. In practical terms, it involves producing information on the environmental and social consequences of different economic activities that attributes responsibility and blame to particular groups of actors, and disseminating it to the public, the media and the target actor. Oftentimes, this means singling out events that can resonate with the public and trigger adverse reactions towards a target actor, such as egregious examples of environmental destruction or human rights violations.<sup>191</sup>

In some cases, dramatic events, such as industrial accidents or oil spills, are given extensive media coverage and provide norm entrepreneurs with evidence that certain patterns of behavior are having immoral, unethical or unwanted outcomes. In other cases, such as gradual environmental degradation, both the choice of event and which TNC to target can be strategically driven by what the public and the media might be interested in. In some cases, norm entrepreneurs eager to earn public attention may deliberately obstruct business activities by engaging in civil disobedience, or intentionally damaging corporate equipment or materials. By engaging in such activities and linking certain business activities to environmental or social harms, norm entrepreneurs in effect define problems by identifying an event or trend as morally undesirable and inappropriate, and associating it with actors and forms of behavior.<sup>192</sup> As such, they help set the normative context within which policy agendas are formed.

### *Denials*

If norm entrepreneurs are successful, the process moves to the next phase of the 'norm emergence' stage, in which the norm gains recognition in some circles and manifests itself in specific accusations of wrongdoing against TNCs. Information

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<sup>191</sup> Nelson (1995), p.55.

<sup>192</sup> This is significant, because as Underdal (1998) states, 'the context into which a particular problem is framed can make a difference with regard to, inter alia, the (kinds of) perspectives and premises that are considered relevant or appropriate and which actors will have access to the policy-making process.' ( p.19)

about TNCs that violate the norm is more readily available, and shared internationally. In such cases, the dynamic transnationalizes, as domestic pressure groups receive rhetorical and material support from allies in other states, whether they be NGOs or national governments. In turn, as the targeted TNCs are no longer able to simply repress these voices of dissent, they instead resort to issuing public *denials* of the accusations, rejecting the validity of the norm and the assumption that they are responsible for what they stand accused of. Oftentimes, this involves making claims that adhering to the norm falls outside of their mandates as profit-making organizations, and against the interests of shareholders.

However, in contrast to the first phase in which criticisms did not even solicit responses, targeted TNCs now have to justify existing practices against the moral claims of norm entrepreneurs. Therefore, they gradually enter into an argumentative dynamic with their adversaries, responding to specific accusations of wrong-doing or irresponsibility with counter-evidence. In turn, norm entrepreneurs are required to delegitimize existing norms governing the behavior of target actors by arguing that compliance with them leads to immoral or unethical outcomes. They do so by creatively manipulating language, framing causal stories about the origins of environmental and social harms, and attributing meaning to particular material events. In response, targeted actors may initially indirectly respond to the accusations by profiling themselves as responsible and reputable, or dismissing their adversaries as ill-intentioned and illegitimate. Yet, by publicly engaging in such exchanges, they do give recognition to the existence of the norm, which is evidence that the norm is influencing interactions and the definition of interests.

### *Tactical Concessions*

In the subsequent phase, the increasing moral resonance of the norm, and its growing appeal among a growing share of the public and the media, severely undermines the credibility and persuasive strength of repeated denials of wrongdoing. At this stage, norm entrepreneurs often attempt to mobilize other actors, by for example organizing consumer boycotts and running media campaigns aimed at triggering adverse market reactions against the targeted TNCs. In most cases though, the level of public concern is low, and the degree to which product markets are affected is limited. Nevertheless, worried about their public image and the value of their corporate brands, targeted TNCs decide to make *tactical concessions*, or instrumental acts meant to quell criticisms and deflect attention while not dramatically reforming their business practices to conform with the new norm. Oftentimes, these manifest themselves in declarations to comply with ‘indeterminate’, vague rules that are not conducive to enforcement.<sup>193</sup> In turn, they enter the public discourse on the environmental and social impacts of transnational business, and argue that responsibilities lie with governments or that their impact on the environment and local communities is overall positive. By extension, the social interactions between norm entrepreneurs and the targeted TNC shifts from tactical confrontations to strategic argumentation, aimed at

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<sup>193</sup> For the distinction between ‘indeterminate’ and ‘determinate’ rules, see Franck (1988), pp.713-725.

advocating the legitimacy of norms through persuasion, rather than exposing norm violations by confrontational means.

In addition, TNCs may draft and implement internal codes of conduct that identify and signal their commitment to broad values and principles that are meant to guide the professional behavior of staff. Other initiatives may include giving charitable donations to popular moral causes, or joining roundtables, committees or industry groups that work towards convincing consumers and the public at large of the public benefits that the industry provides. In undertaking such initiatives, targeted TNCs make rhetorical and largely symbolic statements that recognize the validity of the norm and affirm its relevance to their practices, but do not follow them up by making substantive changes to existing policies and procedures or the introducing new ones. It also serves to mobilize additional pressure, as public expectations naturally grow alongside public declarations by targeted TNCs that the norm is both relevant and valid to their policies and strategies.

So despite the lack of behavioral changes, the public recognition of the legitimacy of the norm provides a critical window of opportunity for norm entrepreneurs to continue the process of conditioning target actors to the norm. As a result, it is at this stage that private governance emerges, in the sense that norm entrepreneurs have successfully been able to shift the standard of good conduct, the economic incentives of certain actions, or fundamental understandings that animate particular widespread activities.<sup>194</sup> Despite not being embedded in guidelines or codes of conduct, changing public expectations could nevertheless push targeted TNCs down different policy trajectories, in which they increasingly have to measure the adverse impacts they have on a wide variety of public interest concerns, and demonstrate how they are minimizing these. A notable trend in this regard is the proliferation of corporate sustainability reports, and the general growth of corporate publications on environmental and labor issues.

### *Prescriptive Status*

But issuing verbal commitments without making behavioral changes also means there will be a contradiction between rhetoric and action. This discrepancy is often used by norm entrepreneurs to question the sincerity and commitment of the targeted TNCs to causes that they themselves have endorsed. As such, if norm entrepreneurs are successful in associating this ‘implementation gap’ to material events that visually cause harm or injustices, targeted TNCs may be forced to go beyond tactical concessions and give norms *prescriptive status*. This may entail adding safeguard measures to existing business practices, such as adhering to and implementing ethical standards and codes of conduct, or avoiding certain types of business altogether. If the process reaches this stage, it means the tactical concessions made by individual TNCs have not been successful in satisfying the norm entrepreneurs’ demands for accountability and transparency. At this stage, targeted TNCs may recognize the

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<sup>194</sup> Wapner (1997), p.81.



adverse publicity affecting their entire industry, and seek collective solutions to containing and mitigating public criticisms, and ultimately, declining corporate reputations. This may include attempts to collaborate with, or in alternative language, co-opt norm entrepreneurs by inviting them to join public-private partnerships that give recognition to the norm and formalize a set of policy prescriptions that speak directly to the business activities subjected to criticisms.<sup>195</sup> In many cases, these forms of governance include the participation of international organizations that have themselves institutionalized the norm and integrated it into knowledge and standard-setting activities.

The substantive change to business practices that may result from such efforts, even if only undertaken by a handful of market participants, is perhaps the most critical point of the norm evolution process. As the norms reconstitute the social purpose of the targeted TNCs, by for example associating norm compliance with manifestations of 'corporate citizenship', the pressure often increases on competitors that remain defiant in their opposition to the norm.<sup>196</sup> As a result, the norm may diffuse across issues areas and institutional contexts by virtue of the inter-linkages that exist between transnational markets. Over time, this may trigger a 'norm cascade', in which both material and discursive pressure on norm violators to become norm followers. According to Finnemore and Sikkink (1998), this commonly occurs after the number of norm-following target actors has reached a tipping point, or a critical mass sufficient to trigger a contagion effect that puts peer pressure on deviant target actors. Thus, the original norm entrepreneurs receive significant support from target actors that have adopted the new norm.

Whereas the previous tactical concessions can be explained as simple instrumental acts meant to deflect criticism from norm entrepreneurs that lack significant international support, the changes in corporate behavior that follow a norm cascade are commonly identity-related, as targeted TNCs become norm followers in order to preserve their membership in an imagined community of actors. While TNCs may have economic incentives to follow the norms, or more likely, may have disincentives to violate it, it is nevertheless social sanctions that induce them to change their behavior. In particular, in cases where norm-following becomes synonymous with responsible corporate conduct within a defined group of private actors, the norm is likely to diffuse rapidly. However, whereas some TNCs may have given the norm prescriptive status by integrating it into internal corporate policies and strategies, others make seek to counter public and peer pressure by making tactical concessions, or alternatively, engage in 'green-washing'. In fact, it is common to observe large variations in compliance with environmental and social norms among private actors in the same industry. Thus, one of the objectives with this analysis is to identify some private actors, but not others, choose to adopt a norm.

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<sup>195</sup> On public-private partnerships and transnational governance, see Börzel and Risse (2002). Newell (2001a) refers to these coalitions as 'stewardship' regimes. (p.94)

<sup>196</sup> Examples may include the integration of norms related to environmental protection, indigenous people's rights and gender equality within multilateral development banks.

### *Rule-Consistent Behavior*

In the final phase, patterns of *rule-consistent behavior* spread across target TNCs, as norm-following becomes widespread and a central aspect of corporate identities. Yet, relative to norm diffusion and states, Risse and Sikkink (1999) note that this does not mean external pressure is no longer needed to ensure norm compliance, as domestic political changes within states may alter the political commitment to the norm.<sup>197</sup> Similarly, in the context of private actors, new market conditions or other circumstances may induce TNCs to change their business practices, and revert to norm-violating behavior. Nevertheless, at this phase of the model, the norm has become widely accepted and has attained a 'taken-for-granted' quality.<sup>198</sup> By extension, compliance is not questioned by most market participants, and a norm violation would not only be counter-intuitive, but go against the identities and social purposes of TNCs. Furthermore, the validity of the norm is no longer a significant source of public debate, and norm-following is a matter of habit, rather than a result of deliberate, conscious actions.

Overall, the model proposes that norms emerging and diffusing in the private sector are more likely to succeed if they have first been legitimized by states and state-based organizations and regimes.<sup>199</sup> Norms that 'socially fit' existing norm structures are much more likely to be persuasive, given that they do not fundamentally conflict with the pre-existing institutionally-defined identities and interests of most states.<sup>200</sup> That is why norms that are institutionalized in the international system are almost by definition more prominent, and more likely to diffuse further.<sup>201</sup> The assumption that international legitimation matters is consistent with assumption made by Risse and Sikkink (1999) with regard to the diffusion of human rights norms among states, namely that the starting point is the preexistence of human rights norms that are firmly embedded in international treaties widely ratified by states.<sup>202</sup> This does not only account for the often significant institutional and normative linkages between state-based and private forms of governance, it also recognizes that private governance does not emerge from an institutional vacuum, but often builds on ideas and norms that have emerged and evolved in different institutional settings.

Yet, the centrality of states as international legitimizing agents does not mean norm entrepreneurs depend on state support to successfully engage private actors.<sup>203</sup>

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<sup>197</sup> Risse and Sikkink (1999).

<sup>198</sup> Finnemore and Sikkink (1998), p.904.

<sup>199</sup> See Claude (1966) for her seminal work on the role of international organizations, notably the United Nations, in providing 'collective legitimation' of norms and forms of behavior.

<sup>200</sup> Keck and Sikkink (1998), p.201.

<sup>201</sup> See Finnemore and Sikkink (1998), p.906. In addition, Florini (1996) notes that 'international norm change depends on the percentage of a population of states holding a given norm.' (p.371)

<sup>202</sup> Risse and Sikkink (1999), pp.1-6.

<sup>203</sup> For example, one of the driving forces of private environmental governance in the last decade has been the emergence of a transnational corporate accountability movement, see for example Bendell (2004), DeWinter (2003), Newell (2001) and Wapner (1996).

Indeed, one of the notable observations made about private governance is how states and state-based organizations are often marginalized in transnational rule-making processes. However, this does not negate the fact that the norms and principles often advocated by norm entrepreneurs, such as transparency, environmental protection and human rights, are persuasive precisely because they have been firmly embedded in constitutive charters of international organizations, such as the U.N Charter. By harnessing this 'moral leverage', norm entrepreneurs are able to overcome resource limitations, combining a strong ideational dedication with having 'the better argument' in confrontations with states or TNCs.<sup>204</sup> As such, inter-state systems of governance often set an important institutional precedent for private environmental governance, as norms that are aligned with those dominant in state structures are deemed more legitimate than those that are not.

## Conclusion

The preceding discussion of power-, interest, and knowledge-based perspectives on governance drew on the regime literature to illuminate how mainstream theories understand the role of international norms in world politics.<sup>205</sup> This chapter proposed to evaluate the explanatory power of each in relation to this case, as a means to advance our understanding of private governance formation. Subsequently, it proposed an analytical approach to understand the emergence, diffusion, and adoption of norms in transnational markets based on the evolution of interactions between norm entrepreneurs and target actors, as identified by Risse and Sikink (1999). This model would be used to structure the empirical analysis and consider at what logics of social action dominate different stages of the norm evolution process.

More broadly, the chapter attempted to make the case that a synthesis approach is more suited for understanding why new forms of private governance at the transnational level are emerging. The case for considering how norms influence corporate behavior recognizes that the legitimacy of different corporate practices is in large part determined by the evolution of public expectations. As Risse (2000) summarizes, debates in the international public sphere, what is referred to here as a transnational policy realm, have a stronger ideational dimension and are more likely to invoke identity-related issues than those that take place within conventional multilateral or bilateral diplomatic channels.<sup>206</sup> First, such debates are less constrained by the bureaucratic machinery of states and the legal norms and practices of statecraft, and tend to be more open to a diverse range of actors and voices. Secondly, those policy issues that garner the most attention and that have a

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<sup>204</sup> Risse (2002). In making the case for understanding political change within a 'logic of arguing', he makes two supporting claims; it advances understandings of how actors develop shared knowledge and understandings of the underlying 'rules of the game, and it illuminates how norms constitute the identities and interests of actors, which in turn allows them to mutually challenge and explore the validity claims of those norms and identities. (p.2)

<sup>205</sup> Indeed, Robert Keohane, a proponent of rationalist regime theory, recognizes this limitation. (Keohane 1998, p.393)

<sup>206</sup> See Risse (2000), p.22-23.

transnational significance, such as questions about humanitarian interventions or development aid, directly concern the identity of states and other non-state actors. As such, policy positions are commonly acts of symbolism rather than means to a strategic end. And third, while open and inclusive, debates in the international public sphere nevertheless have a ‘civilizing’ effect by de-legitimizing policy positions that overtly favor self-interests over altruistic concerns.<sup>207</sup>

The subsequent empirical analysis will use this framework and trace the emergence of the Equator Principles to the evolution of particular environmental and social norms in the international system, first within multilateral development banks, and then subsequently, within commercial banks operating in the global project finance market. In doing so, it will refer to the five phases identified by Risse and Sikkink (1999) – repression, denial, tactical concessions, prescriptive status and rule-consistent behavior – and identify how and why norm entrepreneurs were able to achieve political victories and move the process to the next stage.

The next chapter will outline the existing understandings and practices in project finance that govern the behavior of global banks relative to environmental and social issues, as this presented the material and discursive opportunity structure for new norms to enter project financing. Subsequent chapters will provide an historical overview of how and why environmental and social norms emerge and diffused within the World Bank, and subsequently, the IFC and other multilateral development banks. In turn, the institutionalization of these norms in the multilateral system did not only legitimize them, but also essentially created a policy problem that, in time, all financial institutions engaged in project finance had to respond to. In turn, the final chapter revisits the three sets of hypothesis generated from the main theoretical perspectives on governance formation in international relations, summarizes the main findings of the thesis and discusses its implications for further research.

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<sup>207</sup> As Newell (2001) notes in relation to TNCs, it is becoming increasingly difficult for them to argue for the pursuit of commercial self-interests at the expense of some recognized public goods, as they are forced to justify their business decisions in ways that give recognition to well-established environmental and social norms.

## ***4. Project Financing: The Art of Managing Risk***

### **Introduction**

Private governance that addresses particular industries is often embedded in existing corporate practices, and draws on the understandings, norms and rules that govern decision-making in a particular market. By extension, to understand how and why particular norms emerge and diffuse in the corporate sector, it is instructive to consider the norms that preoccupy the policy space. For example, an analysis of the FSC or the Responsible Care Program benefits from an understanding of the institutional characteristics, market structures and production processes of the global timber and chemicals markets, respectively. This includes an overview of the major actors influencing the production, trade and consumption of goods, their sources of power and influence, and crucially, the conceptual lens through which environmental and social issues are understood, discussed and managed.

The Equator Principles is intended to provide a common framework for managing environmental and social issues in project finance transactions. This chapter will argue that, apart from the effects of norm entrepreneurs, the emergence of the Equator Principles is inextricably linked to the nature of project financing and the growth of commercial project lending in developing countries. In particular, the centrality of risk management in project finance lending is firmly recognized in the Equator Principles, as its environmental and social standards are meant to supplement existing project risk management practices, rather than replace or fundamentally alter these. This provides the social context within which the legitimacy of various demands placed on commercial lenders is determined, including the need to prevent or mitigate adverse environmental and social impacts. Therefore, the environmental governance of large development projects cannot be understood without an appreciation for the nature and purpose of risk management as a framework for investment decision-making.

This chapter has four sections. The first provides a brief survey of the history of international project lending, identifying the extent to which the growth of project finance market has been shaped by the internationalization of banking and the liberalization and deregulation of public services in developing countries. The second section describes the distinguishing features of project finance relative to others forms of corporate finance, and identifies project risk management as the decision-making framework within which project finance transactions are negotiated and implemented, and environmental and social issues are identified and addressed. The third section discusses the legal origins of environmental and social risk management practices in project finance, and considers the commercial rationale for considering environment and social issues in project finance transactions. And finally, the fourth section surveys the various actors and interests that influence the preparation and implementation of project finance transactions, focusing on the significant role of

host governments and multilateral development banks in allocating and absorbing project risk.

#### **4.1 Project Finance and Development**

Project finance has been instrumental in capitalizing infrastructure development in countries that have lacked access to long-term financing because of underdevelopment, weak regulatory and legal structures, unstable institutional environments, and poor corporate governance. Particularly during the past two decades, it has played a central role in increasing long-term private capital flows to developing countries, and enabling TNCs to enter domestic industries that were previously restricted to state-owned enterprises. As such, the global project finance market builds on the long history of private financing of major infrastructure projects in developing countries, dating back to the colonial trade in the nineteenth century. The concentration of capital and technological resources that characterized international project lending during this time period laid the foundation for the modern project finance market, particularly the dominance of commercial banks from former colonial powers, in addition to the United States.

##### *A Short History of International Banking*

As late as the 1950s and 60s, most infrastructure projects in industrialized countries were built under state supervision and funded by national reserves or sovereign debt. In many developing countries that gained independence from colonial powers, infrastructure was inadequate or in disrepair, and had in large part been developed to benefit commodities exports, with less emphasis on providing basic services for domestic populations. To redress this balance, many developing countries embraced infrastructure development strategies based on a policy of economic nationalism, favoring domestic public financial institutions over private foreign banks. As a consequence, international financial flows from multilateral and bilateral sources far outweighed private capital flows, as a wave of economic reform programs were enacted across the developing world aimed at redistributing national wealth to deprived regions and sectors long ignored by colonial powers. Local subsidiaries of foreign banks were nationalized, and national development agencies were established to enable government to control the allocation of capital and investment in the economy. And publicly owned and mandated development agencies flourished, as they became the primary vehicles for channeling World Bank loans to physical infrastructure projects.<sup>208</sup>

Over time, the post-1945 period proved to be a favorable environment for the expansion of international trade and finance flows, initially due to the capital demands of postwar reconstruction in Europe and Japan, and subsequently as a result of the restoration of external convertibility in Europe and the liberalization of capital

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<sup>208</sup> Wade (1997)

markets. In the early 1970s, the breakdown of the Bretton Woods system of fixed exchange rates coincided with the liberalization and deregulation of financial markets in industrialized- and some middle-income countries, which facilitated greater capital mobility.<sup>209</sup> At the same time, the oil crisis and subsequent shortages also provided incentives to ease barriers to expanding energy production and produced large payment imbalances between the primary oil-producing and oil-consuming nations, increasing the overall demand for long-term debt and other financial services. Indeed, between 1972 and 1980, developing country sovereign debt held by private creditors increased almost twenty-fold.

The growth in international banking was driven by the development of securities markets and the general shift in financial services provision towards underwriting debt and equity.<sup>210</sup> The favorable conditions encouraged U.S and European banks to open representative offices in developing countries as part of a diversification strategy aimed at establishing a banking presence in other financial markets outside of North America and Western Europe.<sup>211</sup> As an example of the growing importance of foreign sources of income, the international earnings of major U.S banks grew by nearly 25 percent from 1972 to 1977.<sup>212</sup> At this stage, infrastructure services in virtually all developing countries, and in most developed ones, were controlled by the public sector in vertically integrated utilities.<sup>213</sup> But significantly, the energy crisis and the associated growth in demand did prompt regulatory reforms in the United States and the United Kingdom, which provided the first opportunities for commercial bank lending to power and energy projects.<sup>214</sup>

In the early 1980s, the debt crisis significantly curtailed capital flows to developing countries and thereby reduced private investment in large infrastructure projects. Long-term private capital flows would not recover until reforms in previously state-dominated sectors were enacted in some developing countries, notably Chile, Turkey and the Philippines. The deregulation and privatization of many domestic economic sectors increased their attractiveness to foreign investors, bringing about a dramatic increase in transnational capital flows. Alongside granting private entry into infrastructure projects, regulatory authorities overseeing financial markets were restructured so as to facilitate the expansion of financial services, and the emergence of non-bank financial institutions.<sup>215</sup> Advances in information and communications technologies further reduced transaction costs, opened up new markets, and facilitated financial product innovation, particularly in the telecommunications

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<sup>209</sup> Das (2003).

<sup>210</sup> See Reinecke (1995), pp.39-56.

<sup>211</sup> Donaldson (1988).

<sup>212</sup> Davis (1979).

<sup>213</sup> World Bank (2004)

<sup>214</sup> According to Heinz and Klaimieier (2004), the financing of oil exploration and production in the North Sea signified the birth of the modern project finance market, and provided the basis for its application to other industry sectors. In 1972, British Petroleum (BP) initiated this growing trend by raising about £500 million from a syndicate comprising of 66 banks to develop its Forties field in the North Sea.(IFC 1999).

<sup>215</sup> Das (2003).

sector.<sup>216</sup> In this context, project finance provided a useful vehicle for many heavily indebted developing countries to attract private infrastructure finance while retaining some level of control of individual projects, and restrictions on foreign investment and ownership.

Until the 1990s, long-term capital flows to developing countries mainly consisted of bank loans to governments and private companies. The period associated with financial globalization that followed triggered a substantial growth in foreign direct investment and portfolio investments, including bond and equity flows.<sup>217</sup> During the 1990s, all forms of long-term financing to developing countries increased, with foreign direct investment representing the bulk of growth.<sup>218</sup> Between 1991 and 1997, private long-term capital flows roughly quintupled, with the volume of project finance deals increasing six-fold to £26 billion.<sup>219</sup> And although long-term official aid flows declined almost 40 percent during the same period, multilateral or bilateral financing to private entities nearly tripled, growing from £4.5 billion to £12 billion.<sup>220</sup>

In the financial sector, advances in information and communications technologies accelerated rates of transactions and led to innovations in financial products to meet new demands. Financing structures and modalities that reduced the risk of investment sprung up in response to the greater willingness of financial institutions to enter developing countries. For example, financial institutions would syndicate loans, or sell a portion of a loan to other financial institutions, in order to reduce the risk of the investment. In other cases, loans would be packaged together in the form of securities and sold as bonds on the open market.<sup>221</sup> Thus, increasingly, financing of projects was fragmented, and provided in a mix of different modalities, including debt, equity and bonds.

During 1990s, foreign direct investment in financial services surged and broadened considerably. Whereas previous foreign bank expansions focused primarily on providing financial services to their international corporate clients, they were increasingly driven by profit opportunities in local markets.<sup>222</sup> In relation to project finance loans, it was primarily a series of regulatory reforms in several large developing country economies that triggered the surge in the number and volume of project finance transactions in the early 1990s.<sup>223</sup> Privatization of traditional public sector industries, harmonization of tax regimes, and easing restrictions on foreign

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<sup>216</sup> World Bank (2004).

<sup>217</sup> Long-term capital flows are generally assumed to encompass bonds, portfolio equity investment, foreign direct investment, and bank lending and other private credits with maturation periods that exceed one year.

<sup>218</sup> As an additional indicator, the output of the finance, insurance, and real estate sectors in the United States reached £700 billion in 1991, surpassing manufacturing for the first time in history. As recently, as 1985, their contribution to US GDP was 15 percent less than manufacturing. (Henwood 1998)

<sup>219</sup> World Bank (2001, 2004).

<sup>220</sup> IFC (2002).

<sup>221</sup> Henwood (1998).

<sup>222</sup> Domanski (2005).

<sup>223</sup> Shaw (1999).



investment and ownership all enticed multinational corporations and commercial lenders to increase their participation in this form of financing.

As a result, the sectoral diversity of project financing increased significantly beyond energy and transport, to include manufacturing, tourism, chemicals, and telecommunications. Not surprisingly, many of the countries that undertook the most extensive liberalization and deregulation programs became the primary benefactors of long-term commercial bank lending. As a result, the geographical distribution of private capital flows was heavily skewed, largely favoring those regions that already had experienced relatively high growth rates, such as East Asia and Latin America. Conversely, previously marginalized regions, notably Sub-Saharan Africa, largely remained unable to attract private capital flows during this period.<sup>224</sup>

Nevertheless, to hedge against the higher levels of investment risk in developing countries, commercial banks continued to diversify the range of financial products they offered. Project structures became increasingly complex, reflecting the risk-aversion of participants and complicated governing structures of projects financed as part of privatization schemes. Whereas the success of infrastructure projects in previous years was dependent on sound civil engineering, the growth of the project finance market in the 1980s and beyond was based on advances in financial engineering in light of the higher levels of investment risk in developing countries. In particular, a variety of developments enabled major corporations and public-sector enterprises to access financing in equity markets, often at more favorable terms than bank loans.<sup>225</sup>

In 1997, the Asian crisis produced a remarkable downturn in long-term private capital flows, and illustrated the volatile nature of this type of financing. Between 1997 and 2004, each significant measure of infrastructure finance to developing countries—total external finance, project finance, and investment with private participation—declined by at least 50 percent.<sup>226</sup> While overall long- and medium term private debt flows decreased by less, commercial banks lending remained flat until 2004 before experiencing record-level annual growth rates.<sup>227</sup> During the same period, net official aid flows diminished substantially, in large part due to debt forgiveness, as well as the result of large debt repayments by some middle-income countries.

### *Recent Trends in Project Financing*

This brief history of international banking and project lending reveals two distinct features that have a bearing on current global project finance market, and the environmental governance of project finance transactions. First, the market was long dominated by European and North American banks that possess the vast financial and

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<sup>224</sup> Grieco and Ikenberry (2003), pp.259-266.

<sup>225</sup> Smith and Walter (2003).

<sup>226</sup> World Bank (2004).

<sup>227</sup> World Bank (2006).

technical resources necessary to arrange and finance complex infrastructure projects in difficult institutional contexts. Therefore, it is highly concentrated, characterized by long-term capital flows from commercial banks in OECD countries to capital-intensive, but lucrative, projects in developing countries. Furthermore, the legacy of colonial trade can be seen in the regional characteristics of the market, in which British banks are concentrated in East Africa, French banks in West Africa, and Spanish banks largely operating in Latin America.

Secondly, the nature and scale of international project lending is significantly driven by the legal, regulatory and policy environment in developing countries. Specifically, international project lending curtailed during times of economic nationalism or economic stagnation in developing countries, notably in the 1950s and 60s, and again during the debt crisis in the early 1980s, and in the aftermath of financial crisis in the late 1990s. Conversely, it has surged during time periods in which commercial opportunities have presented themselves to foreign investors and companies, as was the case during the colonial era, and again in the early 1990s with the liberalization and deregulation of previously restricted economic sectors.

And third, the management of investment risk has been a significant determinant of project success. Apart from greater access to markets, the recent growth of the project finance market has also been driven by financial innovation, in which new ways of structuring financial packages and allocating risk among public and private parties have enabled infrastructure projects in developing countries to access long-term private capital for the first time. It has manifested itself in increasingly complex financing structures, in which a growing array of lenders, risk guarantee agencies and technical experts enter into contractual arrangements that enable investment risk to be sufficiently reduced at a satisfactory cost.

Yet, the nature of project financing differentiates it from most other financial markets. Given the scale of investment, both in terms of financing volume and project size, project financing is time-intensive for all parties involved, requires considerable risk management expertise and involves significant involvement of the public sector. And the financing modality is only used for large, complex projects likely to generate significant revenue streams, thus naturally constraining the size of the market. In 2004-05, only 216 projects were financed worldwide, totaling £38 billion, with 61 percent of projects in either power or infrastructure.<sup>228</sup> However, this year was part of a longer recovery after the credit crisis of 2000. Current growth is primarily driven by continuing deregulation and privatization in the power, telecommunications, and transportation sectors, and by the globalization of project financing products, particularly project bonds.

Furthermore, a fact that is often overlooked in more favorable accounts of financial globalization is that the tremendous growth in long-term private capital flows was heavily skewed towards a handful of large, middle-income countries. For example, between 1990 and 1996, roughly 44 percent of infrastructure finance to developing

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<sup>228</sup> EIRIS (2006).

countries went to East Asia alone, and within this region, predominately to China and Malaysia, and to a lesser extent Indonesia, the Philippines, and Thailand.<sup>229</sup>

Following the Asian crisis, flows shifted to other regions, notably Latin America, which experienced its own period of dramatic reductions after the Argentinean crisis in 2001. Other regions, notably South Asia, Sub-Saharan Africa and Middle East and North Africa, did not benefit hugely from the growth in long-term capital flows in the 1990s. These regional imbalances combined with the sudden downturn following economic crisis illustrates how long-term private capital flows are significantly driven by perceptions of risk, particularly the uncertainty presented by the political, social and legal environment of the host country.

The growth of the project finance market, particularly in developing countries, represents an important sub-theme to the emergence of environmental and social norms. By virtue of expanding in developing countries, commercial lenders have increasingly found themselves involved in large-scale development projects in ecologically-sensitive regions, often inhabited by indigenous people and local communities that have limited political rights domestically. As such, the management of so-called non-financial risks that may impact project profitability has arisen as a major concern for commercial project finance lenders.

The next section will describe the characteristics and purposes of project risk management, as the conceptual lens through which commercial lenders engage with environmental and social issues, and formulate project-level responses to them.

#### **4.2 The Financial and Legal Structure of Project Finance**

Project finance is a specialized form of financing that is predominately used to finance projects that require large amounts of capital investments, and are expected to generate significant revenues over an extended period of time once the project is in operation.<sup>230</sup> A common characteristic of project financing is a long initial 'search' phase, in which government and project sponsors explore a variety of project proposals through extended negotiations.<sup>231</sup> While project finance is theoretically appropriate for financing any economic activity that can be legally separated from project sponsors, it is predominately used for projects in capital-intensive economic sectors, such as extractive industries, or energy, transportation, and communications infrastructure. And as these sectors are often heavily regulated due to their central role in national economic development, private companies often undertake projects in the context of concession arrangements with governments, in which private ownership, investment and operation is predicated on a set of limited financial, economic and legal conditions.

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<sup>229</sup> World Bank (2004).

<sup>230</sup> Pollio (1999), and Smith and Walter (2003), pp.125-146.

<sup>231</sup> Miller and Hobbs (2005).

In contrast to corporate finance, debt and equity in this form of financing are provided to a self-liquidating single purpose company, commonly a joint venture between a domestic- and a foreign TNC. This project company owns and operates the project, and controls its physical assets and underlying contracts.<sup>232</sup> The capitalization of the project company is typically a lot less than the financial needs of the project, and the difference is typically made up by debt or bonds.<sup>233</sup> The assets of the project, the contracts associated with its construction and operation, and the cash flow generated by it, are all legally separated from the balance sheets of project sponsors.

<sup>234</sup> As part of this legal arrangement, project sponsors are barred from redeploying any resources raised through the project for any other purposes.<sup>235</sup>

Debt financing is commonly provided by multiple lenders organized in loan syndications, often exceeding dozens of commercial lenders. Such arrangements allow individual banks to provide debt to multiple projects in small amounts, rather than single projects in large amounts, thereby diversifying their financing and reducing their overall risk exposure.<sup>236</sup> Financing projects through syndications also provides individual banks with greater access to collective information and expertise, and the ability to engage in loan trading and derivatives sales.<sup>237</sup> In addition, many syndicates include multilateral development banks and bilateral export credit agencies that bring significant risk management resources to bear and have close relationships with both project sponsors and host governments, which provides additional security to participating commercial lenders.

The exact financing structure of individual projects varies, but a shared characteristic is a high debt-equity ratio, making them highly leveraged transactions.<sup>238</sup> Typically, equity provided by project sponsors represents no more than 20 to 40 percent of total financing, with the remainder of capital raised through a combination of bank loans and bond issues.<sup>239</sup> Once financing has been committed, creditors cannot seek compensation from the operators of the project or the host government in the event that the project is unable to generate sufficient cash flow to service debt obligations. Therefore, project finance is commonly referred to as either non- or limited recourse, since creditors fully or mainly depend on future revenue streams for loan repayment. Non-recourse project finance refers to a financing structure in which lenders and creditors have no direct recourse to the sponsor beyond the assets being financed. In contrast, limited recourse project finance, which is common for projects in developing countries, does provide lenders and creditors with some limited security, usually in the form of pre-completion guarantees during the construction phase.

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<sup>232</sup> IFC (1999)

<sup>233</sup> Smith and Walter (2003).

<sup>234</sup> IFC (1999).

<sup>235</sup> Pollio (1999).

<sup>236</sup> Donaldson (1988).

<sup>237</sup> Smith and Walter (2003).

<sup>238</sup> Pollio (1999).

<sup>239</sup> Dailami and Leipziger (1997).

### *Project Finance as Risk Management*

Project finance principally functions as a risk management structure chosen by lenders, sponsors and governments for its risk sharing attributes and associated financial advantages over other forms of financing.<sup>240</sup> Indeed, while project finance does remain the only source of financing available for many poor countries wishing to undertake capital-intensive development schemes, most project finance transactions take place in countries where access to long-term private capital is not particularly constrained. The argument that the potential for managing risk, rather than the possibility of accessing to capital, drives a borrower's decision to opt for project financing is further supported by the fact that many energy and infrastructure projects are developed by major TNCs that possess significant financial resources and enjoy strong credit ratings.<sup>241</sup>

In managing risk, decision-makers choose one of four possibilities depending on the significance of the risk; prevention, mitigation, transfer, or acceptance. The choice of strategy is primarily driven by the overarching objectives, namely the protection of project revenue streams, and more broadly, shareholder value. But generally, decisions about the level of risk mitigation are based on what is financially acceptable to those exposed to the risk, rather than an absolute concern for eliminating the risk entirely.<sup>242</sup> As a result, the expectation is that a project proposal would only be rejected in the most extreme cases.<sup>243</sup> The following passage illustrates the underlying legal rationale for addressing environmental issues.

'A lawyer advising a financial institution in any type of financing does not and should not concern himself (unless the client asks him) with whether the activity being financed will have a beneficial or a deleterious effect on the environment, whether it will be good or bad for the indigenous population, or even whether it is 'sustainable' (at least beyond the terms of financing). Rather, the lawyer's role, both in addressing environmental matters and in general, is to identify, assess and allocate risk.'

Frye (1998), p.481.

In fact, this rational and technical perspective does not only apply to legal advice, but reflects the broader normative context within which decisions on environmental and social issues are taken. As a decision on whether to devote time and resources to identify, assess and mitigate adverse impacts is taken within an overarching concern for expediency and cost-efficiency, those impacts that may represent a financial liability for the project are prioritized over those whose links to cost are less certain.

To understand the growth of project finance, it is therefore necessary to consider the wide range of investment risk that can be associated with large-scale infrastructure projects, and how commercial lenders, project sponsors and governments are able to address these in a project finance structure.

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<sup>240</sup> See Hainz and Kleimeier (2003), and Pollio (1999).

<sup>241</sup> Pollio (1999).

<sup>242</sup> Pollio (1999).

<sup>243</sup> IFC (1999).

### *Types of Project Risk*

The concept of 'project risk' significantly informs how environmental and social issues are governed in project finance transactions. Project risk is crudely defined as the probability of project failure, and ultimately, the aversion of risk among lenders is driven by a desire to avoid financial misadventures. In the context of project finance, project risk can be defined as 'the possibility that the project will be unable to produce output in the quantity or quality or at a cost that ensures sufficient cash flow generation to repay the original indebtedness.'<sup>244</sup> The nature of risk associated with individual projects will in large part determine its exact financing structure.<sup>245</sup> Generally, the higher the level of perceived project risk, the more risk mitigation measures are needed. For example, projects in countries with significant political and financial volatility would require more government assurances and support schemes to be able to attract risk-averse private creditors and investors.

The level of risk that lenders are exposed to varies considerably between the pre- and post-completion stages. The process starts with the initial formulation of a project proposal and associated preliminary discussions with public authorities regarding concessions and approvals. This phase is characterized by a high level of risk, as a series of critical decisions can make or break a project. Lenders would typically commission feasibility studies to determine the viability of any proposal. The study would assess the financial risk of the project, manifested in the strength of the financing plan and the size and certainty of the project revenue stream. The plan would typically include a period schedule that sets out the various costs and receipts that constitute the projected cash flows and financial statements of a project. This provides the basis for considering its financial viability by comparing expected project expenses and revenues according to different performance scenarios, with the aim of ensuring that annual revenue streams are sufficiently large to cover debt repayments.<sup>246</sup> This would provide the basis for establishing how much equity the project requires, and the capacity of the project sponsor to cover any cost-overruns associated with construction. In addition, lenders would consider whether the proposed technology is suitable and cost-efficient for the project, and if contractors and sub-contractors identified by the project sponsor possess the necessary experience and competence.

Alongside the analysis of the financial plan, the commercial lender must identify and evaluate a variety of project risks that could derail the revenue predictions presented by the project sponsor. The literature typically distinguishes between two types of project-related risks.<sup>247</sup> Commercial risks are those related to the development and construction of the project, the maintenance of assets and the identification of a target

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<sup>244</sup> Pollio (1999), p.4

<sup>245</sup> IFC (1999).

<sup>246</sup> Shaw (1999).

<sup>247</sup> IFC (1999).

market for the project output. This category also includes broader risks bearing on the project economics, such as interest rate changes, inflation, currency risk, and price fluctuations associated with raw materials and energy. Non-commercial risks relate to the policy environment of the project, and include unfavorable legislative and regulatory changes that adversely affect construction or operation, including expropriation of assets and the failure of the host government or public enterprises to meet contractual obligations. It also includes political and civil disturbances, including the likelihood of armed conflict.

For projects generating an output for a particular market, such as energy, water or oil, the primary risk to project revenue streams is reduction or disruption of supply or demand.<sup>248</sup> In terms of the production process, a variety of problems can hamper the project in its operational phase, such as unexpected maintenance costs of project facilities, price increases on equipment and materials, or disruptions to project inputs and outputs. In many cases, projects generate only one product, and may rely heavily on particular raw materials or sources of energy, and are therefore very vulnerable to price fluctuations. Therefore, lenders would seek assurances from project sponsors and the host government that the project can generate sufficient output and command a high enough price to adequately service debt payments.<sup>249</sup> If the borrower is in material breach of project management practices stipulated in the loan agreement, it would be liable, whereas if the government arbitrarily revokes a critical operating license after the project is in operation, the lender has no recourse for financial losses incurred as a result.<sup>250</sup>

In relation to policy or legal risks, the ease with which project sponsors are able to secure critical licenses to operate from public authorities is central to ensuring that the project progressing according to schedule, and is able to mobilize the necessary capital. This is a function of the efficiency and fairness of national or local planning processes, as well as the corporate management reputation and financial track record of the project sponsor. In many cases, favorable political connection and outright corruption plays a role in allocating concessions between bidding parties. Furthermore, as regulatory changes may affect project performance, lenders often seek assurances from government that unfavorable legislation will not be enacted during the lifetime of the project. Even if construction does get underway, it is possible that unanticipated political or economic developments cause project sponsors or government to abandon the project prior to its completion.<sup>251</sup> To facilitate these negotiations and obtaining the necessary assurances from relevant regulatory authorities, the participation of a multilateral financial institution with established relationships with host governments can be instrumental.

Once the financial and technical aspects of the project have been thoroughly appraised and the necessary regulatory approvals and capital has been obtained, the

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<sup>248</sup> Shaw (1999).

<sup>249</sup> Shaw (1999).

<sup>250</sup> Pollio (1999).

<sup>251</sup> Hines (1997).

project enters its construction phase. During this period, when enormous capital costs accumulate prior to any revenue being generated, equity investors bear most, if not all of the risk.<sup>252</sup> But as it requires large volumes of capital, project construction is typically financed by a combination of equity, subordinated debt and senior debt guarantees. Risks during the construction phase primarily relate to delays caused by labor strikes, late delivery of equipment or material, or unanticipated weather events.<sup>253</sup> To protect themselves against risk during this phase, lenders take out insurance and often use 'turnkey' construction contracts that condition incremental loan disbursements on the satisfactory completion of particular tasks, providing a financial incentive to avoid delays and cost-overruns.<sup>254</sup> This would include provisions that define the penalties that will be incurred in case of cost overruns or construction delays, and performance bonuses to reward completion ahead of schedule or below cost.

Once construction is completed, the project transitions into its operational phase, upon which lenders would have ensured that all completion undertakings identified in the loan agreement would have met or exceeded the standards defined in the project feasibility report as minimum to ensuring the project's financial viability. As the project produces output, it begins generating cash flow that is principally used to repay lenders. At this stage, project risk is in principle lower, as the project sponsors have been vetted, the necessary government approvals and concessions have been secured, and the project economics have been deemed satisfactory. And since the loan converts from being secured to a limited or non-recourse financing once the project is completed, lenders are forced to saddle any financial losses incurred during its operational phase, apart from those resulting from breaches that are deemed to be within the borrower's control.<sup>255</sup> But once the project sponsors have fully repaid outstanding debts, the commercial lenders no longer bear any obligation or responsibilities in relation to the project.

It becomes apparent from this analysis of project financing that the transaction cannot be narrowly characterized as a transfer of debt from a lender to a borrower. Instead, a wide variety of actors, interests and sources of expertise converge in arranging project finance with the aim of mitigating project risk to a level that allows it to raise the necessary equity and debt financing. The next section illustrates how and on what grounds adverse environmental and social impacts of projects first gained interests among financial institutions, and subsequently, how they are commonly managed in project finance transactions.

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<sup>252</sup> Pollio (1999).

<sup>253</sup> Smith and Walter (2003).

<sup>254</sup> Donaldson (1988).

<sup>255</sup> Pollio (1999).



### **4.3 Environmental and Social Risk Management in Project Financing**

Decisions regarding the construction and operation of individual investment projects, and the formulation of environmental management plans, can have significant environmental and social ramifications beyond the project itself. On the one hand, project financing can contribute to reducing pollution and waste by facilitating the transfer of clean technologies to heavy industries, increase the availability of electricity and water services by increasing energy production, and improve regional economic development and integration by developing transportation and communications infrastructure. As an example, a proportion of the project financing provided by multilateral lenders to Eastern Europe and Russia after the fall of communism upgraded heavily polluting industrial facilities, and improved the management of toxic wastes that had by and large been neglected by government previously.

On the other hand, project finance can have a variety of adverse consequences for local communities and the environment. As large infrastructure projects are often part of national economic development programs, they may come at the expense of local communities, particularly if their rights are poorly protected in the legal system. For example, hydropower development may submerge vast areas and force the resettlement of local communities, road projects in frontier regions may aid illegal loggers by providing them with access to previously isolated forest resources, and oil pipelines may harm fish stocks or increase the risks of oil spills. As a result, the decision-making process by which environmental and social issues are considered in project finance can actually have a significant bearing on the development path of national economies, and the plight of local communities and sensitive ecosystems in project-affected areas.

Yet, the fiduciary relationship that exists between commercial lenders and their borrowers typically prevents the former from exerting too much influence on the latter. While project finance does increase the leverage of the lender compared to ordinary corporate loans by virtue of relying on project revenues for repaying debts, the financing structure still limits the extent to which lenders can place conditions on the use of funds. Therefore, fiduciary obligations require that lending conditions be justified within the parameters of project risk, by only addressing possible threats to predicted project revenue streams. This limitation is at the heart of debates regarding the legitimate roles and responsibilities of commercial lenders in mitigating or preventing adverse environmental and social impacts in large-scale infrastructure projects.

The translation of an adverse environmental impact into project risk is often convoluted. But the literature typically distinguishes between two types of environmental risk; direct risks, or those over which a bank may be held directly liable or responsible, and indirect risks, or those that may impact the borrower's capacity to repay the loan.

### *Direct Environmental Risks*

The most direct environmental risk to the lender emerges in cases where collateral used to secure a project finance loan may be devalued by being associated with environmental liabilities, or when lenders assume direct liability for reversing or compensating for environmental damages, as in the case of rehabilitating a contaminated facility or property. In addition, the lender may be held directly liable for environmental damages caused by the project.<sup>256</sup> This would normally require that the lender exercises a greater level of control and influence over the project than what is typical, either by commanding the environmental management policies and procedures of the borrower, or by acquiring ownership of polluting assets as a result of workout or recovery procedures.<sup>257</sup> In either case, loan covenants often exempt creditors from such direct environmental risks by allocating these to project sponsors.

In fact, the earliest practices of environmental risk management in commercial banking emerged among U.S. banks in response to the prospect that they could be held liable for clean-up costs associated with environmental contamination. In 1980, the U.S. Congress passed the Comprehensive Environmental Response, Compensation and Liabilities Act (CERCLA), more commonly referred to as Superfund, which sought to define liabilities for environmental contamination associated with commercial properties. During the ensuing decade, a number of legal cases favored secured lenders by maintaining that they could not be held responsible for the environmental pollution caused by borrowers and required to pay associated remediation costs.<sup>258</sup> Liability would only be assumed in one of two narrow circumstances; if the removal of environmental contamination was so costly that it forced the borrower to foreclose on the loan, and thus transfer the ownership of the facility, along with its liabilities, to the lender, or if the lender was actively involved in the 'day-to-day' operation of a facility.<sup>259</sup>

However, the reassurances that secured lenders were given in relation to environmental liabilities soon ceased. A landmark ruling in 1990 provided a broader interpretation of lender liability and thereby dissented from previous rulings, a reversal which reverberated among lenders around the world. The case, *the United States vs. Fleet Factor*, concerned the allocation of responsibilities for environmental contamination discovered by the Environmental Protection Agency (EPA) at a cloth printing facility that had borrowed money from Fleet Factor Corporation.

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<sup>256</sup> For example, financial institutions that have provided project financing to the recently completed Baku-Tbilisi-Ceyhan pipeline have been warned by NGOs and legal experts that they could face court action if the pipeline leaks. (EIRIS 2006)

<sup>257</sup> Case (1999).

<sup>258</sup> Jeucken (2001)

<sup>259</sup> Frye (1998).

In a widely quoted excerpt of the decision, the U.S Eleventh Circuit Court ruled that;

'...a secured creditor may incur . . . liability, without being an operator, by participating in the financial management of a facility to a degree indicating a capacity to influence the corporation's treatment of hazardous wastes. It is not necessary for the secured creditor actually to involve itself in the day-to-day operations of the facility in order to be liable . . . Nor is it necessary for the secured creditor to participate in management decisions related to hazardous wastes. Rather, a secured creditor will be liable if its involvement with the management of the facility is sufficiently broad to support the inference that it could affect hazardous waste disposal decisions.'<sup>260</sup>

Whilst only applicable to lenders with exposures in the U.S, the ruling was seen by many as a possible precedent for the development of lender liability regulation elsewhere, and thus prompted many European banks to expand their environmental risk management practices. In 1992, an EPA ruling sought to remove uncertainty produced by the *Fleet Factor* ruling by allowing secured creditors to foreclose on contaminated property without incurring liability for clean-up costs, given that certain requirements are met. Subsequent federal and state-level legislation and a number of legal cases brought additional clarity to this issue, and generally reduced the liability exposure of lenders.

The Superfund legislation and the *Fleet Factor* case meant negative environmental impacts could in certain circumstances represent a direct risk to lenders, by allowing for the possibility that lenders could be held responsible for environmental clean-up costs. These legislative and legal developments established a relationship between commercial bank lending and adverse environmental impacts. The threat of legal liabilities associated with environmental contamination meant that many lenders began integrating environmental risk management into relevant investment decisions. Particularly in the U.S, lenders would finance domestic brownfield development with extreme caution, knowing well that any financial liabilities associated with existing environmental contamination could far outweigh the commercial revenues generated by the financing. It led many to create environmental units staffed by lawyers charged with assessing whether the project sponsor could be subjected to legal claims associated with environmental contamination. In short, it gave credence to the notion that irresponsible or negligent behavior on the part of the borrower could not be overlooked by lenders, which essentially prompted more comprehensive due diligence prior to issuing loans to commercial borrowers.

Meanwhile, the European Commission's *Green Paper on Remedying Environmental Damage*, released in 1993, promoted the precautionary principles and prevention as the foundation for allocating responsibilities for environmental damages and choosing types of interventions.<sup>261</sup> The British Bankers' Association (BBA) strongly criticized the report for not exempting lenders from assuming responsibilities for

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<sup>260</sup> United States v. Fleet Factors Corporation, 901 F.2d 1550 (11th Cir. 1990).

<sup>261</sup> European Commission, Green Paper on Remedying Environmental Damage, COM (93) 47 final, 14 May 1993.

environmental liabilities associated with borrowers, acutely aware of the legal risks that American banks were facing.<sup>262</sup> At the national level in the United Kingdom, similar legislation was underway in the form of the Environment Bill, passed in 1995. The text led the BBA to seek clarification of the terms 'knowingly permit', arguing that 'lenders are not environmental experts and it is important that attempts to assess the quality of a borrower's management ...should not make banks liable for the obligations of their borrowers.'<sup>263</sup> And as in the U.S case, the BBA noted that an exception to this position was one where 'banks actually exercise effective control' over a borrower's business.

### *Indirect Environmental Risks*

The potential for a direct risk notwithstanding, environmental and social issues become relevant to commercial lenders primarily as potential project risks that may undermine future revenue streams. Since the collateral in project financing is lower than in ordinary credit transactions, credit risks are automatically higher, and there is a direct link between the social and environmental risks of the project and the credit risks borne by the lenders.<sup>264</sup> Such indirect risks emerge when adverse impact on the environment and local communities by way of an intermediary mechanism are predicted to negatively affect project profitability. These indirect risks rest with the borrower, but nevertheless may impact its ability to repay loans to the lending bank or it may materially affect the value of the collateral, and in the worst cases, fall within default risk.

The type and gravity of environmental and social issues vary between projects, and is to a large extent driven by the industry sector. In most cases, ecological- and socio-economic impacts are often highly interdependent, since local communities often have a major stake in environmental resources in the project-affected area, and likewise, adverse environmental impacts may in fact materialize as project risks only because they harm the livelihoods of people and induce local protests that disrupt the project. Such impacts translate into indirect risks when they require major changes to project design.<sup>265</sup> For instance, banks acknowledge that any borrower penalty for non-compliance with environmental legislation, or subsequent loss of market position, is a risk to repayment. Thus, an adverse environmental impact can represent a risk if it prevents the project sponsor from obtaining the necessary environmental operating licenses to dispose waste or discharge pollution. In such cases, regulatory authorities act as arbiters of risk, capable of deciding whether or not to impose significant financial costs onto the project. Therefore, as part of their due diligence,

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<sup>262</sup> For an extensive discussion of the legal risks faced by British banks in relation to environmental contamination, and the policy positions of the BBA, see McKenzie and Wolfe (2004).

<sup>263</sup> Quoted in ISIS (2002).

<sup>264</sup> Amalric (2005).

<sup>265</sup> Case (1999).

creditors seek to ensure that contracts for project development and implementation conform to local or national environmental laws and regulations.<sup>266</sup>

And finally, as will be discussed in greater detail in chapter 6, projects that generate significant adverse environmental and social impacts can attract negative media attention, and thereby harm the reputation of financial institutions. Unlike other types of risk, reputational risks are not necessarily related to mismanagement, negligence or incompetence, but can emerge in cases where projects for various other reasons simply generate significant adverse publicity. In contrast to legal risks, which emerge out of violations of laws and regulations, reputational risks are therefore much more intangible, as they are largely determined by the court of public opinion, thus more difficult to identify, assess and mitigate.

The next section will define project financing as a transnational policy area, characterized by clashes between domestic, international and transnational policy imperatives, and the contestation of norms defining what constitutes responsible and appropriate corporate conduct relative to the protection of environmental resources and upholding the rights of project-affected communities. It highlights the roles, responsibilities and motivations of a variety of public and private actors, and how these shape the management of environmental and social issues in individual transactions, as well the evolution of environmental lending policies.

#### **4.4 Actors, Interests and the Allocation of Risk**

Modern project finance transactions are often characterized by financially and legally complex operations with high financial risk, requiring the mobilization of a wide variety of public and private actors with development, construction, operation, financing and investment capacities and expertise.<sup>267</sup> The project preparation phase can be characterized as a process through which the project concept, the sponsoring coalition, and the institutional framework co-evolve.<sup>268</sup> In the contractual structure that emerges out of these negotiations, the project company retains a central position. The ownership of the project company may be divided between a few large, active owners, commonly a combination of foreign and domestic investors, as well as multilateral- or commercial lender in a minority position. It may also include contractors, who apart from holding equity, take part in the construction and operation of the project.

Public authorities partake in a myriad of ways, as regulators, licensing agencies, equity investors, and not least, as suppliers of project inputs or purchasers of project outputs. Financial institutions, including multilateral development banks, export credit agencies and commercial banks, provide debt and may also take on minority equity stakes. And whilst often lacking legal recourse, stakeholders affected by the

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<sup>266</sup> Hines (1997).

<sup>267</sup> See Esty (2004).

<sup>268</sup> Miller and Hobbs (2005).

project can influence it by exerting political pressure on project sponsors and creditors to mitigate, prevent or provide compensation for certain adverse impacts.

As many projects lead to major transformations of regions or industrial sectors, a large variety of conflicting ideas and interests often surface during the preparation stages. The complexity of project preparation and contractual arrangements can often be overwhelming. A wide range of problems can impede project preparation and operation, including a lack of a shared agreement on and commitment to project objectives among parties, poorly designed or incomprehensive project plans, unclear lines of authority and responsibility, resource constraints, poor risk analysis and inadequate control mechanisms, and inefficient bureaucracies.

### *The Role of Commercial Lenders and Project Sponsors*

The boom in the global project finance market in the early 1990s can be traced to the deregulation and liberalization of energy, water and extractive industries sectors in developing countries, and the commercial investment opportunities this provided to foreign investors. These reforms were driven by an infrastructure development strategy based primarily on private sector investment and operations, which provided TNCs and lenders with opportunities to expand into hitherto closed markets. To facilitate these transnational capital flows into large-scale development projects, project finance represented the financing structure of choice among borrowers, lenders and host government alike, as it enabled lucrative projects to be pursued despite being operated by companies with insufficient creditworthiness, and located in countries with high levels of investment risk.

For commercial lenders, the financing structure of project finance has strong risk-sharing attributes that isolates and protects the substantial project revenue streams from the financial risks posed by the operational environment. First and foremost, project finance is conducive to creating loan syndicates, which provide commercial lenders with a mechanism to better manage and mitigate financial risks, facilitated in a variety of contractual arrangements with different parties, including host country governments and development agencies. The complex web of contractual arrangements that characterize this form of financing contributes to safeguarding creditor interests.<sup>269</sup> Secondly, in comparison to conventional lending, project finance loans provide commercial lenders with potentially higher spreads and generate substantial fee revenues, especially if they act as both arrangers of syndicates and funders of the project.<sup>270</sup> And thirdly, project finance is conducive to enabling the participation of multilateral development banks in private sector projects, which reduces the political risks associated with a project. Therefore, commercial lenders often partner with multilateral development banks, since the latter's institutional relationship with public authorities can ensure that domestic policies and regulations impacting the revenue streams remain relatively stable

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<sup>269</sup> Pollio (1999).

<sup>270</sup> Donaldson (1988) and Pollio (1999).

throughout the lifetime of the project. In most cases, infrastructure lending in developing countries is dependent on the participation of a multilateral- or bilateral development agency to attract additional financing from commercial banks.

For project sponsors in developing countries, project finance provides them with a mechanism to maximize their financial leverage without solely relying on their own creditworthiness to access capital. First, by establishing a separate project company together with a reputable foreign TNC with a strong track record, they are able to access long-term capital from risk-averse investors beyond what their own balance sheet would normally allow.<sup>271</sup> Secondly, as their own resources and operations encompass levels of risk that they are unable to bear alone, project sponsors can through project finance reduce their own financial risks by insulating their core business from the costs of project failure.<sup>272</sup> And since project finance loans may in some cases be structured as off-balance sheet financing, it often comes with considerable tax advantages compared to corporate loans. And thirdly, the structuring of debt in syndications facilitates the participation of both multinational companies and lenders, which increases the flows of capital, knowledge and information to borrowers. In the context of complex infrastructure projects, this enables project sponsors to gain access to the latest technologies and project management practices.<sup>273</sup> In terms of access to financing, loan syndications often combine loans of different types and maturities, which provide borrowers with flexibility in using loan funds during the construction period, and the ability to refinance debt once the project is operational.<sup>274</sup>

### *The Role of Host Governments*

As individual projects may significantly impact a country's national economy and resources, it is not surprising that governments play a critical role in the development of large projects.<sup>275</sup> In many cases, project finance transactions are central to national development plans, and thus promoted aggressively by governments, sometimes as part of broader economic reform programs financed by multilateral development banks. And even if a project is solely financed and operated by the private sector, it is both undesirable and impractical for government not to be involved in the development of the project.

Indeed, the sheer size and duration of some undertakings suggest that public interests will be heavily implicated. While not representative of a typical project, the Three Gorges Dam project under construction in China does illustrate the scale of

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<sup>271</sup> IFC (1999).

<sup>272</sup> Pollio (1999).

<sup>273</sup> See Bond and Carter (1994).

<sup>274</sup> World Bank (2004).

<sup>275</sup> Miller and Hobbs (2005).

transformational change that can result from a single project. When completed in 2009, the enormous dam will create a 600 kilometer reservoir expected to submerge 160 towns and cities, 770 villages, 800 ancient sites, 657 factory and mining sites, 139 power stations, 956 kilometers of roads and 23,800 hectares of crop land.<sup>276</sup> Project cost may exceed £15 billion. On a lesser scale, but by no means trivial, other major undertakings with significant consequences for economic, political, social and environmental development have been financed through project finance in recent years, notably the Chad-Cameroon and Baku-Ceyhan-Tblisi, pipelines.

For a number of reasons, host governments and public authorities overseeing the compliance with domestic laws and regulation can in principle exert significant influence over the project, although this is borne out in the context of negotiations with foreign operators and lenders. Oftentimes, a large-scale development project begins when a government releases a policy statement that announces a set of regulatory changes that provide incentives for certain undertakings.<sup>277</sup> First, individual projects are most often undertaken in economic sectors that are heavily regulated or dominated by state-owned enterprises, such as energy, water and transportation infrastructure. In many cases, the acquisition of ownership stakes by foreigners is severely restricted or even impossible, as governments are hesitant to relieve control of strategically important industry sectors.<sup>278</sup> Apart from the enactment of favorable legislative changes that allow entry of foreign investors and operators into domestic sectors, governments often retain some control in negotiations with project sponsors over concession agreements. These would specify the conditions for financing and operating a facility, and any arrangement that would transfer project assets to the government in the future.

As per Hines (1997), such concessions are often negotiated in the context of one of four project structures. A turnkey arrangement is one in which a facility is returned to a public authority immediately after construction. Under a 'build-own-transfer' (BOT) scheme, the most favored by governments wishing to involve foreign investor in infrastructure development, developers and consortium partners would own and manage the project until the initial investment is recovered, upon which the project reverts to a state-owned entity without any continuing obligation to the project. Usually, it is based on a government granting a franchise to a project sponsor, either negotiated or as part of a competitive bidding process, to design, construct, finance and operate the facility for a period of years. When ownership and operational responsibilities rests with developers for an extensive period, the arrangement is referred to as 'build-own-operate-transfer' (BOOT), which is rare, but favored in cases where host governments wish to secure the long-term involvement of foreign investors. And finally, under the seldom used 'build-own-operate' (BOO) scheme, ownership and control of the project commonly lies with a foreign investor from the outset for an extended, often indefinite period

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<sup>276</sup> Case (1999).

<sup>277</sup> Miller and Hobbs (2005).

<sup>278</sup> Hainz and Kleimeier (2003).



Secondly, apart from their role as owners and regulators, host governments often provide significant assurances and incentives for creditors and investors to partake in infrastructure development. At the most basic level is a well-functioning and comprehensively enforced legal system that provides the necessary assurances to creditors and investors that contractual agreements will be honored by all parties and enforced by the courts.<sup>279</sup> For example, in the context of financing a privately owned power plant, creditors would want to know whether legislation exists that would allow it to connect to the national grid, and whether public authorities involved in power regulation, transmission and distribution tend to honor their contractual obligations.<sup>280</sup> As risk allocations are implemented through contractual arrangements between parties, the satisfactory mitigation of legal risk is essential for any project.

Third, a mature legal structure is often complemented by a policy framework that is open to foreign investment and ownership in relevant economic sectors, and allows for easy conversion of local currency into foreign exchange in order for project sponsors to service foreign debt obligations. In a study of sixty large projects, Miller and Hobbs (2005) found that 'important regulatory or institutional changes' were critical to the development of nearly two-thirds of the projects. Furthermore, in many cases, project sponsors were not simply passive beneficiaries of favorable institutional changes, but 'contributed to the creation or the modification of the institutional framework into which they became embedded, through a process of co-determination.'<sup>281</sup>

Such institutional change often takes place in the context of partial or full privatization programs, in which governments may enact a series of legal and regulatory changes facilitating greater private participation and ownership in economic sectors previously reserved for state-owned enterprises. In the power sector, this would include allowing private power plants to set prices on energy output according to their own profitability, rather than a tariff set by the government. Apart from scaling back government ownership and supervision in relevant economic sectors, such reforms may seek to encourage private creditors and investors by including favorable tax treatment of income or subjecting projects to minimal or no import duties on machinery and equipment associated with project construction and operation.<sup>282</sup>

And fourth, government participation in the risk management process is vital for a project to come to fruition. Indeed, in many countries, private investors are hesitant to invest unless direct government support to improve the project's cash flow or reduce risk is provided.<sup>283</sup> Oftentimes, creditors and investors would analyze the institutional environment in the host country separately from the credentials of

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<sup>279</sup> Bond and Carter (1994).

<sup>280</sup> Hines (1997).

<sup>281</sup> Miller and Hobbs (2005), p.43

<sup>282</sup> Dailami and Leipziger (1997).

<sup>283</sup> Dailami and Leipziger (1997).

project sponsors.<sup>284</sup> In cases where a project generates a product, governments may respond to concerns over market risks identified in such analysis by granting a revenue guarantee, such as the right to sell project output at a fixed price over a certain time period regardless of real price fluctuations in the market.

Similarly, governments can guarantee a fixed input price, for example on energy in the case of aluminum production and manufacturing. Such hedging against market risk is especially important in volatile economies and commodity markets, where risk-averse lenders demand such assurances prior to making lending commitments for projects that may span decades. In the absence of such measures, creditors that have committed funds in project finance structures may be vulnerable to market instability, as occurred during and after the Asian crisis. On that occasion, over-extended creditors suffered as numerous project sponsors cancelled or deferred major projects, and some in operation experienced financial difficulties because of problems associated with reduced market demand for output.<sup>285</sup>

Government risk guarantees are most often issued in greenfield power projects, since project sponsors often rely heavily on debt for financing the initial construction of the project. In turn, creditors are eager for governments to absorb some of the project risk associated with the large amounts of financing placed in sunk assets, and the long duration of the project. This is most commonly done in the context of power purchasing agreements (PPAs) in energy projects, in which the project company is guaranteed a universal fixed tariff on power purchases for the life of a power plant.<sup>286</sup> In cases where project revenue is generated in local currency, governments may also ensure convertibility and absorb the exchange rate risk by inserting an inflation-index clause in PPAs, thus protecting project lenders and sponsors from inflation in cases where project revenues are in local currency.<sup>287</sup>

### *The Role of Multilateral Development Banks*

Individual projects that contribute to the privatization of energy and water services cannot be understood without reference to the broader economic reforms programs initiated by many governments. And similarly, the wave of infrastructure privatizations that have taken place in some middle- and low-income countries cannot be understood without alluding to the influence of multilateral financial institutions, particularly the World Bank and the IMF, in pressing for such reforms by making infrastructure finance contingent on private sector participation. In particular, multilateral development banks targeting the private sector, notably the IFC, the Inter-American Development Bank (IDB) and the EBRD, have explicitly sought to expand private participation in infrastructure development by using multilateral financing to catalyze private ownership and investment.

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<sup>284</sup> Hines (1997).

<sup>285</sup> IFC (1999).

<sup>286</sup> IFC (1999).

<sup>287</sup> See Dailami and Leipziger (1997), pp.6-8.

More generally, the role and influence of multilateral development banks in the project finance market is complex and multi-faceted. First, as significant proponents of private sector development, they have encouraged the deregulation of economic sectors and the privatization of infrastructure development and services, thereby providing market opportunities for foreign lenders and investors. While the pendulum is slowly swinging back to a more balanced view of what constitutes the optimal role of public and private actors in infrastructure, multilateral development banks have long been strong advocates of privatization and deregulation of infrastructure. As Buiters and Lankes (2003) of the EBRD proposed, multilateral development banks should participate directly in the private investment process and aid governments in establishing an institutional environment that can best foster market-oriented economic growth. Similarly, the World Bank (2004) noted with a certain amount of dismay that in many developing countries, 'the agenda of market liberalization, regulatory reform, and the restructuring of state-owned monopoly utilities remains unfinished.'<sup>288</sup> The policy conditionalities of structural adjustment programs, which pressured many developing countries to allow greater private investment and participation in domestic industries, embody this ideological preference.

Secondly, apart from their indirect influence through knowledge diffusion and policy-based lending, multilateral financial institutions often seek to directly encourage private investment by leveraging their financial and technical resources. Specifically, multilateral financing to the private sector is typically structured in the form of seed financing that is intended to attract additional private investment. To facilitate commercial bank participation, multilateral lenders may use their extensive relationships with them to explore the prospects for commercial financing on behalf of a borrower. As an illustration of this practice, despite the growth in long-term commercial bank lending in the 1990s, a major share of all project finance transactions involved at least one official aid agency.

Third, the participation of multilateral development banks is critical to most large-scale development projects in developing countries, as it mitigates the level of political risk associated with the project. Specifically, it is essential for commercial banks to obtain assurances that the government will not enact any regulatory or legislative changes that would adversely impact the financial viability of the project during its duration. Because of their close relationship with host governments, multilateral financial institutions can be said to provide a 'quasi-guarantee' that such reforms would not happen.<sup>289</sup> To a lesser extent, the participation of multiple commercial lenders from countries of strategic importance to the host government, such as significant trading partners or creditors, can provide a de facto guarantee against adverse political moves.<sup>290</sup> But additionally, a project finance transaction often also includes political risk insurance provided by an export credit agency or the Multilateral Investment Guarantee Agency (MIGA). However, the risk of parties

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<sup>288</sup> World Bank (2004), p.154.

<sup>289</sup> Hines (1997).

<sup>290</sup> Smith and Walter (2003).

backing out of agreements still remains, as was most recently manifested in the Chadian government's decision to violate key provisions in its financing agreement with the World Bank over the Chad-Cameroon oil pipeline.

And fourth, multilateral development banks often bring significant technical knowledge and resources to project preparation.<sup>291</sup> As lead arrangers of loan syndications, the time and resources that they spend on project due diligence will in effect be shared by all participating banks. Therefore, their participation also enables commercial banks to participate in project finance transaction that would otherwise be too risky and complex to adequately assess on their own.

## Conclusion

This chapter has argued that an analysis of the emergence of the Equator Principles requires an appreciation for the significance of project risk management as the framework within which commercial banks engage with environmental and social issues in project finance transactions. It briefly surveyed the history of international project lending, emphasizing its association with export-oriented growth and a boarder neo-liberal policy agenda in developing countries. It outlined the distinguishing features of project finance as a financing structure, focusing on the centrality of project risk management as the contextual basis for decision-making, and the influential role of host governments and multilateral development banks.

Overall, it is in the context of identifying, assessing and managing project risk, and by extension structuring the financial package, that commercial lenders interact with and influence the environment and local communities in their project financing. The identification and analysis of environmental and social issues as 'risk' is based on a set of assumptions about the nature of environmental change that has a profound impact on governance outcomes. Chief among them is a strong profit motive dictating that adverse environmental and social consequences are only relevant to commercial lenders insofar as they pose a risk to project profitability, or the broader commercial interests of the financial institution.

The emergence of a significant reputational risk associated with large-scale project financing has indeed broadened the spectrum of environmental and social issues that are deemed relevant project finance lenders. Since reputation is driven as much by public perceptions of harm than actual material changes, those impacts that are likely to generate negative publicity by attracting the attention of transnational advocacy groups or the media became much more significant. Nevertheless, employing risk management as the conceptual lens through which the significance of environmental and social issues are understood, narrowly circumscribes the rationales and responsibilities of both lenders and borrowers and provides the basis for lenders to rule out certain environmentally beneficial interventions on the grounds that they have little bearing on the risk of the project financing.

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<sup>291</sup> Buitter and Lankes (2003).

The analysis raises interesting questions with regard to private governance formation that will be discussed in later chapters. It identified the existence of legal and regulatory requirements as a central motivation for commercial lenders to initially consider the adverse environmental and social impacts of project financing in developed countries. The fact that previous environmental risk management practices had been driven by a requirement to comply with host country laws and regulations poses the question as to whether voluntary regulation can adequately compensate for poor legal and regulatory systems in developing countries.

Yet, as subsequent chapters will illustrate, the emergence of environmental and social norms in commercial project financing posed a different threat to commercial project lenders. Whereas environmental and social risk management was long motivated by a need to comply with host country laws and regulations in order to secure much needed operating licenses, adhering to the demands of transnational advocacy groups has little to do with project-level management. In fact, what is at stake for commercial banks is not only their corporate reputation as responsible project lenders, but their image and reputation in the financial sector at large.

The next chapter will outline how environmental and social concerns emerged and became institutionalized in multilateral development banks, and how this influenced the emergence of the Equator Principles

## ***5. The World Bank Group and the Environment***

### **Introduction**

Multilateral development banks play a critical role in managing large resource-transfers between developed and developing countries. For example, as the world's self-proclaimed depository of development knowledge, the World Bank has become a powerful arbiter of development norms, defining what constitutes legitimate policy interventions for developed and developing countries.<sup>292</sup> In terms of the Equator Principles, the emergence of the framework cannot be examined in isolation of broader currents in global environmental politics, particularly in relation to development financing. The practice of environmental review of projects was first introduced at the World Bank in the early 1970s to ensure that its public sector projects did not harm the environment. Then, during the ensuing three decades, the practice expanded in complexity and scope in response to revelations that projects were causing ecological damages despite having been supposedly reviewed by environmental specialists

This chapter will provide a historical account of the evolution of environmental practices at the World Bank and the IFC, starting with the World Bank's initial concession in the early 1970s that environmental problems should be regarded as a legitimate concern to multilateral development banks. The argument for historicizing a discussion of the Equator Principles is that its emergence cannot be explained in isolation of the way environmental and social concerns emerged and evolved in multilateral project financing. Specifically, the institutional context within which environmentalism first arose at the World Bank, and the nature of how this additional organizational objective was integrated into its operations would later significantly shape the emergence of environmental practice at the IFC, and subsequently, the diffusion of these to commercial banks via the Equator Principles. The lasting impacts of this process is two-fold, one linked to the legal and normative responsibilities of project lenders, and the other being the range and type of policy interventions that would be considered appropriate or legitimate to address environmental degradation and poverty alleviation.

The first section will illustrate how the environmental agenda first emerged within the World Bank, and identify the leadership of the Bank, notably President McNamara, as central to this development. The second section will provide an overview of how and why transnational advocacy groups first interacted with the World Bank, and how this changed its environmental and social mission, and more broadly, its organizational identity as a development institution. The third section surveys the environmental reforms at the IFC in the 1990s, and finds important parallels with the World Bank. And finally, the fourth section discussed why and how environmental

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<sup>292</sup> See Bøås and McNeill (2004), Finnemore (1996), p.125, and Woods (2006).

and social norms came to diffuse across these international organizations, and its broader implications for the environmental and social governance of project finance transactions.

### **5.1 The Emergence of an Environmental Agenda at the World Bank**

At its inception in 1944, the World Bank's primary stated mission was to aid post-war reconstruction in Europe, but following decolonization and the 'emergence' of independent underdeveloped countries, it soon found itself immersed in its secondary purpose, providing aid for economic development. Its initial development rationale was to correct capital markets inefficiencies in its borrowing countries, produced by the lack of long-term private funds at reasonable interest rates necessary to finance large-scale development projects.<sup>293</sup> Until the late 1960s, its development strategy was largely based on export-led growth and large-scale energy, transportation and agricultural infrastructure development, whose benefits were expected to trickle-down to the poor. Its staff, which grew immensely during this period commensurate to the financing needs of borrowers, was largely technically-trained professionals who had few incentives to or interests in addressing the environmental impacts of their decisions. And international NGOs and other interest groups, who later were to have an enormous influence on the evolution of environmental policies and procedures within the Bank, had yet to direct their attention towards the multilateral development banks.<sup>294</sup>

Upon assuming the Presidency of the Bank in 1968, Robert McNamara rapidly expanded the Bank's operations and gave it a broader development agenda, with poverty reduction as its central tenet. This redefinition was partially a response to emerging criticisms of the Bank's development orthodoxy, with claims that its focus on large-scale development projects failed to provide real direct benefits to the poor, and in fact exacerbated social inequalities in borrowing countries.<sup>295</sup> It was during this time that the Bank became the first development institution to directly consider the relationship between environmental problems and economic development. Given the technocratic nature of its professional staff and development practices, it was perhaps not surprising that its approach was based on developing appraisal methodologies and technical procedures for integrating environmental issues into its traditional economic cost-benefit analysis.

In 1970, as one of his early initiatives, McNamara established an Office of Environmental Affairs (OEA) reporting directly to him and staffed by a single environmental advisor, whose main task was to devise appraisal tools and provide advice on how to reduce the 'environmental externalities' of projects. The following year, a suggestion to consider the environmental impacts of projects in appraisal work

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<sup>293</sup> Gilbert and Vines (1999)

<sup>294</sup> Wade (1997), p.615

<sup>295</sup> Gilbert and Vines (1999).

appeared in the operational policies of the Bank for the first time.<sup>296</sup> As part of its work, the OEA also took on a broader educational responsibility to render environmental concerns more legitimate to operational staff, as well as the borrowing countries of the Bank.

Following the establishment of OEA, environmental review became the mechanism by which the Bank first addressed environmental issues in its operations.<sup>297</sup> It entailed reviewing the environmental impacts of project under preparation, and suggesting measures to mitigate or prevent them.<sup>298</sup> By implication, the OEA's role became largely advisory, entailing that operational staff were by no means bound by the results of environmental reviews in the unlikely event that their projects were subjected to them. In other cases, the office was asked to work on residual matters that did not clearly fall within the remit of other departments or divisions.<sup>299</sup> Crucially, this included an external public relations function aimed at 'turning around' external criticism, a role that would become increasingly significant.<sup>300</sup>

This choice of intervention ensured that the disruption to operations and strategies caused by the assumption of an environmental commitment would be minimal, as it shifted the debate over environmental problems from principles to technical matters that could easily be managed internally.<sup>301</sup> It also reflected McNamara's belief that by and large, Bank projects had negligible adverse environmental impacts. However, its introduction into the formal project cycle of the Bank, which is the bureaucratic process that moves project proposals from the identification stage to Board approval, was still contentious and opened a rift between operational and environmental staff that would have a lasting influence on the Bank.<sup>302</sup> In fact, from the beginning, many operational staff had strong reservations with regard to the usefulness and feasibility of identifying and assessing environmental impacts of projects, as they were considered outside the realm of the Bank's work and could not be easily integrated into their quantitative analysis.<sup>303</sup>

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<sup>296</sup> OPM 2.20, see Wade (1997), p.616. Furthermore, the conceptual foundation of environmental review can be found in the landmark National Environmental Protection Act of 1969, which requires an environmental impact assessment to be conducted of all proposed major development projects in the United States as an element of the planning approval process.

<sup>297</sup> The instrument was modeled after the U.S National Environmental Protection Act (NEPA) of 1969. It was first applied on an ad-hoc basis and would not become a requirement for all projects until 1987.

<sup>298</sup> Le Prestre (1989), p.26

<sup>299</sup> Le Prestre (1989).

<sup>300</sup> Wade (1997).

<sup>301</sup> Le Prestre (1989), p.27

<sup>302</sup> Highlighting the conflicting interests faced by the OEA, according to Le Prestre (1989), it was generally not 'judged against the soundness of its environmental analysis and requirements, but according to the degree to which it hindered the pursuit of the organization's goals.' (p.66)

<sup>303</sup> Le Prestre (1989), p.23. They largely considered environmental protection to be the responsibility of other international organizations, such as the newly established UNEP, and domestic governments.



## 5.2 Transnational Advocacy Groups and the World Bank

By 1979, an institutionalized environmental assessment process that formally integrated environmental issues into project planning had become common practice amongst some bilateral aid agencies. In contrast, even though the Bank had issued various general and thematic guidelines on how environmental issues should be addressed in project design, operational staff at the Bank still enjoyed wide discretion and flexibility.<sup>304</sup> During the ensuing decade, the growing gap between the Bank's rhetorical statements about its environmental commitments and the extent of substantive changes in its operational policies and procedures was being exposed and increasingly scrutinized.

The growth of the environmental agenda at the World Bank is really a study of its evolving relationships with transnational advocacy groups.<sup>305</sup> The effort was led by U.S.-based transnational advocacy groups, which argued that some development projects had caused significant environmental damage that had not been adequately considered in the Bank's analysis.<sup>306</sup> According to Wade (1997), the World Bank campaign launched by U.S. advocacy groups was part of a wider strategy to increase environmental protection and fight the causes of poverty in developing countries. Their focus on the World Bank was driven by an understanding that it wielded considerable influence on industrial development in developing countries, and received significant U.S. capital contributions to do so. As the U.S. political system grants interest groups more influence over U.S. government policy than other countries, they developed political alliances with key members of the U.S. Congress and sought to mobilize U.S. support for their policy positions relative to the World Bank, thereby maximizing their own political leverage in affecting development policy in other countries.<sup>307</sup> By directly confronting the World Bank on its claim that projects benefited the poor and did not significantly affect the environment, they hoped multilateral financing could be steered away from supporting large-scale, export-oriented development to more decentralized schemes that brought immediate benefits to the poor and protected environmental resources.

Given the technocratic nature of the World Bank's development bureaucracy, the advocacy groups were forced to express their demands in terms of procedural amendments to existing financing practices to be deemed relevant. They called on the World Bank to employ more environment specialists, expand the range of projects to be reviewed and the depth of individual assessments. Furthermore, they also wanted an extension of the time allotted to public consultations with local communities and

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<sup>304</sup> Wade (1997), p.611

<sup>305</sup> For a brief history of Bank-NGO relations, see O'Brien et.al (2000), pp.18-23, pp. 28-32, and pp.115-134.

<sup>306</sup> Wade (1997), p.614

<sup>307</sup> See Bramble and Porter (1992), Keck and Sikkink (1998), and Wade (1997). According to Bruce Rich, a lawyer at the Environmental Defense and a key figure in the NGO campaigns against the World Bank, it was led by a few motivated individuals at U.S.-based NGOs that met at least bi-monthly in full, and more frequently in sub-groups, to form a common strategy and discuss the activities of each coalition member. (Rich 1993)

increase public access to project documentation. In response, the Bank maintained that adding significant staff was not necessary, as a concern for environmental matters was already an integral part of the professional practices of its operational staff and already part of existing risk management processes. Furthermore, it claimed that subjecting a wider range of projects to environmental reviews and deepening investigations was unnecessary as only a small portion of them were likely to cause environmental damage.

### *Repressions and Denials: The Controversy over Polonoroeste*

In 1981, the Bank implemented the North West Integrated Development Program (Polonoroeste) in Brazil, which primarily involved the construction of a 1500 km highway to facilitate the migration of urban poor to Brazil's less-populated regions.

<sup>308</sup> The project was introduced by the Bank as a poverty initiative and a model for comprehensive regional and development planning, as it included programs meant to set aside land for small farmers, protect forests, and manage the resettlement of indigenous peoples.<sup>309</sup> As it unfolded, federal and regional public agencies in Brazil responsible for implementing the protections and safeguards under the terms of the financing agreement with the Bank failed to do so. In turn, it was to be depicted by critics as 'the quintessential example of the [the Bank's] wider pursuit of misguided development strategies', and came symbolic of the Bank's propensity to financially support 'problem projects' in developing countries.<sup>310</sup>

In 1984, three years after Polonoroeste had been implemented, a research collaboration between U.S advocacy groups and their Brazilian counterparts documented that the implementation of Polonoroeste ran counter to almost all of the Bank's earlier forecasts and its ongoing external communications.<sup>311</sup> For example, since road building preceded most adjacent projects, the highway facilitated the migration of small farmers, as intended, but also failed to prevent the influx of loggers, miners and cattle ranchers into uncolonized and in some cases protected land, whose activities soon dwarfed agricultural production in the region.<sup>312</sup> In order

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<sup>308</sup> Wade (1997), p.637

<sup>309</sup> Wade (1997), p.637-8

<sup>310</sup> Wade (1997), p.638

<sup>311</sup> In 1991, an internal evaluation report produced by the Bank's Operations Evaluations Department (OED) revealed that project proponents were primarily driven by the need to provide Brazil with credit to mitigate its balance-of-payments crisis, and actively marginalized operational staff that evaluated the project on its own merits. This meant crucial feasibility studies and consultations were either poorly executed or never conducted, in the interest of saving costs, limiting time delays, and preventing the discovery of problems that could jeopardize the project. As a result, the initial projections with regards to the migration patterns, agricultural production and impacts on forests were widely off the mark. (as cited in Rich 1993, p.174; OED (1991), Approach Paper: The Bank's Role in Environmental Issues in Brazil, produced jointly with the Brazilian Planning Ministry, Washington D.C: World Bank Joint Audit Committee). The OED has since been renamed twice, initially to the Operations Evaluation Group (OEG), and then more recently, to the Independent Evaluation Group (IEG).

<sup>312</sup> Wade (1997), p.648

to build awareness of these adverse impacts, the environmental advocacy groups in Washington D.C organized a major campaign to halt loan disbursements that included media stunts, petition letters, site visits to the region, and significantly, lobbying the U.S executive director at the Bank as well as key members of the U.S Congress.

Initially the Bank refused to directly engage with the transnational advocacy network and defended its position by claiming its constitution barred Bank officials from engaging directly with citizens, interest groups or legislators, as these should only be communicated with indirectly through the appointed representatives of member-states on the Bank's Board. But this interpretation was successfully challenged by a prominent U.S congressman, who frustrated by the unwillingness of the Bank to adequately respond to concerns over the controversy of Polonoroeste, insisted on meeting the World Bank President in person. This proved significant, and provided a foundation for advocacy groups to increase their leverage by strategically aligning their demands with members of congressional committees that had significant influence over the U.S capital contributions to the Bank's funds. This collaboration resulted in multiple congressional hearings on Polonoroeste and the need for environmental reforms in the Bank, in which advocacy groups lambasted the OEA as a 'public relations sham', and documented numerous past projects with significant adverse environmental and social impacts that had been neither assessed nor mitigated once known.<sup>313</sup>

### *Suspicion, Skepticism and Mistrust: The Legacy of Polonoroeste*

The public controversy over the Polonoroeste marked a turning point in the emergence and diffusion of environmental and social norms in multilateral project financing. The norms promoted by the transnational advocacy network gained legitimacy precisely because of the exposed environmental degradation and social injustices associated with Polonoroeste, and other projects as well. Even though many of the failures associated with the project was the result of poor implementation by Brazilian public authorities, the World Bank as a lender of capital was forced to take much of the blame in the court of public opinion. By extension, the project marked the first time lenders were held morally responsible for the adverse environmental and social impacts of projects, raising public expectations considerably. The main legacy of this controversy was that it was no longer legitimate to perceive the financing of large-scale development projects as a purely technical intervention that should be prepared and implemented solely by professional experts, usually economists and engineers. Instead, the sheer scale of the projects and their environmental, social and economic impacts on entire countries and regions meant

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<sup>313</sup> According to Rich (1993), these included, among others, 'huge dams that displaced indigenous peoples, botched irrigation schemes that contributed to the spread of waterborne diseases such as malaria and schistosomiasis, cattle ranching schemes that destroyed tropical forests, massive resettlement projects.' (p.113)

the debate over planning and implementation moved into the public realm, by way of more information disclosure and opportunities for public consultation.

Apart from its symbolic impact on public perceptions of large-scale project financing, Polonoroeste was significant for a number of reasons. First, the project controversies and the aftermath signified the emergence of an effectively organized and increasingly influential transnational advocacy network addressing the environmental and social policies and procedures of multilateral development banks.<sup>314</sup> According to Rich (1993), the success of the coalition was not due to a centralized command, but a horizontally organized network that drew on all of the resources and connections of its members. Over time, large-scale development projects became a rallying point for environmental advocacy groups in many Western capitals, symbolizing the destructive potential of uninhibited export-led growth, and the social injustices caused by capital exporting countries to the world's poor.

Secondly, while the Bank's strategic vision of development has always been contentious, the public nature of the debate brought the divisions over multilateral financing to the fore and revealed the political dimensions of the Bank's appraisal methodologies. Project financing is political by nature, as it effects the distribution of economic resources and political influence between domestic interest groups. But the greater attention to the adverse environmental and social impacts of projects proved controversial both within the Bank and with many of its borrowers. Internally, it pitted environmental specialists against operational staff, who suspected the environmental agenda to be a Trojan horse for external interest groups that did not favor the World Bank's broader development policies and strategies.<sup>315</sup> Likewise, borrower governments often resented expensive compensation schemes and time-intensive impact studies, and viewed these as unfairly imposed loan conditionalities that would do little to aid their development prospects.

Third, the experience with Polonoroeste solidified the view among advocacy groups that the Bank rarely communicated with the public in an objective or accurate fashion, which would come to characterize relations between them for years to come. In particular, environmental publications were received with increasing skepticism, assumed to deliberately present an issue in a way most favorable to the Bank. In this regard, the experience with Polonoroeste also provided evidence of just how far project proponents are willing to go in order to further their own personal careers or avoid confronting governments. For example, this included withholding critical

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<sup>314</sup> See for example, Bramble and Porter (1992), Keck and Sikkink (1998), pp.135-160, Rich (1993) and Wade (1997).

<sup>315</sup> Over time, the introduction of environmental review would result in much internal controversy, as operational staff either rejected or failed to understand the relevance of environmental problems to the Bank's mandate. In addition, the specialization and separation of environmental due diligence from operations gave the impression that environmental specialists were second-guessing the work of operational staff. As a result, a 'syndrome of mistrust' developed, Wade (1997) argues, because 'the behavior of each side served to confirm the negative expectations of the other.' This, he continues, 'eroded the effectiveness of the environmental staff and discredited the idea of 'environment' as a proper subject of Bank concern.' (p.632)

project information from their superiors within the Bank, much less the general public, actively marginalizing skeptics in the project preparation work, and skipping the most elementary aspects of environmental and social reviews. And even in the aftermath, advocacy groups witnessed that the careers of project officers that had been indirectly criticized in both external and internal evaluation reports, barely suffered from their demonstrated failures.

Fourth, the project exposed how the nature of the Bank's operational mandate, as well as the career incentives of project officers, could be at odds with the spirit of its environmental review guidelines. The constraints imposed on the Bank by its peculiar mandate meant that its financial performance is heavily reliant on the number and size of credit requests from a few large borrowers, which made a chronic shortage of viable projects a constant worry.<sup>316</sup> The importance of lending volumes increased significantly under President McNamara's tenure, as he introduced annual lending targets for each sector. This produced an operational environment characterized by a 'pressure to lend' on operational staff, exerted by creditors, borrowers and management, placing a premium on increasing the number, size and pace of loan disbursements, and subordinating concerns for project quality.<sup>317</sup>

By extension, transnational advocacy groups understood these revelations as evidence that internal organizational objectives, and external pressures to promote export-oriented growth, often conflicted with the policy recommendations embedded in the environmental and social norms they were promoting, particularly forest conservation and upholding the rights of indigenous people. For example, the internal incentive structure within the Bank meant the career opportunities of operational staff were less tied to the outcome of individual projects they had managed than the size of their lending portfolios. Not only did this favor larger projects over smaller ones, increasing the likelihood of significant environmental impacts, but it also produced a disincentive for project officers to select projects that were difficult to appraise, or required borrowers to commission often costly and time-consuming environmental reviews, even in cases where they were obviously needed.<sup>318</sup>

Fifth, through its handling of Polonoeste, the extent of the Bank's immense faith and confidence in its ability to engineer economic and social change on a massive scale through centralized, vertical and expert-driven planning came to the fore and received serious public scrutiny for the first time.<sup>319</sup> Generally, the Bank was

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<sup>316</sup> Rich (1993).

<sup>317</sup> Le Prestre (1989), Rich (1993), and Woods (2006). For example, as Wade (1997) notes in relation to the Polonoeste project in Brazil, 'the road component was particularly attractive because it promised to disburse about \$250 million quickly at a time when other ways to disburse to Brazil were limited.' (p.640) Therefore, as Brazil was its largest and most important borrower, project officers became reluctant to confront federal and regional authorities responsible for implementation failures.

<sup>318</sup> Rich (1993).

<sup>319</sup> As Rich (1993) notes, 'its vision of global central planning was based on an extraordinary assumption; the staff of the World Bank would, through visits ('missions') of a few days or weeks, combined with desk research, take the lead in gathering data to prepare a development plan for 'every relevant aspect' of a 'nation's social framework.' (pp.85-86)

convinced that by employing its appraisal methodologies and integrating appropriate safeguards into the financing arrangements, any potential danger, almost no matter how large or complex, could be identified and averted.<sup>320</sup> This optimism prevented project officers from considering the damaging impact of vested interests or the eventuality of other unanticipated developments during the implementation phase. It also reflected the 'deal-making mentality' that characterized the Bank, which emphasized project preparation and completion over supervision and monitoring.<sup>321</sup> The Bank repeatedly claimed its involvement in complex projects was absolutely critical to ensure that environmental and social issues would be addressed, since the development would have gone ahead regardless, with far worse consequences.<sup>322</sup> The scrutiny of its operations exposed how the Bank had exaggerated the extent and quality of its environmental work and the influence of the OEA within the Bank.<sup>323</sup>

And sixth, but not least, the effectiveness of the advocacy campaigns in documenting the mismanagement of projects and forming alliances with politicians with direct influence over U.S capital contributions to the Bank, put the World Bank on the defensive and triggered a significant transformation in the Bank's rhetoric about its engagement with the outside world. In relation to transparency, requests made to the Bank for project-related documentation were often refused on the basis of confidentiality considerations, as the Bank held that such actions was at the discretion of the borrower. And mindful of potential reputational damages, information that was cleared for release was carefully 'sanitized' to avoid the disclosure of controversies.<sup>324</sup> However, in light of the implementation failures unearthed in relation to Polonoeste, the judgement over confidentiality and the practice of withholding critical information was increasingly the object of sustained public criticism.

### *The Tactical Concession: The Environmental Reforms of 1987*

The controversy over the Polonoeste project marked the beginning of more formalized interactions between Bank officials and advocacy groups over environmental and social policies, and in some cases, the management of controversial projects. The emergence of a coalition between U.S-based advocacy groups and selected members of the U.S Congress would have a lasting impact on the World Bank's environmental and social practices, and more broadly, the integration of environmental and social norms into development finance. On the back of

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<sup>320</sup> Wade (1997)

<sup>321</sup> Wade (1997), p.649

<sup>322</sup> Wade (1997), p.638

<sup>323</sup> In one instance, the Bank continued to claim that all projects were reviewed for their environmental impacts during the early stages of project preparation, even though this had been clearly contradicted by leaked internal files. Specifically, a leaked internal file noted that, 'as a matter of routine, environmental issues are not considered, but that they are taken into account in specific instances where environmental consequences are pointed out by the Bank's environmental advisor, the press, or special interest groups in host countries.' (quoted in Rich 1993, p.118)

<sup>324</sup> Rich (1993).

campaign victories against the World Bank, the advocacy groups would later confront the IFC over its failure to follow the World Bank's environmental and social policies in its private sector financing. Moreover, the campaigns against leading commercial banks would be staged by many of the same groups, and in some cases, the same individual activists. As such, the networks that emerged and solidified during the World Bank campaigns in the 1980s would have a lasting impact on the environmental and social governance of global project finance, across public and private financial institutions.

The turning point for the World Bank's engagement with environmental and social issues occurred in 1986. In September that year, at the Annual Meeting of the World Bank and IMF in Washington D.C, environmental activists mounted a huge banner on the side of a World Bank, which read, 'The World Bank Destroys Tropical Forests.' Shortly thereafter, then President Barber Conable presented plans for a major reorganization of the Bank at an event hosted by the World Resources Institute (WRI), the environmental research and advocacy organization. The reforms would involve a vast expansion of its centralized environmental office, creating a new Environmental Department (ED) and four regional environmental divisions (REDs). As a result of this expansion, the number of staff engaged in environmental work would grow ten-fold. New environmental programs would be launched to secure the sustainability of tropical forests, thereby specifically responding to the concerns of transnational advocacy groups raised by the Polonoeste controversy. And lastly, the Bank was going to improve its communication and interaction with advocacy groups, and seek to involve them in all areas of Bank operations.

#### *The Norms Gain Prescriptive Status: The Narmada Dam Controversy*

These initiatives paved the way for the defining policy development at the World Bank that would later come to influence the evolution of practice at other project lenders, both public and commercial. In 1989, the World Bank approved *Operational Directive 4.00 – Annex A: Environmental Assessment*, which would in 1999 be converted into a formal operational policy. Its intention was to help 'to ensure that [projects] are environmentally sound and sustainable.'<sup>325</sup> As with earlier policy developments in the mid-1980s, the revision was significantly driven by the implementation problems and ensuing public relations disasters of a large-scale infrastructure project, the Narmada Valley Dam. It further provides evidence of the significant role that 'problem projects' play in expanding the scale and scope of environmental project review in project lending, by forcing lenders to mitigate downward spirals in organizational legitimacy by heeding to the demands of critics.

The Narmada Valley projects involved a cluster of dams envisioned along the Narmada River for hydropower and irrigation. The first dam would produce a 200 km long reservoir, Sardar Samovar, and an extensive canal network that combined would cause the forced displacement of more than one hundred thousand households. The

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<sup>325</sup> World Bank (1999), p.1.

Indian Government first approached the Bank for funds in 1979, and following reconnaissance missions and appraisals during the next four years, the Bank disbursed the first loan installments of £225 million in March 1985. Following the disbursement of loans, the lack of coordination or oversight between and among federal and regional authorities led to implementation failures. An independent study commissioned by the Bank's only expert in resettlement issues, discovered that villagers had not even been informed, much less consulted, of the Indian government's resettlement and rehabilitation plan, as agreed with the Bank.<sup>326</sup> Furthermore, as with Polonoroeste, it was revealed that neither the Bank nor the Indian government was committed to carry out environmental reviews of the likely consequences of the large-scale development. As a result, by the time the project was approved by the Board, there was virtually no knowledge of the conditions of forests or their future prospects, or the project's consequences for ground water and other water resources used by downstream communities.<sup>327</sup>

A transnational advocacy campaign, coordinated with local protest groups, mobilized as early as 1982 and exerted significant pressure on the Bank throughout the decade. By 1989, U.S.-based advocacy groups had gathered the strong support of the U.S Executive Director, and were able to push through a congressional subcommittee hearing specifically on the Narmada project. Once again, the Bank was faced with sustained pressure from a transnational advocacy network that included local groups in the Narmada Valley, which enjoyed support from several executive directors. And in contrast to previous campaigns, the Narmada campaign was more directly focused on halting loan disbursements and stopping the project altogether, rather than improve its design.

Among its demands, the campaign urged the Bank to commission a review of the project by an independent panel. In a tumultuous period, Medha Patkar, the leader of the local Save the Narmada Movement, led a march to the dam site aimed at stopping construction. Following confrontations with police, some marchers began a hunger strike, and insisted that the Bank undertake a comprehensive review of the project. While initially reluctant, Bank executives later agreed, hoping to settle the controversies delaying the project. The review, released in June 1992 and led by a former head of the United Nations Development Program (UNDP), was highly favorable to the advocacy groups' cause.<sup>328</sup> It concluded that the project was unlikely to perform as planned with regard to hydrological predictions and resettlement. On the latter, it rather embarrassingly claimed extensive knowledge about the problem of resettlement actually existed and had been generated within the Bank, but never used to produce remedial action plans.<sup>329</sup>

In response to the review, the Bank sent a mission to evaluate the project, which reported back and argued for a suspension of loan disbursements until certain

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<sup>326</sup> Wade (1997), p.691.

<sup>327</sup> Wade (1997), p.693.

<sup>328</sup> Morse Commission (1992).

<sup>329</sup> Wade (1997).



conditions were met. However, senior managers of the project instead suggested to give the borrower another six-month period to make amends, partly motivated by a desire not to hand advocacy groups another win. In March 1993, the Board weighed the progress made by the Government of India towards the benchmarks set by the Bank, and again, implementation of environmental obligations, particularly related to rehabilitation and resettlement, was unsatisfactory. The eventual decision was to cancel further loan disbursements altogether.

The project deepened the divisions between project proponents within the Bank and external critics, including U.S congressional members, advocacy groups and project-affected people, and heightened the urgency among the Bank's senior executives to improve external communications and respond to criticisms. By placing the World Bank at the center of a regional transformation that would displace local communities and cause widespread environmental damage, the development impact of its operations were yet again questioned in the media. For the Bank, it further highlighted the extent to which 'problem projects' identified as rallying points for transnational advocacy groups could become sources of considerable reputational damage, as they fomented adverse media coverage that provide ammunition to external critics on the left and the right. From then on, the fear of negative publicity became a significant underlying motivation for the Bank, and project lenders more generally, to undertake environmental review of projects and subject them to public consultation.

The next section describes how the World Bank emerged stronger from this legitimacy crisis and increasingly became regarded as an important environmental actor in world politics. On the back of these negative experiences, it increasingly sought to find ways to integrate environmental and social concerns into public sector projects, and doing so became integral to its reputation as a champion of sustainable development. With the release of the seminal *World Development Report* in 1992, it became a significant advocate of ecological modernization, promoting national policies and strategies that favored export-oriented growth, while focusing on reducing the emission-intensity of development and redistributing revenue towards poverty reduction.

### **5.3 The World Bank as an Actor in Global Environmental Governance**

The preceding sections have outlined how the practice of systematically assessing environmental and social impacts was pioneered by the World Bank, and became institutionalized fully primarily as a result of pressure from transnational advocacy groups and some powerful shareholders for more transparent, accountable and inclusive project lending. Yet, it is important to note that the World Bank's entry into global environmental politics in the early 1970s was less a function of external pressure, than a desire by its senior management to position the organization at the center of a burgeoning policy area. During the few years preceding the UNCHE in Stockholm, it helped define the cognitive frame through which the environmental

challenge would be conceptualized as an organizational objective for multilateral lenders, and now increasingly commercial banks. At a time when public debates over environmental issues focused on truly complex human-induced pressures on environmental resources, the Bank chose to approach this challenge by subjecting project proposals to an environmental review meant to identify and assess the adverse impacts of large development projects. In this way, the World Bank played an instrumental role in formulating the legal and normative responsibilities of financial institutions to mitigate adverse environmental and social impacts in project lending.

Yet, the controversy over Polonoeste demonstrated the extent to which the World Bank's commitment to environmental protection was substantially constrained by the lack of staff and resources, resulting in a piecemeal approach in which projects were not systematically assessed for environmental damages. Thus, the demands made by transnational advocacy groups, embedded in the symbolism of tropical rain forests, concerned a considerable expansion and formalization of existing review procedures and guidelines. The analysis demonstrated how the World Bank initially repressed criticisms, arguing that its identity as a multilateral institution barred it from interfering with 'political' issues such as environmental protection or upholding the rights of indigenous people. This initial repression of criticisms later gave way to public statements of denial that the operational staff of the World Bank were not fully committed to its environmental mission, and that they violated review procedures in cases where these conflicted with the commercial incentive to lend more money, quickly. Yet, failure to win the argument in the wake of mounting evidence that the World Bank's existing guidelines were not producing satisfactory outcomes, senior management were forced to make what amounted to tactical concessions that gave recognition to the moral claims of advocacy groups without significantly altering lending practices. Only when the environmental and social norms became formally institutionalized in the World Bank's operational policies did they gain prescriptive status, which was further backed by the introduction of the World Bank's Inspection Panel in 1995.

At this stage, the World Bank began acting as a norm entrepreneur in its own right on the international stage, diffusing environmental knowledge, expertise and practices in its research and financial operations. Following the institutionalization of the environmental and social norms in operational policies, these soon became recognized as the standard of good conduct for development lenders, evidenced by a 'cascading effect' across the aid industry. By the mid-1990s, all multilateral development banks, including the EBRD, the Asian Development Bank (ADB) and the IDB, had developed environmental and social standards for project lending, intended to ensure that projects contribute to sustainable development in some form.<sup>330</sup> Since then, many bilateral aid organizations have followed suit, and an EIA study and a subsequent EIA report has provided the basis for managing project-related environmental and social risks in development projects worldwide.

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<sup>330</sup> Kennedy (1999), Kjørven (1998), and Rees (2000).

While in hindsight, environmental project review may come across as the most effective and only feasible intervention to ensure that project financing contributes to sustainable development, this rather limited approach represented one of many plausible interventions. For example, even within the constraints posed by its project-based operations, it could have revised its broader operational strategies in environmentally-sensitive industry sectors, such as extractive industries or forestry, by either changing the composition of its sectoral portfolios by including more environmentally-friendly projects, or placing explicit constraints on the types of projects that would be eligible for financing. Furthermore, its direct relationships with national governments presumably gave it a unique opportunity to develop national action plans on most critical environmental issues, a practice it did not pursue until the mid-1990s. It could have more actively encouraged the expansion of environmental laws and regulations, as a sound regulatory framework has been recognized as an important prerequisite for reducing urban air and water pollution in developed countries. It could have approximated the conceptualization of the environmental challenge that came to inform the activities of the newly established UNEP, which was mandated to look at the regional and global dimensions of environmental problems.

Instead, the analysis identifies how new norms always confront existing normative structures when they enter organizations and become embedded in organizational practices. In this context, the World Bank's own organizational structure and professional culture ensured that its conceptualization of the environmental challenge would not conflict with the norms and principles of development economics. Given the dichotomous view of the environment-development debate at the time, characterized by a dominant understanding that the two policy objectives could not be fully reconciled, it was important for the World Bank that the global consensus would come down on the side of economic growth as a solution to environmental degradation. Therefore, in terms of defining an institutional response to the environmental challenge, the result was a set of environmental and social lending procedures that conformed to widely-recognized environmental and social norms, such as environmental protection, public participation and transparency, whilst sitting comfortably within the existing commercial and political objectives of multilateral financing. In turn, this 'compromise of liberal environmentalism', to use Bernstein's phrase, meant the emphasis from the beginning was on the mitigation of adverse impacts, rather than prevention, as the environmental agenda did not significantly impact project selection or change the opinion of export-oriented growth as a model for development.<sup>331</sup>

The next section introduces the IFC as a multilateral institution, and identifies its distinct organizational characteristics as a lender mandated to supplement the World Bank by promoting private sector growth and investment.

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<sup>331</sup> Bernstein (2001).

## 5.4 The International Finance Corporation: Its Origins and Evolution

Multilateral development banks that predominately finance private sector entities, notably the IFC and the EBRD, have a distinctly commercial orientation to their operational mandate and organizational structure. Whereas the World Bank offers project and programmatic loans to governments, their financing operations are overwhelmingly transaction-based and revolve around the identification, assessment and approval of profitable investment projects in the private sector. While they do offer advisory services to government entities in support of regulatory reforms that further private sector development, they do not provide policy- or sector loans that address the broader institutional basis for development. By implication, lending and equity financing is provided under a narrower mandate, carried out in sector-based banking divisions run by finance professionals that are trained in investment and risk management practices.

So while they do operate within a broader mission to promote sustainable development, commercial viability is the overarching criterion for selecting projects and negotiating financing terms, as projects do not benefit from host government guarantees. When financing development projects, they often take on the same commercial risks as private lenders do, and seek to operate within the constraints and opportunities of the market place in order to demonstrate the commercial viability of developing country investments. Under these circumstances, managing and mitigating investment risk by carefully structuring the transaction and involving a multitude of different financial institutions becomes central to realizing individual projects. By implication, they are therefore more 'bank-like' than public sector lenders, with an organizational culture, operational structure and professional staff more narrowly attuned to identifying and assessing commercial investment opportunities.<sup>332</sup>

Spanning more than a half-century, the IFC has a long history that predates all other multilateral development banks, and programs within them, that provide financing directly to the private sector. This underscores the fact that multilateral financing to the private sector at a significant scale is a relatively recent phenomenon. Indeed, the IFC's annual commitments did not exceed £500 million until the mid-1980s, when there was a notable shift in multilateral financing towards private sector investments and economic reforms programs designed to encourage private sector growth. In 1989, the IDB established the Inter-American Investment Corporation (IIC) to primarily finance small business growth through financial intermediaries, and in 1994, it created the Private Sector Development Department (PRI) to financially support the privatization of large-scale infrastructure in Latin America. In 1991, the EBRD was established to promote market reforms and private sector growth in the former planned economies of Eastern Europe and the republics of the former Soviet

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<sup>332</sup> Gutner (2002).

Union. During this time, the ADB and the African Development Bank (AfDB) also obtained authorization to lend for non-guaranteed private investments.

From the beginning, the IFC has been associated with a neo-liberal economic philosophy that placed the private sector at the center of economic progress and human welfare, and considered the state ownership and regulation as an obstacle to fulfilling the potential of human ingenuity. Its origins are closely associated with big business and finance. In 1951, an U.S development policy advisory panel first endorsed the idea of establishing a public financial institution affiliated with the World Bank, and mandated to support private sector development and encourage private investment in developing countries.<sup>333</sup> The basic assumption held by the panel was that only by supporting private enterprise and investment and encouraging the emergence of an independent private sector could developing country governments achieve economic development. Subsequently, Eugene Black, the World Bank president, worked with his assistant Richard Garner, a banker and former executive of General Foods, to advance the idea to establish a lending institution that 'would be owned by governments but act like a corporation', promoting private enterprise.<sup>334</sup> In 1955, separate Articles of Agreement were drafted to create the IFC, a financial institution that was to become the primary multilateral vehicle for pushing private sector growth in developing countries.

Established in 1956, the IFC operates independently of the World Bank, managing its own funds. Its operations are meant to supplement the operations of the World Bank, which lends exclusively to member state governments, by encouraging the growth of productive private enterprise in member countries, particularly in the less developed areas. The Articles of Agreement of the IFC, largely unchanged since its inception in 1956, clearly identify it as a commercially-driven bank exclusively established to further private sector development. They explicitly state that its investments need to be productive, which means the selection and design of projects is significantly driven by profitability. And since it was to encourage private ownership and the emergence of liberal, competitive markets, it offers financing on terms and conditions that mirror those of private investors.<sup>335</sup> In addition, as with the World Bank, its purpose is not to compete with private investment in developing countries, but to complement it and encourage more of it. This is referred to as its 'catalytic role', namely offering types of financing and selecting the kinds of investments that are most likely to encourage and expand private ownership, participation, and investments in its member developing countries. In combination, these provisions necessarily, and intentionally, restrict its investment opportunities.

Its commitment to increase the share of private ownership and participation was especially strong in its engagement with domestic capital markets, which are traditionally among the most heavily regulated. As early as 1971, the IFC established a Capital Markets Department to conduct research evaluating financial markets in

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<sup>333</sup> This panel was led by Nelson Rockefeller, Governor of the state of New York from 1958-1973.

<sup>334</sup> From IFC's website, [http://www.ifc.org/ifcext/50thanniversary.nsf/Content/IFCs\\_Origins](http://www.ifc.org/ifcext/50thanniversary.nsf/Content/IFCs_Origins)

<sup>335</sup> Rich (1993), p.77

member countries, and provide technical advice and assistance to governments. Oftentimes, this amounted to encouraging deregulation and liberalization, establishing or strengthening market-enabling institutions, and assisting with the privatization of public financial institutions. In addition, since the early 1960s, it has syndicated loans for commercial banks as part of its B-loan program, in which it combines its own funds with those of commercial banks into one lending package, allowing the participating bank to benefit from the IFC's superior credit standing, while the IFC can increase the leverage of its own project finance loans. And finally, in the 1990s, the IFC began to increasingly channeled funds through financial intermediaries, such as commercial banks and private equity funds, instead of directly to project clients. By 2000, the financial sector had become IFC's single largest recipient of funds, amounting to 46 percent of new approvals.<sup>336</sup>

The growth of the IFC had largely occurred in the shadow of the more publicly visible World Bank. Yet, the substantial growth of its lending portfolios meant that its influence on economic development in many developing countries was substantial. Furthermore, the growing global appetite for private capital meant the IFC was often brought in as a multilateral partner in large-scale infrastructure projects, such as oil and gas pipelines. As a result, the scope of its lending policies increasingly affected how environmental and social issues were dealt with in development projects.

## 5.5 Transnational Advocacy Groups and the IFC

During the two decades from 1970 to 1990, the environmental and social impacts of the World Bank's public sector projects were increasingly scrutinized, yet the private sector operations of the IFC were largely overlooked. In its early years, the IFC's investments were largely sheltered from the scrutiny of environmental advocacy groups, and by its own accord, it showed little interest in systematically considering environmental and social issues in its investments.<sup>337</sup> As late as 1989, the IFC regarded its policy to only lend to projects with a 'satisfactory ex-ante economic rate of return' to be its most fundamental development contribution.<sup>338</sup> It considered the financial profitability of the companies it assisted as the 'sine qua non' of its development impact.<sup>339</sup> In many ways, the expansion of private ownership and investment was an end in itself, assumed to be a proxy for a positive development outcome, and it was the role of the IFC to encourage private sector growth in developing countries.

In the early 1990s, it began to engage with the growing debate over the role of the private sector in promoting sustainable development. In 1992, the IFC participated in the preparatory meetings for the United Nations Conference on Environment and Development (UNCED) in Rio de Janeiro. The IFC had engaged with the Business

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<sup>336</sup> See IFC (2000) and Curmally, Sohn and Wright (2005).

<sup>337</sup> IFC (2002b)

<sup>338</sup> IFC (1989), p.2

<sup>339</sup> IFC (1989), p.1

Council on Sustainable Development (BCSD), which in large part coordinated the input from the business community to the conference.<sup>340</sup> In turn, the BCSD produced a ringing endorsement of the IFC as a force for good, arguing that multilateral financing to the public sector had long held back the more positive role that the IFC could play in building liberal capital markets in developing countries.<sup>341</sup> It referred to state-owned enterprises in developing countries as ‘hidden reserves’, and lauded the IFC’s role in accelerating privatization by ‘reinforcing the regulatory structure and depth of emerging markets.’<sup>342</sup> The same year, the World Bank’s annual *World Development Report* focused on the relationship between economic development and the environment, and argued that solving the most pressing environmental was completely compatible with, and indeed necessitated, continued private sector development and economic growth.<sup>343</sup>

Thus, in the global debate over the role of TNCs in reducing environmental degradation, the IFC sought to position itself as a source of business expertise on environmental management in developing countries. As part of this new mission, it argued that its operational mandate to further private sector growth was fully compatible with environmental protection. In fact, the IFC increasingly framed an engagement with the environmental agenda as a commercial opportunity for business, a theme that would become its mantra for winning over skeptics in the business world. Instead of highlighting the constraints placed on environmentally reckless corporate strategies by growing public concern for environmental issues, it claimed ‘competitive advantage will increasingly be derived from superior environmental performance.’<sup>344</sup> This view became increasingly influential in national policy circles, manifested in the politics of ‘ecological modernization’.<sup>345</sup> Within business, the growing influence of this perspective manifested itself in the spread of corporate social responsibility as a new paradigm for understanding the role of business in society, reflected in the growth of environmental management and self-regulation as

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<sup>340</sup> The BCSD would later become the World BCSD, after it merged with the World Industry Council on the Environment (WICE), a creation of the International Chamber of Commerce (ICC). See Vormedal (2006) for a historical overview of the organization and its influence on global governance.

<sup>341</sup> Schmidheiny (1992).

<sup>342</sup> Schmidheiny (1992), p.57

<sup>343</sup> World Bank (1992). The report argued that ‘the view that greater economic activity inevitably hurts the environment is based on static assumptions about technology, tastes and environmental investments’ (p.38)

<sup>344</sup> IFC (1992), p. V.

<sup>345</sup> Mol and Sonnenfeld (2000) and Weale (1992). These ideas first gained mainstream attention with the publication of *The Competitive Advantage of Nations* in 1990, by Harvard economist Michael Porter. He argued that tougher regulations are beneficial for both states and private companies. The assumption was based on a prediction that regulatory standards would inevitably be incrementally tightened across countries. In such a scenario, states should gradually adopt the highest standards so as to attract companies at the forefront of research and innovation in environmental technology, and develop an industrial base that is not vulnerable to regulatory developments elsewhere. Similarly, firms should adhere to the highest standards irrespective of the regulation they are subjected to in their respective national jurisdictions, so best manage the adjustment costs they would inevitably face, and gain a competitive advantage over companies that use inefficient and irresponsible production methods.

the most appropriate and effective institutional responses to environmental problems.

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Yet, at this stage, policy pronouncements about promoting responsible corporate conduct were not followed up by an expansion of formal requirements to undertake impact mitigation measures. In fact, until 1988, the IFC had no separate environmental and social policies and procedures designed to address the diverse, and often unique operational contexts of private sector projects. Nor did it have environmental staff that would conduct environmental reviews of project proposals under consideration. Instead, the OEA at the World Bank was officially responsible for reviewing project proposals considered by the IFC, alongside those prepared by World Bank operational staff. In 1988, to relieve the World Bank of its workload, the IFC commissioned a consultant to review its projects, and the following year, it hired its first environmental advisor to oversee project compliance with local environmental laws and regulations, as well as the World Bank's guidelines and policies.<sup>347</sup>

As part of adding environmental staff, the IFC also adopted a policy that required projects to be in compliance with the World Bank's environmental guidelines to be eligible for financing.<sup>348</sup> In 1990, a set of environmental review procedures were formalized, and according to the IFC, its projects would thereafter be 'consistent with the spirit and intent of the appropriate World Bank guidelines and policies.'<sup>349</sup> Accordingly, it claimed its only environmental advisor reviewed approximately 100 project proposals in that year alone.<sup>350</sup> However, it would later admit that 'one individual was simply not enough to address such a large number of projects thoroughly.'<sup>351</sup>

The following year, one additional environmental position was added, and an Environmental Unit was established within the Engineering Department. The IFC stated the Unit would review all projects with a potential impact on the environment during the appraisal process, and subsequently monitor them to ensure conformity with World Bank and international guidelines and host-country regulations.<sup>352</sup> This review of projects was expanded from previous years; in addition to potential environmental impacts, the Environment Unit would also assess impacts on employees and the local population, resettlement and other socio-economic questions,

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<sup>346</sup> See Drahos and Braithwaite (2000), Falkner (2003), and Haufler (1999). On the role of multilateral development banks in promoting CSR, see Vives (2004) and IFC (2002). Arguments in favor of environmental management rest on a number of ideological assumptions; 1) that the environment can and should be rationally managed, that 2) corporate managers are the appropriate people to do this and have an appreciation of the environment, that 3) business has the necessary technical resources, and that 4) traditional management tools, upon which new approaches will be based, are appropriate and adequate for protecting the environment. (Williams 2001)

<sup>347</sup> IFC (1992).

<sup>348</sup> IFC (1989a).

<sup>349</sup> Quoted in IFC (2002b), p.31

<sup>350</sup> IFC (1990).

<sup>351</sup> IFC (2002b).

<sup>352</sup> IFC (1991).



occupational health and safety issues and risks to life and property. In 1992, the Environmental Unit was renamed the Environment Division, and integrated into a new Technical and Environment Department, and the IFC adopted the environmental screening categorization procedures already formalized within the World Bank.<sup>353</sup> It added three high-level positions, and retained four environmental specialists as full-time consultants. While not having formally adopted the environmental framework governing the execution of World Bank projects, the IFC claimed its environmental review procedures would ensure 'consistency with the spirit and intent of appropriate World Bank policies and guidelines.'<sup>354</sup>

As part of this reorganization, the Environment Division became responsible for 'identifying environmental projects suitable for IFC financing, and working with project sponsors to develop bankable projects.'<sup>355</sup> Furthermore, a newly created Infrastructure Department would be responsible for completing environmental projects developed by the Environmental Unit. Accordingly, the purpose of many of these environmental projects would be to transfer the ownership and operations of water infrastructure from national public monopolies to foreign companies. Operationally, investments in the 'environmental' sector largely came to mean involving both foreign and domestic private companies in infrastructure development in areas such as water supply, wastewater treatment, and waste management. Early accomplishments it chose to highlight include Aguas Argentina, a waste and wastewater services project in Buenos Aires that was the largest privatization of water services outside Western Europe, a Thai oil refinery, and a wastewater plant in Puerto Vallarta, Mexico.<sup>356</sup> However, the IFC was also serving as a preparatory and executing agency for private sector projects funded by the Global Environment Facility (GEF), which typically included more traditional conservation projects.

In many ways, the origins and nature of these careful environmental reforms are similar to those undertaken by the World Bank in the early 1970s. Just as the World Bank sought to insert itself as a major actor at the Stockholm conference to influence the brewing global debate over environmental degradation, so did the IFC ally itself with the private sector and promote its cause at the Earth Summit in Rio in 1992. In both cases, the initial impetus for engaging with environmental issues did not primarily come from transnational advocacy groups or even board members, but rather, a desire to influence a growing policy agenda that would influence its future organizational roles and functions. As such, once transnational advocacy groups pressed for greater accountability and transparency, the IFC had already formulated a policy position on the environment that was significantly shaped by its mandate as a promoter of private sector growth. In turn, this organizational environment, dominated by finance professionals, investment practices and analysis, served as a

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<sup>353</sup> IFC (1992a). The use of environmental screening categories – A, B, C or FI – to classify project proposals according to their potential environmental risks, was institutionalized in the World Bank's investment cycle as part of the *Operational Directive on Environmental Assessment* 4.00 (1989).

<sup>354</sup> IFC (1992).

<sup>355</sup> IFC (1993), p.88.

<sup>356</sup> IFC (1994), p.104

filter through which environmental and social issues emerged and eventually became institutionalized in the IFC's operational policies. In this regard, the socialization of the IFC also resulted in the commercialization of the environmental and social lending practices of the World Bank, as the IFC, by mandate, was forced to create commercial justifications for undertaking such interventions.

In short, the IFC became a subject of the growing norm cascade that followed the World Bank's environmental reforms, which made it increasingly difficult for public lenders to claim that they operated responsibly if they did not formally comply with the World Bank's environmental and social standards and procedures. In 1992, despite announcing new environmental guidelines and initiatives, including smaller projects with clear environmental benefits, the IFC's environmental commitments were increasingly being compared and contrasted to those of the World Bank. Most notably, the IFC came under increasing pressure to formally adopt the World Bank's *Operational Policy on Environmental Assessment*, as well as other thematic policies that placed environmental and social conditions on project finance loans.

Given the preexistence of the World Bank's environmental and social policies, any announcements made by the IFC that it would more systematically manage the environmental and social impacts of projects immediately raised expectations that it would align its due diligence procedures with those of the World Bank and other multilateral lenders. In fact, the environmental and social norms advocated by the transnational advocacy network, particularly those pertaining to information disclosure, public participation and environmental impact studies, had become so recognized as the only legitimate standard among development institutions that compliance with them was perceived as a benchmark for responsible lending. Thus, given the widespread legitimacy of their moral demands, the only challenge remaining for the transnational advocacy groups was to persuade the IFC, and perhaps more importantly, dominant board members, that the financing of private sector projects should be governed by the same norms as those governing public sector lending.

As with the case of the World Bank, it would be a project that generated considerable local controversy and subsequently became a rallying cry for activists that would turn the tide. Just as the exposed adverse impacts of Polonoeste undermined the World Bank's claim to have environmental and social guidelines in place, so did a large-scale infrastructure project place questions about the robustness of the IFC's environmental and social procedures. In turn, the diffusion of these norms from the institutional context of the World Bank to that of the IFC can be attributed to the political activities of transnational advocacy groups, which did not differentiate the environmental responsibilities of these institutions, despite the fact that they had widely different operational mandates.

*From Denials to Tactical Concessions: The Impact of the Pangué controversy*

In 1992, the IFC became embroiled in a controversy over its financing of a Chilean hydropower dam.<sup>357</sup> During the course of a few years, the growing social interactions between the IFC and transnational advocacy groups would eventually redefine IFC's mission as a multilateral financial institution, ending in the formal adoption of the World Bank's environmental and social standards and procedures.<sup>358</sup> In confronting the IFC, transnational advocacy groups drew on the same advocacy strategies they had used when they first pressed the World Bank to adhere to well-recognized environmental and social norms in the financing operations. In response, the IFC initially rejected accusations on the basis that its private sector projects could not be driven by political imperatives, yet gradually, it succumbed to pressures and made important concessions. In explaining this movement of position, the main factor was the IFC membership of the World Bank Group, which obliged it to follow the operational policies of the World Bank, if not legally, at least ethically. As such, the moral claims of transnational advocacy groups became embedded in broader discussions about organizational coherence and policy development within the World Bank Group.

As with the World Bank and Polonoroeste, the IFC's environmental and social record became closely associated with a particular problem project, in which a series of implementation failures were exposed and made public by transnational advocacy groups. The Pangué project involved the construction of a major hydroelectric dam on the Bío-Bío River, constructed by the Spanish energy company ENDESA, with an additional five dams slated for construction. The Bío-Bío watershed is home to indigenous communities, and the Pangué dam flooded 450 hectares of land, displacing 53 people. However, given that the construction of the dam would effectively open up the watershed for energy development, the overall impact of the five additional hydropower projects on the river would likely be much more substantial. Therefore, in anticipation of its significant impact on the environment, the project was assigned screening category 'A', meaning the borrower would be required to undertake a broader range of due diligence actions.

Alongside the ecological impacts, the greatest controversy centered on the impact on river communities, with allegations of human rights violations and unfair compensation. With clear parallels to the still ongoing Narmada Dam controversy, the project generated the largest petition drive against the IFC in history, and mobilized local and transnational advocacy groups, as well as local communities, legal groups and even the American Anthropology Association. And significantly, as was the case when they contested the financing of Polonoroeste, environmental advocacy groups based in Washington D.C took advantage of their access to U.S policy-makers and found strategic allies in the U.S Congress to support their

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<sup>357</sup> See Hair et.al (1997) and Park (2006), pp. 174-176, for more on this controversy.

<sup>358</sup> This contention finds support in existing research on the 'greening' of the IFC, notably Park (2006).

arguments against the IFC.<sup>359</sup> As a result, the U.S Treasury met with officials from the IFC in 1992 to discuss the environmental and social impacts of the proposed project. To mark its discontent, the U.S Executive Director on the IFC's Board abstained from the project approval vote.

Alongside the brewing controversy, the IFC continued to expand its environmental management expertise, and increasingly reaffirmed a commitment to promote sustainable development in its project operations. In 1993, the IFC stated the environment had become 'one of its most urgent priorities.'<sup>360</sup> As part of a bank-wide restructuring which divided Operational Directives into three new categories – Operational Policies (OPs), Bank Procedures (BPs), and Good Practices (GPs) – the IFC undertook a revision of its environmental review procedures to standardize its informal application of World Bank policies and guidelines, and more clearly allocate environmental responsibilities among internal staff, and between the IFC and project clients.<sup>361</sup> Environmental procedures were further strengthened; for example, impact assessments of individual projects would be conducted 'at the earliest possible stage' and updated 'during each new phase of a project.'<sup>362</sup> All projects would need to meet 'stringent environmental standards', and the purpose of the review was to 'ensure that projects are environmentally sound and sustainable.'<sup>363</sup>

In 1994, a general disclosure policy was adopted, which according to the IFC, 'attempted to balance the private sector's need for confidentiality with the public's right to know about issues affecting it and involving the use of public funds.'<sup>364</sup> It formalized the disclosure of key project-related environmental documents; the Summary Project Document (SPI) prepared for each project proposal under consideration, the Environmental Assessment of category 'A' projects, and the Environmental Review Summary of all category 'B' projects. All of these were to be disclosed through a newly established World Bank Public Information Center.<sup>365</sup> Furthermore, following World Bank practice, IFC projects deemed to have significant adverse environmental impacts would be required to undergo public consultation during the environmental assessment stage, and make the ensuing report public. It strengthened monitoring and supervision procedures of financed projects, requiring all borrowers to submit and annual report on implementation. According to the IFC, it would review them 'thoroughly', and recommend remedial measures to solve any problems.

By 1995, the Environment Division had eight higher-level staff and ten external consultants.<sup>366</sup> In reference to these organizational changes, it stated a commitment to become more proactive in the environmental arena by 'refining its project review

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<sup>359</sup> Park (2006), p.175.

<sup>360</sup> IFC (1993), p.87.

<sup>361</sup> World Bank (1995).

<sup>362</sup> IFC (1993).

<sup>363</sup> IFC (1993), p.87.

<sup>364</sup> World Bank (1995), p.200.

<sup>365</sup> World Bank (1995).

<sup>366</sup> World Bank (1995).

process to retain a high standard of excellence while avoiding unnecessary bureaucracy.’<sup>367</sup> To further integrate environmental concerns into Bank operations, the IFC conducted environmental management training for internal staff, educating them on the World Bank’s policies and guidelines, and the IFC’s environmental review procedures.

The same year, advocacy groups filed a complaint with the World Bank’s Inspection Panel over the Pangué project, alleging that the IFC had violated the World Bank’s operational policies. While the panel rejected the claim, arguing the IFC’s operations fell outside of its jurisdiction, it provided support for the critics’ argument that the IFC was regarded as a member of the World Bank Group, but not subject to all of its operational policies. In 1996, during the midst of the Pangué controversy, the IFC stated that projects would be required to meet the more stringent of host country standards and World Bank guidelines. During the year, its Environmental Division had worked closely with World Bank to update its environmental guidelines. It had also hired its first social specialist, reflecting the growing stature of the social dimensions of sustainable development. This also signaled a closer alignment with the World Bank’s poverty alleviation mandate.

But the reforms did not signal a departure from its focus on promoting private sector development. On the contrary, according to the IFC, meeting the overriding objective of the World Bank Group of alleviating poverty ‘would directly depend on its success in supporting the momentum of private sector development.’<sup>368</sup> Symptomatically, on its 40<sup>th</sup> anniversary in 1996, the IFC proclaimed that its investments had collectively contributed to the widespread acceptance in the developing world of;

‘an economic model based on privatization, liberalization of trade and investment regimes, establishment of domestic capital markets, and encouragement of a dynamic, competitive local private sector with a growing export base.’<sup>369</sup>

However, in response to critics questioning the impacts of its project operations, increased attention would be given to ex-post evaluations of the actual development impact of projects. The IFC’s Economics Department and Operations Evaluations Group jointly produced a set of indicators to measure ‘a project’s contribution to the growth of productive private enterprise and efficient capital markets, to sustainable economic growth, and to economic welfare, improved living standards and quality of life.’<sup>370</sup> While environmental protection or positive environmental change did not seem to feature prominently in this list of ‘development impacts’, the IFC reiterated that it had ‘come to view environmental issues as an important part of its development impact.’<sup>371</sup>

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<sup>367</sup> World Bank (1995), p.205.

<sup>368</sup> IFC (1996), p.5

<sup>369</sup> IFC (1996), p.10.

<sup>370</sup> IFC (1996), p.6.

<sup>371</sup> IFC (1996), p.7.

### *Norms Gain Prescriptive Status: The Reforms of 1998*

The controversy over the Pangué project had illustrated how giving tactical concessions had failed to reduce public criticisms, which were also coming from inside the U.S Congress. To address the Pangué controversy, World Bank President Wolfensohn commissioned an independent internal review of the project, specifically considering allegations of policy violations.<sup>372</sup> The results of the investigation confirmed that the IFC had failed to comply with the World Bank's policies when financing the project, and had inadequately monitored project impacts. In turn, it recommended a series of environmental and social reforms to remedy these problems. The same year, the World Bank reorganized existing thematic policies and developed new ones to form a set of environmental and social *Safeguard Policies* that stipulated various assessment, consultation, disclosure, monitoring and reporting requirements placed on borrowers.

In 1998, on the back of the Pangué review, the IFC formally adopted most of its recommendation, thus institutionalizing environmental assessment, as well as thematic policies covering impacts in a variety of thematic areas.<sup>373</sup> It also adopted a set of *Environmental and Social Review Procedures*, which formalized the requirements placed on borrowers, and outlined the internal procedures by which the IFC assesses project proposals.<sup>374</sup> Combined, these reforms produced a policy framework that would become the 'foundation for IFC's work in the environmental and social areas and for assessments of IFC's compliance and accountability' until its revision in 2006.<sup>375</sup> Furthermore, it hired its first NGO liaison officer, and introduced the Office of the Compliance Advisor/Ombudsman (CAO) help the IFC and MIGA address the complaints of people adversely affected by projects. Similar to the World Bank's Inspection Panel, this office allowed project-affected communities to submit complaints in cases where an alleged failure by the IFC or MIGA to follow their own operational policies adversely affected them.

According to the IFC, the controversies surrounding the Pangué project were instrumental in the institutionalization of environmental and social lending policies and the creation of a formal accountability mechanism.<sup>376</sup> In the words of one former

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<sup>372</sup> The report was headed by Dr Jay Hair, a former president of both the National Wildlife Federation (NWF) and the International Union for the Conservation of Nature and Natural Resources (IUCN), see Hair et.al (1997).

<sup>373</sup> In 1998, these operational policies and directives, adopted at different times, became collectively known as the Safeguard Policies; Environmental Assessment (OP 4.01, Oct.1998), Natural Habitat (OP 4.04, Nov.1998), Pest Management (OP 4.09, Nov.1998), Forestry (OP 4.36, Nov.1998), Safety of Dams (OP 4.37, Sept.1996), International Waterways (OP 7.50, Nov.1998), Indigenous Peoples (OD 4.20, Sept.1991), Involuntary Resettlement (OD 4.30, June 1990), Cultural Property (OPN 11.03, Sept.1986). In addition, the IFC added a Child and Forced Labor Policy Statement.

<sup>374</sup> IFC (1998).

<sup>375</sup> IFC (2002a), p.33

<sup>376</sup> IFC (undated) 'The Pangué Hydroelectric Project – Lessons Learned', Date of Access: February 7, 2007, see [http://www.ifc.org/ifcext/enviro.nsf/AttachmentsByTitle/p\\_pangue\\_summary/\\$FILE/pangue\\_summary.pdf](http://www.ifc.org/ifcext/enviro.nsf/AttachmentsByTitle/p_pangue_summary/$FILE/pangue_summary.pdf)

official, while the project demonstrated that environmental and social issues could pose real risks, senior management reacted defensively by suggesting a wide range of reforms to make sure that the IFC would not be criticized again.<sup>377</sup> Specifically, its assumption that minimal direct environmental impacts would ensure that external criticisms would not materialize proved wrong. For the IFC, the Pangue project demonstrated how 'indirect impacts can pose equal, if not greater, reputational risk to the IFC and the sponsor than direct project impacts.'<sup>378</sup> By extension, it created a direct link between the process of environmental and social risk management and the reputation of the IFC as development institution.

The significance of reputational risk as a motivation for institutionalizing environmental and social policies and procedures would again manifest itself when transnational advocacy groups began to pressure commercial banks. Before reviewing the growing pressures on the commercial banking industry in detail, the next section will briefly discuss how advocacy campaigns against the IFC contributed to its transformation into a leading proponent of corporate social responsibility and voluntary business regulation, thereby emerging as an intellectual and operational partner for the commercial banks. Crucially, for the first time, the IFC formulated and increasingly promoted commercial justifications for complying with the operational policies of the World Bank, thereby strengthening their legitimacy among commercial project lenders and borrowers.

## **5.6 The IFC as an Actor in Global Environmental Governance**

As with the World Bank, the IFC emerged out of its environmental reforms in 1998 as a new actor in global environmental governance, recognizing the need to protect the environment and local communities, whilst integrating this agenda into its commercial objectives as a financial institution. Alongside expanding environmental and social review, it also completed its first comprehensive client survey in order to identify its competitive strengths and weaknesses as a financial institution in an increasingly crowded market place. According to the IFC, it revealed that while clients valued its membership in the World Bank Group, the expertise of its staff, and the environmental and social guidance it provided, they also felt that the IFC was 'too slow to respond, shunned risk, and had a culture which had become bureaucratic and inward looking'.<sup>379</sup> In response to these findings, the IFC's senior management became increasingly focused on understanding the financial and technical needs of its clients, and finding ways to improve the development impacts of its projects.

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<sup>377</sup> EPFI-08.

<sup>378</sup> IFC (undated) 'The Pangue Hydroelectric Project – Lessons Learned', p.3. Date of Access: February 7, 2007, see [http://www.ifc.org/ifcext/enviro.nsf/AttachmentsByTitle/p\\_pangue\\_summary/\\$FILE/pangue\\_summary.pdf](http://www.ifc.org/ifcext/enviro.nsf/AttachmentsByTitle/p_pangue_summary/$FILE/pangue_summary.pdf)

<sup>378</sup> EPFI-08.

<sup>379</sup> IFC (1998), p.2

This marked the beginning of an internal process whereby an Operational Strategy Group, together with a number of environmental specialists in its Environment Department, collaborated to better integrate the IFC's environmental and social mission with its commercial objectives as a financial institution.<sup>380</sup> Known as the 'Sustainability Initiative', this strategy included efforts to raise the awareness of the benefits of environmental risk management, both internally and externally, through research dissemination, training programs, and the establishment of partnership with a number of environmental business networks.<sup>381</sup> It received critical support from Peter Woicke, a career investment banker who became the IFC's Executive Vice President in 1999, and saw it as a way for the IFC to increase the value of its environmental and social expertise and positively differentiate itself from other financial institutions servicing the private sector in developing countries.<sup>382</sup>

Significantly, while it sought to expand the IFC's environmental and social mission, it was forcefully launched as a business-driven initiative aimed at improving relationships with clients and enhancing their competitiveness. As such, the approach conformed to the 'client-driven' agenda that was increasingly influencing policies and strategies within the World Bank Group more broadly.<sup>383</sup> It also stated it would place a greater emphasis on achieving positive development outcomes, in line with growing skepticism in some policy circles that multilateral financing to the private sector was still necessary, given the tremendous growth in private capital flows to developing countries in the 1990s. According to IFC officials, this pressure provided an additional rationale for reforming its approach to environmental and social risk management, away from a focus on process compliance to a greater emphasis on achieving development outcomes.<sup>384</sup>

Within this new discursive context, the IFC's institutional role was to supplement its due diligence framework with a focus on identifying, enhancing and realizing the

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<sup>380</sup> According to the Director of the Operational Strategy Group, moving beyond the narrow conception of environmental and social issues as risks to the status quo was instrumental to making its environmental and social mission consistent with its mandate to foster social change in developing countries in the form of private sector development (IFC-02)

<sup>381</sup> The IFC's initial definition of 'sustainability', which would evolve over time, referred to 'development which is viable over the long-term—in its financial, economic, environmental and social dimensions-- and not development achieved in the short-term at the expense of longer-term prosperity.' (p.14) By emphasizing the synergies between economic, social and environmental objectives, it cast the consideration of environmental and social issues as a central component of profitability, thereby reinforcing the notion that they were compatible with its mandate to catalyze private sector growth and development.

<sup>382</sup> IFC (2000). According to Armstrong, Woicke expressed a desire to introduce an initiative that would 'change the face of the organization by placing sustainable development central to its organization, management and values' (IFC-04).

<sup>383</sup> In terms of the environmental agenda, this most forcefully manifested itself in June 2006, when the World Bank announced it would disband the Environmentally and Socially Sustainable Development (ESSD) network and merge it with the Bank's infrastructure department, and create a new Sustainable Development Department. It was meant to streamline management and enhance coordination between operational and support staff, ultimately increasing its efficiency in meeting the demands of borrowers during the preparation of projects.

<sup>384</sup> IFC-01.



'business case' for its clients to voluntarily adopt environmental and social practices.<sup>385</sup> By taking on an advisory role relative to borrowers, rather than a role as a regulator, it placed less emphasis on broadening and enforcing rules and requirements, and more on appealing 'to firms' self-interest as a means of enhancing the sustainability of economic activity.'<sup>386</sup> The premise was that 'many opportunities exist for businesses in emerging markets to benefit from actions that advance sustainable development', and it became the role of the IFC to convince private clients of the financial benefits of considering environmental and social issues.<sup>387</sup> In doing so, it sought to assert itself as 'a partner of choice', and claimed it possessed 'an expertise in sustainability that is second to none among financial institutions and multilateral development banks.'<sup>388</sup>

In September 2002, the IFC co-hosted a side event with the WBCSD at the World Summit on Sustainable Development (WSSD) in Johannesburg.<sup>389</sup> At the event, the IFC launched *Developing Value*, a report that presented a series of carefully chosen case studies identifying ways in which private companies had benefited from implementing a 'sustainability action.'<sup>390</sup> In expanding the awareness of the 'sustainability' concept, the IFC identified itself as a resource for 'business people in emerging markets who are struggling to find the right balance between financial pressures on the one hand, and sustainability challenges on the other.'<sup>391</sup> It was thought that harmonizing its environmental and social practices with those favored by many TNCs, some of which were receiving financing from the IFC, would enhance its legitimacy in the private sector.<sup>392</sup>

The IFC's participation at the WSSD alongside the WBCSD essentially replicated its involvement in the Rio Summit ten years before. Yet, while its policy recommendations were broadly similar, the IFC had during the interim period hired environmental and social specialists, established an Environmental Department, and provided environmental risk management training to hundreds of financial institutions. On this basis, it had acquired superior expertise in managing environmental and social issues in private sector projects in developing countries that was widely recognized among commercial banks, and proved conducive to facilitating discussions about developing common environmental and social standards to be used by commercial banks in project financing. Reflecting this expertise, the IFC expanded its environmental and social risk management training in the

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<sup>385</sup> IFC (2002).

<sup>386</sup> IFC (2003), p.20.

<sup>387</sup> IFC (2002), p.6.

<sup>388</sup> IFC (2003), p.2.

<sup>389</sup> For an assessment of the role and influence of the WBCSD in global governance, see Vormedal (2005).

<sup>390</sup> These case studies were organized across seven categories; governance and engagement, stakeholder engagement, environmental process improvement, environmental products and services, local economic growth, community development and human resource management. (IFC 2002)

<sup>391</sup> IFC (2002) p.7.

<sup>392</sup> As one senior IFC official noted, understanding environmental and social issues as potential 'value added activities' for private investors and companies more accurately reflected what the market was increasingly looking for. (IFC-01)

commercial banking industry, influencing the evolution of lending policies and practices.

In fact, the emergence of the IFC as a promoter of corporate social responsibility as the most appropriate institutional response to integrating environmental and social concerns into investment practices increased its legitimacy among TNCs and laid the foundation for its role and influence in the drafting and launch of the Equator Principles. This will be discussed in greater detail in the next chapter.

## **Conclusion**

The chapter has chronologically documented the emergence and evolution of environmental review as an institutional mechanism to govern the environmental and social impacts of project finance loans. It has traced the practice of environmental review to the early 1970s, when the World Bank first became engaged in global environmental debates and articulated how it would address environmental pollution in its development projects. At that time, its mandate was narrowly defined as promoting economic development, assumed to be a public good in itself, regardless of its environmental and social impact on society. In this context, addressing the adverse environmental and social impacts of projects by placing conditions on loans was regarded as a political act, and thereby in violation of the World Bank's 'apolitical' mandate.

Yet, over time, economic development was no longer understood in isolation of the rapid environmental degradation that was occurring in many developing countries, particularly the degradation of tropical forests. Furthermore, in cases where projects involved the forced resettlement of people, the World Bank was forced to address the negative impacts on their livelihoods, beyond getting assurances from borrower governments that compensation would be provided. Overall, project financing was transformed in the public mind from a financial transaction driven by a single requirement to attain a satisfactory rate of financial return, to a development intervention meant to generate a wide variety of development benefits.

The analysis has demonstrated that contestation, both internal and external, has been central to the evolution of environmental and social lending policies at the World Bank, and subsequently the IFC. Specifically, ideologically rooted differences over what constitutes the appropriate roles and responsibilities of multilateral development banks significantly shaped debates over the purpose and scope environmental and social lending policies. In turn, the legitimacy and popular strength of transnational advocacy groups has increased amidst revelations that both the World Bank and the IFC have supported projects that were not in compliance with their operational policies. Thus, tactical concessions were no longer tenable responses amidst evidence of significant implementation gaps. Therefore, both the World Bank and the IFC gave the norms prescriptive status by embedding them into operational policies, and making norm compliance obligatory for internal staff. And in turn, both organizations

transformed themselves into self-proclaimed sources of knowledge and expertise in environmental and social risk management, promoting themselves as significant actors in global environmental governance.

As a result of being institutionalized in multilateral lending policies, the environmental and social norms advocated by transnational advocacy groups came to define what constituted appropriate and legitimate lending. The next chapter will illustrate how the norm cascade eventually came to include commercial project lenders as well. In remarkably similar ways, transnational advocacy groups were successful in directing public attention towards the lending practices of commercial banks, and identifying a gap between their lending policies and practices and well-recognized norms in the multilateral system. Just as the IFC had initially argued its private sector mandate exempted it from complying with these norms, so did commercial banks. But, in the face of a norm cascade caused by the growing influence of transnational advocacy groups and the emergence of corporate social responsibility in the corporate sector more generally, the defense eventually succumbed to external pressures, and several industry leaders transformed themselves from denying the legitimacy of the norm to promoting it as a central aspect of risk management processes.

## ***6. Commercial Banks and Sustainable Development***

### **Introduction**

The last chapter documented how the World Bank Group's growing influence on economic development in developing countries caused transnational advocacy groups to promote environmental reforms in its lending policies as a way to increase environmental protection and improve the conditions of project-affected communities. Over time, external pressure induced both the World Bank and the IFC to formally integrate environmental and social concerns into their lending policies and practices. While these developments, and the norm cascade they triggered, are important factors in explaining the emergence of the Equator Principles, this chapter will also seek to place the framework within the broader historical context of an emerging environmental agenda in the commercial banking industry. Specifically, the rise of corporate environmental policies among commercial banks coincided with growing public attention in developed countries towards the role of TNCs in fostering sustainable development in developing countries, as manifested at the Earth Summit in Rio.

In the 1990s, alongside the campaigns against the IFC, transnational advocacy groups increasingly brought attention to how private investors in the West were bankrolling large projects in developing countries that were causing widespread environmental damages. The analysis will highlight how the proliferation of transnational advocacy campaigns against controversial development projects not only undermined the corporate reputation of the private companies in charge, but also their private financial backers. On numerous occasions, advocacy groups alleged that commercial banks were financing profitable projects at the expense of the environment and local communities, and feeding narratives to the press that were reminiscent of those that had been written in connection with World Bank and IFC projects. In turn, it was the cumulative public pressure that was building on the project finance industry that gave rise to a collective will among commercial banks to explore a common industry framework.

The chapter will be structured as follows. The first section will survey the literature on the influence of transnational advocacy groups on the emergence and diffusion of environmental and social norms in TNCs. Subsequently, the second section will review the 'greening' of the commercial banking industry, as a subtext to understanding how and why the Equator Principles emerged. The third section identifies how transnational advocacy groups began to focus on the involvement of commercial banks in large-scale infrastructure projects in developing countries, and how this triggered social interactions reminiscent of those between the World Bank, the IFC and their critics in civil society. And finally, the fourth section provides a review of how commercial banks responded to these advocacy campaigns, illustrating how the existence of the World Bank's environmental and social standards in many

ways constituted not only how their roles were understood, but the way in which their lending could be made more responsible and accountable.

## 6.1 Transnational Advocacy Networks and Transnational Business

Whereas TNCs are the primary driving force behind the transformation of the global economy, transnational advocacy networks have become central to the emergence of a transnational public policy realm confronting TNCs, multilateral development banks and international economic regimes.<sup>393</sup> In fact, the parallel growth of TNCs and transnational advocacy groups, and the evolution of interactions and confrontations between them, has become one of the hallmarks of world politics in an age of globalization.<sup>394</sup> Just as TNCs have grown tremendously in scale and numbers, so have advocacy groups. While their growth has been steady for a number of decades, the 1990s saw a particularly dramatic proliferation in areas like the environment, human rights and poverty, evident in statistics on organizational membership, growth of voluntary sectors in the economy, and accreditation to U.N conferences.<sup>395</sup> Aided by advances in internet and communications technologies, they have been able to build broad-based networks across national borders, held together by a shared commitment to common causes, the constant exchange of ideas and information, and collective advocacy in the form of petitions, press releases and policy reports.<sup>396</sup>

As such, transnational advocacy groups have been critical to the emergence of a counter-discourse on globalization, highlighting the adverse impacts of transnational economic activity on the environmental and local communities in developing countries, and more generally, confronting corporate power. The rise of voluntary self-regulation has been widely challenged by the contestation of the notion that market-driven solutions can deliver the structural transformation of the global economy that is required to reverse current trends of environmental degradation associated with corporate activities. In doing so, they have depended on various sources of authority and influence.

First, on the back of popular support and increasingly targeted media campaigns, transnational advocacy groups have become a constant source of pressure on the centers of power in the international system, affecting governments, transnational corporations and international financial institutions alike. Since ‘the Battle of Seattle’, large-scale public demonstrations have become a hallmark of international conferences on trade, finance or development, prompting event organizers to select increasingly remote places as conference venues. And by mobilizing public opinion

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<sup>393</sup> As with transnational corporations, transnational NGOs are by no means a recent phenomenon, but have a long historical record of significant accomplishments, from abolishing slavery to institutionalizing universal suffrage. See Drahos and Braithwaite (2000), pp.497-501, for a brief discussion.

<sup>394</sup> See Börzel and Risse (2002) for a discussion of public-private partnerships as an emerging feature of global governance.

<sup>395</sup> Bendell (2004), pp.12-13.

<sup>396</sup> Drahos and Braithwaite (2000), Keay (2002), and Willets (2005).

in host countries, and in many cases, the developing country in which corporate practices are undertaken, they can directly confront and engage with TNCs.<sup>397</sup> Therefore, they no longer depend on domestic political channels to influence corporate behavior, but exert influence internationally as political actors in their own right, able to bypass conventional inter-state relations to shape transnational policy-making processes.<sup>398</sup> By coordinating their efforts, appealing to moral principles, and exploiting tensions among states and industry sectors with divergent interests, advocacy groups have been able to achieve political success with relatively marginal financial resources.<sup>399</sup>

Secondly, transnational advocacy groups have become recognized as the standard bearers of social justice and environmental protection, and more importantly, as sources of knowledge and expertise in areas of development policy.<sup>400</sup> In fact, progressive foreign policy on environmental matters is often a result of domestic pressure from advocacy groups.<sup>401</sup> By virtue of their expertise, they have acted as policy advisors for national governments and their delegations to environmental conferences, and in some cases, been included in the monitoring arrangements of international environmental regimes, such as Greenpeace in the Arctic Whaling regime.<sup>402</sup> And they have helped form political coalitions among states vulnerable to environmental change, as in the efforts of the Center for International Environmental Law (CIEL) in establishing the Association of Small Island States as an ally in global climate politics.<sup>403</sup>

Third, in relation to TNCs, there has been a growth in the number of advocacy groups exclusively devoted to surveying and comparing corporate practices, based on the premise that corporate information cannot be trusted and needs to be verified independently.<sup>404</sup> By exposing violations of laws and regulation, or even standards recognized as 'international best practices', advocacy groups have popularized the contention that the activities of TNCs often conflict with the interests of people and the environment. In turn, this has increased the pressure on private actors to transform

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<sup>397</sup> Haufler (1999), Wapner (1997). In terms of business-NGO relations, the literature typically distinguishes between 'rejectionist' strategies, which aim to induce changes to corporate practices by 'naming and shaming' corporate malfeasance, and 'accommodationist' strategies, which place faith in promoting corporate environmentalism by injecting knowledge and information about environmental problems and opportunities into corporate management practices. (Williams 2001)

<sup>398</sup> Williams (2001).

<sup>399</sup> For example, in relation to the first public campaigns against the World Bank in the 1980s, the success of the coalition was not due to a centralized command, but a horizontally organized network that drew on all of the resources and connections of its members. (Rich 1993)

<sup>400</sup> Keck and Sikkink (1998) argue that the success of transnational NGOs can partly be attributed to the strategic framing of environmental degradation around two types of issues, 'bodily harm to vulnerable individuals and legal equality of opportunity, which 'speak to aspects of belief systems or life experiences that transcend a specific cultural or political context. (p.204) For a discussion of framing, see also Payne (2001 and Stone (1989).

<sup>401</sup> Drahos and Braithwaite (2000).

<sup>402</sup> Vogler (2003).

<sup>403</sup> Drahos and Braithwaite (2000).

<sup>404</sup> See for example, Falkner (2003), Haufler (1999), Newell (2001), and Wapner (1995).

voluntary guidelines on responsible corporate practices into legally binding standards, especially those that apply to developing countries with weak environmental regulations.<sup>405</sup> As an element of this trend, transnational advocacy groups are increasingly targeting transnational investors as a means to discipline TNCs operating in developing countries.<sup>406</sup> Following the same logic as the World Bank campaigns, they pressure financial institutions to only finance the foreign expansion of TNCs on certain environmental and social conditions, thereby attempting to use the financial leverage of private investors to diffuse environmental and social norms in transnational markets.

And fourth, by virtue of their public advocacy campaigns and expertise, transnational advocacy groups have amassed considerable legitimating power in the international system. As public awareness about environmental degradation, the effects of free trade on the poor, and the health risks of genetically-modified crops have increased, transnational advocacy groups with large professional staff have become a major influence on public policy, shaping national and international policy agendas. In identifying the adverse impacts of markets on people and the environment, their campaigns have put governments, international organizations and TNCs on the defensive, forced to demonstrate how their policies and practices conform to increasingly well-recognized norms and values, such as the precautionary principle, transparent decision-making and a concern for the poor.<sup>407</sup>

In sum, advocacy groups, organized in transnational networks, wield considerable influence in the international system, from being formal participants in inter-state negotiations to directly lobbying government and TNCs by staging advocacy campaigns and engaging in direct consultations. But more significantly, they participate in transnational institution-building and the emergence of voluntary forms of governance by waging advocacy campaigns and engaging in policy deliberations with business, international organizations and states to define environmental standards for particular industries.<sup>408</sup> In doing so, they have played an important role in developing the norms and principles that form the basis for inter-state agreements and transnational rules emerging out of public-private partnerships.

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<sup>405</sup> Clapp (2005).

<sup>406</sup> According to Emel (2002), transnational advocacy groups primarily draw on four strategies for using transnational capital to spread environmental and social norms; 1) leveraging international financial institutions, that is, putting pressure on or negotiating with the US Overseas Private Investment Corporation (OPIC) and other lending agencies such as the World Bank, etc; (2) shareholder activism; (3) fostering socially responsible investment (including approaching fund managers); and (4) efforts to increase environmental and social disclosure as part of the reporting requirements to regulatory agencies like the US Securities and Exchange Commission (SEC). (p.830)

<sup>407</sup> Newell (2001), refers to this as 'civic regulation', or the continuous process whereby NGOs encourage private actors to justify their actions to broader public constituencies of shareholders, consumers, and civil society.

<sup>408</sup> Falkner (2003), pp.79-80.

## 6.2 Commercial Banking and Environmental and Social Risks

Relative to other industries, the financial sector has been slow in engaging itself with broader development questions, as financial institutions, governments and even civil society long considered financial markets to be only indirectly responsible for environmental degradation and social injustices. Yet, a surge in public interest in the financial sector's impacts on the environment and local communities over the last decade has prompted a broadening and a deepening of environmental risk management approaches, reflected in the emergence of the Equator Principles and other voluntary business regulation at the transnational level. But whereas the original environmental risk management practices developed in response to the risks related to environmental liabilities, the policies introduced during the last decade were prompted by a need to demonstrate how their activities benefited the environment and local communities.

As with other economic sectors, the financial industry was first put in this public spotlight following the Earth Summit in Rio, which formally recognized the role that the private sector played in causing environmental degradation and providing solutions to it. In 1991, Mustafa Tolba, then UNEP's Executive Director, invited a group of five financial institutions to form an advisory group to discuss environmental sustainability in the financial sector.<sup>409</sup> At that stage, UNEP had not considered the role of the financial sector in sustainable development, and the creation of an advisory group was driven by a desire to facilitate a collective discussion on common goals and how to achieve them.<sup>410</sup> A year later, twenty-six financial institutions pledged to incorporate environmental considerations into all internal operations and business decisions by signing a statement of intent.<sup>411</sup>

The event was a milestone, but the vagueness of the statement reflected the generally defensive attitude of commercial banks towards environmental issues, a legacy of the landmark *U.S versus Fleet Factor* decision two years prior.<sup>412</sup> The cautious approach was driven by the assumption that making lofty commitments could represent a risk if the bank was found in violation of these. Instead, the UNEP statement was intended to provide a forum for discussion, encourage policy innovation, and provide environmental specialists within financial institutions with some leverage in their internal discussions with senior management. During this time, many commercial banks started their engagement with environmental agenda by issuing corporate environmental policies that laid out some broad principles of corporate conduct. In the next stage, the policies would provide the basis for setting internal targets for increasing the efficiency of resources and reducing waste. They put in place internal environmental management systems that calculated and monitored resource use with an eye on achieving performance targets and cutting operating costs. In terms of

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<sup>409</sup> These were Barclays, NatWest Bank (now part of RBS), Deutsche Bank, Royal Bank of Canada, HSBC and Westpac.

<sup>410</sup> OTH-02.

<sup>411</sup> According to ERM (2006), none of these original signatory banks were American.

<sup>412</sup> See chapter 4, section 4.3.



external activities, some introduced green products on a limited scale, engaged in philanthropic activities, such as sponsoring green initiatives and participation in community Local Agenda 21 processes, and implementation of the European Eco Management & Audit Scheme regulation.<sup>413</sup> In some cases, these internal and external initiatives were made public in corporate environmental reports.

In general terms, the primary motivation to engage with environmental issues at that stage came from corporate guidelines and principles and the personal beliefs and commitments of key executives within financial institutions. In contrast, economic factors and external pressures from government or advocacy groups mattered less.<sup>414</sup> In addition, the focus on managing internal resources, rather than the impacts of investment decisions, was based on two prevailing assumptions. First, banks were, and remain, extremely reluctant to intervene into the management decisions of borrowers. As per the ethos of risk management, a lender should not constrain the decision-making autonomy of the borrower by applying loan conditions unless they can demonstrate that these financially secure the loan. The fiduciary relationship that characterizes the interactions between lenders and borrowers, and the confidentiality agreements that govern information sharing and disclosure, means commercial banks refrain from placing conditions on financing that lack a clear association with risk.

Secondly, in most financial transactions, including bonds, equity and corporate loans, the exact use of proceeds is not pre-established, which makes it difficult to assess, let alone manage, the environmental impacts of financing. As a result, the growing integration of financial markets, and the innovation of new financial products to more effectively allocate risk between financial institutions, means it can be nearly impossible to ascertain responsibilities for certain adverse impacts, as financing is provided by multiple sources. And third, even in project financing, where the use of proceeds is known, commercial banks were reluctant to confront borrowers in an increasingly competitive marketplace. The expectation was that if a particular commercial bank opted to place environmental conditions on project finance loan beyond those required to manage risk, it would possibly lose business to other financial institutions prepared to lend money with less strings attached.

Yet, it was not until commercial project financing was scrutinized by transnational advocacy campaigns that the development of systematic and comprehensive environmental and social risk management policies within commercial banks gained some momentum. The next section documents the growing public scrutiny of commercial project lending in developing countries, and the ensuing evolution of environmental and social lending guidelines in the commercial banking industry, as a precursor to the Equator Principles.

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<sup>413</sup> BMU (2002).

<sup>414</sup> These observations were made by a study of German financial institutions conducted by the German government (BMU 2002).

### 6.3 Transnational Advocacy Groups and Commercial Banks

Until the mid-1990s, most of the public scrutiny of the environmental and social impacts of project finance deals was directed towards multilateral development banks, and to a lesser extent bilateral export-direct agencies, which not only held strong positions in the market, but were also publicly institutions accountable for their impacts on local populations and the environment. While public development institutions still play a dominant role in large-scale infrastructure projects, commercial banks have in recent years become more visible as lead arrangers or co-financiers of major project finance deals, making them both legitimate and easy targets for transnational advocacy groups.<sup>415</sup> As a result, the environmental and social impacts of their investments have been increasingly exposed and scrutinized in the media, increasing the awareness among consumers about their impact on development.

As noted in chapter 4, most project finance deals in developing countries rely on large amounts of foreign capital, and by extension, facilitate foreign direct investment and ownership in critical industrial sectors in developing countries, such as energy production, water service provision and transportation infrastructure. Foreign debt-financing, including commercial bank loans through loan syndications and individual loans provided by multilateral development banks and export credit agencies, typically account for two-thirds of overall financing in a private infrastructure project.<sup>416</sup> As a result, the high levels of foreign involvement contribute to raising the profile of many project finance transactions in the international media, and effectively draw projects into broader political debates concerning energy and infrastructure development.

While the activities of financial TNCs are global, their corporate identities and practices are often tied to particular states, perhaps more so than corporations in any other sector. Even as transnational conglomerates with offices globally, it is striking how strongly their environmental and social practices are driven by the institutional environment in their home countries. This has a number of explanations. First, in many cases, dominant shareholders are from their home countries, as are Board members and senior management. This affects the organizational culture and professional norms of the commercial bank. By extension, in countries with a strong environmental commitment and awareness in the public sector and the business community, decision-makers within financial institutions and stakeholders will more likely advocate environmental practices. As an example, there is an increasing focus on environmental and social issues in institutional investment, and a growing demand for socially responsible investment products, particularly in the British, Dutch and German markets.<sup>417</sup>

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<sup>415</sup> Case (1999) and Newton (2006).

<sup>416</sup> Dailami and Leipziger (1997).

<sup>417</sup> ISIS (2002).

Secondly, for deposit-taking financial institutions, the retail business in their home countries can be a significant source of revenue, indeed in most cases far outweighing their project finance business. By extension, a much-criticized environmental impact associated with a project finance loan will not only add risk to the project in question, but also represent a 'franchise risk' to the financial institution, as the adversity may affect other lines of business that are not associated with the project.<sup>418</sup> In most cases, these consumer-banking operations were significantly larger in volume and revenue than project financing.<sup>419</sup> Realizing the strategic importance of this business, advocacy groups organized demonstrations and petition drives outside retail branches in a number of occasions, using the consumer-facing business of financial institutions as a leverage to demand change in project financing practices. By extension, this kind of pressure necessarily directs their corporate strategies towards their home countries, and makes them attentive to changes in the domestic business environment.

### *Public Denials of Responsibility*

Throughout the early 1990s, multilateral financing to public infrastructure projects, particularly hydropower dams, had declined dramatically as a result of the controversies surrounding the Narmada Dam in India. In its wake, the IFC, the EBRD and commercial project lenders had stepped in to fill the financing gap, benefiting from a wave of privatizations and liberalization reforms that provided favorable conditions for private capital and TNCs to participate in infrastructure development in developing countries. In addition, commercial banks based in OECD countries emerged as a significant providers of long-term capital in rapidly growing developing countries, becoming associated with high-profile projects in a wide range of environmentally-sensitive sectors, including extractives industries, hydropower, and roads. As a result, it became apparent to a few transnational activists that simply focusing on integrating safeguards into multilateral lending was not enough to ensure that the environment and local communities would not suffer from large project investments.

During the mid-1990s, the reluctance of the World Bank and other public lenders to get involved in complex hydropower projects because of the controversy over the Narmada Dam created an opening for private investors. In 1995, FOE and the International Rivers Network (IRN) launched a campaign against Merrill Lynch and Morgan Stanley over their alleged financial links to the Three Gorges dam project in China, the first of its kind. Two years later, Morgan Stanley Dean Witter & Co., Credit Suisse First Boston Corp., Salomon Smith Barney (later part of Citigroup), and BancAmerica Securities (now part of Bank of America Corp.) underwrote a bond worth £165 million issued by the state-owned Chinese Development Bank.<sup>420</sup> The

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<sup>418</sup> EPFI-06.

<sup>419</sup> For example, in the case of RBS, currently the largest project finance bank in the world by lending volume, the ratio of project financing / consumer banking for 2006 was roughly 1 / 37. (EPFI-06).

<sup>420</sup> 'Pay Attention to Activists or Pay in Money and Grief', by Ricardo Bayon, *American Banker*, June 15, 2001.

project proposal would entail the construction of the world's largest hydropower development, erecting a dam 175 meters tall on the Yangtze River in China, producing a 600-kilometer-long reservoir, and slated to displace more than one million people and cause untold environmental damage. In parallel with RAN's campaign, the IRN persuaded Domini Social Investments to file a shareholder resolution with Merrill Lynch, and another socially responsible fund, Trillium Asset Management Corporation, to file one with Citigroup, asking them to review the environmental and social impacts of their business activities.<sup>421</sup>

The China Development Bank and China Export-Import Bank had issued bonds through major investment banks, which raised concerns among environmental groups that some or all of the proceeds would be used to finance the Three Gorges Dam project. FOE accused Merrill Lynch and Morgan Stanley of disguising their support for the project by providing bond financing through the Chinese banks rather than direct debt-financing to the project.<sup>422</sup> In response, the investment banks either denied financing the projects, or argued that they had received assurances from the Chinese banks that the proceeds would not be used to finance the Three Gorges Dam project.

The campaign came at the heels of board-level decisions at the World Bank, the ADB and the U.S Overseas Private Investment Corporation (OPIC) to disengage from the project.<sup>423</sup> The decision made by these financial institutions was primarily driven by their own concerns with the project, such as an unacceptable level of environmental risk, or because the Chinese government declined to provide sufficient environmental information. Yet, the public scrutiny of the project put pressure on financial institutions to publicly address the environmental and social impacts that might be generated by the project, and how they would be mitigated or prevented.

For FOE, the Three Gorges Dam project highlighted the extent to which private investors were playing a growing role in financing development projects. In addition, it illustrated how commercial project lenders, as well as bilateral export credit-agencies, were increasingly prepared to finance projects rejected by public lenders due to environmental concerns.<sup>424</sup> As such, it revealed how the environmental reforms that had ushered in environmental and social safeguard policies at the World Bank would have little impact in cases where World Bank participation was not required for a project borrower to access long-term financing.

In 1997, to address this gap, the FOE and National Wildlife Federation (NWF) launched the Quantum Leap project, a training and capacity building workshops that provided financial and technical support for NGOs wanting to meet with individual commercial banks. It helped spread awareness of the role of commercial banks in

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<sup>421</sup> 'The New Financial Activists', by Deepak Gopinath, *Institutional Investor*, June 1, 2000.

<sup>422</sup> 'Report Slams Three Gorges Resettlement', *Asia Times Online*, January 24, 2003; 'The Value of an Investment in Human Rights', *The Financial Times*, October 28, 2004.

<sup>423</sup> In contrast, the bilateral export-credit agencies of Canada, Germany, Sweden, Switzerland and Brazil provided more than £700 billion in direct financing for the project, mostly for the purchase of equipment produced by their own big construction and hydroelectric firms.

<sup>424</sup> NGO-01.

financing controversial projects, and understand how their operations differed from multilateral lenders. Led by Michelle Chan-Fishel, the coordinator of FOE's Green Investment Campaign, the objective was to target major commercial lenders that had already issued environmental policies and created internal environmental divisions, and pressure them to address the adverse environmental and social impacts of their investments, not just the resource use and waste associated with their facilities.<sup>425</sup> The same year, the UNEP Banking Initiative issued a revised statement for the banking industry, and also merged with a similar initiative launched for the insurance industry, creating the UNEP Finance Initiative as it is known today.

For many commercial banks, in particularly those based in Western Europe and North America, the late 1990s marked the gradual replacement of a purely legalistic approach to environmental risk management in favor of a more systematic and holistic management system.<sup>426</sup> The former approach reflected an expectation among lenders that the need to mitigate environmental risk to an acceptable level would not substantially affect the financing structure or project design, and could be successfully done by having the borrower absorb the financial costs associated with existing environmental liabilities, or soliciting assurances from public authorities that the project would not be subjected to new laws or regulations that adversely affected its profitability.

More broadly, commercial banks were noticing that TNCs in other industries were increasingly paying attention to risk management in their business, often in the context of corporate social responsibility programs.<sup>427</sup> In terms of project financing, many commercial banks recognized that the environmental impacts of individual projects, often caused by management lapses on the part of borrowers, could attract significant public scrutiny and generate unfavorable media coverage. Given that the broader reputation of financial institutions were at stake, it marked the growing influence of senior banking executives in the development of corporate environmental policies and procedures, including direct oversight of project approval processes. Overall, the growing media visibility of project financing elevated environmental risk management to a long-term strategic concern in which factors beyond those of the project influenced approval decisions.

### *The Campaign Against ABN Amro: The 'Wake-Up Call'*

In 1995, Milieudefensie, the Dutch chapter of FOE International, together with its Indonesian counterpart, launched a campaign against Dutch bank ABN Amro over its financing of a copper and gold mine in Papua New Guinea operated by Freeport-McMoRan. By then, the World Bank Group (through MIGA) and U.S Overseas

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<sup>425</sup> NGO-01.

<sup>426</sup> As Case (1999) notes, commercial lenders often treated the environmental risk management process simply as a tick-box exercise that needed to be completed in order to secure a variety of permissions from planning authorities.

<sup>427</sup> EPFI-14.

Private Investment Corporation (OPIC) had provided insurance for the mine, amidst considerable pressure from transnational advocacy groups, who had arranged meetings between local community groups and the senior management of these financial institutions. At the time, the operation was dumping thousands of tons of tailings directly into a river of vital importance to local communities living downstream from the mine.

In 1996, the mining company cancelled the risk insurance policies, due to reasons which activists believed were tied to the World Bank's intention to imminently investigate the environmental and social impacts of the mine. As a result, FOE, under the direction of Chan-Fishel, identified Freeport shareholders that could be approached and persuaded to submit shareholder resolutions opposing the practices of the mine, and began sending quarterly reports on the company's political risk to all buy-and-sell side gold-mining analysts, contributing to a more than 50 percent fall in its share price.<sup>428</sup> These groundbreaking initiatives reflected the extent to which the globalization of finance, combined with a growing concern in the corporate sector for brand value and reputation, provided opportunities for advocacy groups to leverage finance in their push for more responsible corporate practices.

In 1997, in a letter to ABN Amro, Milieudedefensie requested an interview with its CEO to discuss the project. In his place, ABN Amro was represented by Herman Mulder, a career banker who had just become Senior Vice President for Group Risk Management. The meeting represented the first time in history that ABN Amro had invited an environmental advocacy group to its offices. Following the exchange of views, Mulder assured FOE that his bank did not want to invest in 'controversial projects', and promised to investigate the case and provide a management response within three weeks.<sup>429</sup> ABN Amro took the unprecedented step of asking Freeport-McMoRan to allow an independent environmental and social audit of the mine. FOE questioned its independence, and criticized the failure to consider the linkages between environmental degradation and the livelihoods of local communities, and the influence of the Indonesian military in the region. The response from ABN Amro to Milieudedefensie was delayed by one month, and in the interim, Milieudedefensie sought to mobilize ABN Amro's retail customers in a public campaign that asked: 'Do you know what ABN Amro is doing with your money?'

In parallel, social unrest had broken out among indigenous peoples most affected by the mining operations, after it was revealed that they had not been included in a compensation scheme developed by the mine operators. The campaign against ABN Amro broadened to a coalition consisting of FOE, local community groups and church leaders demanding that the bank clarify its position relative to the compensation scheme, and the project more generally. To ABN Amro's surprise, the ultimate demand was not to divest from the project, but to stay engaged in order to

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<sup>428</sup> Emel (2002), p.839.

<sup>429</sup> Information in this section is based on interviews with key participants in the exchanges between ABN AMRO and FOE. (EPFI-02 and NGO-04).

ensure that the demands of the downstream communities affected by the pollution would be met.<sup>430</sup>

A second meeting with Milieudéfensie eventually took place, in which Mulder openly admitted that ABN Amro should have been aware of the adverse impacts of the mining operations.<sup>431</sup> Given the circumstances, he offered on behalf of the bank to disengage from the project by selling its share. In response, Milieudéfensie reiterated their position that ABN Amro should stay involved and use its leverage to exert maximum pressure on mine operators, based on the fear that a withdrawal could invite another lender with lower standards. The result of the World Bank withdrawing from the project had proven to activists that having a bank engaged provided them with a channel of influence.

The campaign marked the turning point for ABN Amro's approach to environmental risk management. By its own admission, it represented a 'wake-up call' that it has since publicly given Milieudéfensie significant credit for.<sup>432</sup> Following the meetings with FOE and a series of internal management discussions, ABN Amro published its first environmental policy, and announced it would adopt environmental and social guidelines for its project financing in the mining sector, in direct response to the Freeport controversy.

At this stage, public campaigns against commercial project lending broadened and deepened. In the United States, the participation of major investment banks in the initial public offering of PetroChina, China's restructured state oil company, became politicized by the U.S. Congress, since it coincided with the hotly contested debate over whether the United States should resume normal trading relations with China. In 2000, Goldman Sachs was chosen to help underwrite the sale of American depositary receipts in PetroChina, and in the aftermath, FOE accused Goldman Sachs of ignoring the environmental impacts of the company.<sup>433</sup> As a first, it filed a brief with the Securities and Exchange Commission (SEC) arguing that PetroChina failed to disclose required information regarding non-quantifiable business risks, demanding the deal to be delayed.

Over time, a coalition of more than 200 NGOs, including FOE, the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), the Casey Institute, and the Center for Religious Freedom, and a number of pro-Tibetan-independence groups, conducted a collective advocacy campaign against the PetroChina IPO, targeting investment banks, members of Congress and pension fund managers. In the end, the IPO raised about 40 percent less funds than expected, leading transnational advocacy groups to declare victory. While the SEC filing was ultimately unsuccessful, Chan-Fishel argued the financial losses caused by external

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<sup>430</sup> EPFI-02

<sup>431</sup> EPFI-02.

<sup>432</sup> EPFI-02

<sup>433</sup> 'Pay Attention to Activists or Pay in Money and Grief', by Ricardo Bayon, *American Banker*, June 15, 2001.

pressures marked an important milestone for public interest campaigns against financial institutions, and also reflected how policy makers were increasingly interested in the public policy impacts of Wall Street.<sup>434</sup>

The campaign against ABN Amro marked the first time a European bank would be asked to publicly address the environmental and social impacts of its investments overseas. The next large advocacy campaign took place in the United States, and involved the largest project finance bank in the world, Citigroup.

### *The Campaign Against Citigroup: Taking on the Giant*

In 2000, San Francisco-based Rainforest Action Network (RAN) announced it was going to launch a Global Finance Campaign to pressure commercial banks to consider the adverse environmental impacts of their projects. According to Ilyse Hogue, the campaign director, RAN had conducted research on what it considered some of the most destructive development projects, and discovered that Citigroup was financing many of them.<sup>435</sup> In April 2000 at Citigroup's annual shareholder meeting, RAN publicly announced their concerns and plans to launch a campaign against the bank. The following day, RAN was invited to meet with Citigroup officials to discuss their concerns, and in return, RAN invited Citigroup to attend a forum with environmental and labor groups to discuss the way forward. The latter offer was declined, and what followed was perhaps the most targeted and aggressive public advocacy campaign ever lodged against a financial institution.

The campaign, which lasted four years, deliberately targeted Citigroup because of its dominant position in the global project finance market, and because of a marketing campaign it was conducting at the time projecting itself as the best consumer bank in the world. The campaign centered on mobilizing Citibank customers against the bank, and cause an adverse market reaction in its domestic consumer banking business because of its project finance investments overseas. According to one account, 'campaign workers distributed thousands of anti-Citi stickers and fact sheets to protesters in Washington, D.C., and organized demonstration outside Citibank branches in San Francisco.'<sup>436</sup> Its Chief Executive, Sandy Weill, was deliberately targeted, approached at lectures and labeled an 'environmental villain' in a full-page newspaper ad in the *International Herald Tribune*.<sup>437</sup> RAN bought television ads in

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<sup>434</sup> 'The New Financial Activists', by Deepak Gopinath, Institutional Investor, June 1, 2000. In response to the campaign, a Goldman Sachs executive declared: 'For special interests to pursue their agenda through capital markets is inherently dangerous. It will result in capital markets that are less deep and less liquid.'

<sup>435</sup> EPFI-02.

<sup>436</sup> In addition, Wired magazine donated half a page to the campaign in its June issue for an ad that asked, 'It's 10:00 p.m. Do you know where your money is?' accompanied by photos of the environmental and social destruction allegedly caused by Citigroup lending. (The New Financial Activists', by Deepak Gopinath, Institutional Investor, June 1, 2000; NGO-02)

<sup>437</sup> 'The Mosquito In The Tent: A Pesky Environmental Group Called Rainforest Action Network is Getting Under the Skin of Corporate America', by Marc Gunther, Fortune Magazine, May 31, 2004,



which film celebrities were seen cutting up their Citibank credit cards, inducing a reported 20,000 customers to do the same.<sup>438</sup> The campaign was sustained, calculated and aggressive, and placed other large financial institutions active in the global project finance market on high alert.

Given the common practice of financing projects through loan syndications, it was common for campaigns against individual projects to target multiple banks. As a result, regardless of the amount or length of investment, the mere financial association with a project could cause a commercial bank to become a target. Thus, as transnational advocacy campaigns proliferated, so did the number of projects and bank under public scrutiny.

### *The Campaigns Against the Financing of Indonesian Deforestation*

Perhaps no other environmental issues resonate with citizens in Western countries than tropical deforestation. In the 1990s, the expansion of commercial logging and timber product manufacturing in South-East Asia attracted significant attention from commercial lenders, many of which were confronted with the devastating ecological impacts caused by their corporate borrowers. In the early 1990s, the Indonesia government under Suharto instigated a national program to significantly expand palm oil plantations through the privatization of plantation companies and the liberalization of foreign investment. Between 1995 and 1999, the Indonesian government approved expansion of crude palm oil plantations worth more than £10 billion, and began issuing land-clearing permits to plantation companies, including in the less developed forest-rich regions of Irian Jaya, East Kalimantan and Sulawesi. The government-backed program provided incentives for rapid, systematic deforestation, causing widespread social conflict, illegal land clearing practices, and a devastating forest fire that affected the health of 70 million people across South-East Asia, with estimated economic damages in excess of £4 billion.

Following the economic crisis in 1997, the plantation companies were in need of external financing to reinvigorate the industry. Several Dutch banks stepped forward, under heavy criticism from advocacy groups. In 2000, Milieudefensie and Greenpeace in the Netherlands, with input from an Indonesian network of advocacy groups working against palm oil plantations, released a report, *Funding Forest Destruction*, which catalogued the impacts of the government program on Indonesia's forests and the people that depended on them.<sup>439</sup> In parallel, RAN had pressured Citigroup to explain its role in arranging a syndicated loan to the Indonesia company PT Pan London Sumatra Plantation to allow it to purchase London Sumatra, a

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Date of Access: January 12, 2006,

[http://money.cnn.com/magazines/fortune/fortune\\_archive/2004/05/31/370717/index.htm](http://money.cnn.com/magazines/fortune/fortune_archive/2004/05/31/370717/index.htm)

<sup>438</sup> 'The Mosquito In The Tent: A Pesky Environmental Group Called Rainforest Action Network is Getting Under the Skin of Corporate America', by Marc Gunther, Fortune Magazine, May 31, 2004,

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<sup>439</sup> Milieudefensie (2000).

company involved in the clearing and planting of significant palm oil plantations. The Dutch report recommended that Dutch banks refrain from financing plantations unless guarantees were given that the borrower would not clear more land to make way for new plantations, or violate the rights of local people and Indonesian law. By then, the controversy had generated a mass petition and spilled into Dutch politics, prompting policy-makers to address them in parliamentary questions.

In January 2001, the two advocacy groups entered into dialogues with the Dutch banks ABN Amro, Fortis, and FMO, who all acknowledged the plantations may have caused the adverse impacts identified by advocacy groups. In contrast, ING and Rabobank denied the accusations, arguing that they could not be substantiated. But all of them stated that their leverage with the borrower was limited since their financing only represented a marginal share of the overall project costs. Subsequently, the advocacy groups were asked to provide a report that documented the specific environmental allegations against the projects, which claimed financing from Dutch banks was contributing to primary forest conversion, forest fires, illegal logging and social conflict with local people. In the end, three of the banks introduced new environmental lending requirements for forestry and plantation projects that conformed closely to the recommendations made in the report.

Alongside the controversy over the expansion of palm oil plantations, a not entirely separate set of projects was also being heavily scrutinized. In December 2000, the Center for International Forestry Research (CIFOR) and World Wildlife Fund (WWF) released a report – *Profits and Paper* - that documented how up to £7.5 billion in foreign investment into the Indonesian pulp and paper industry was significantly contributing to deforestation. A transnational NGO campaign against a host of commercial banks sought to exploit the leverage they had to induce the logging industry to source more of its timber from sustainable plantations. The publicity peaked in March 2001, when the largest beneficiary of this financing, Asia Pulp and Paper (APP), announced a standstill on all debt repayments, causing the New York stock exchange to suspend trading on its shares.<sup>440</sup> The financial collapse of APP affected numerous financial institutions, and for advocacy groups, was used to illustrate how commercial banks had failed to adequately identify and assess all the risks associated with the investments.<sup>441</sup>

In May 2001, FOE in the United Kingdom and Profundo of the Netherlands released a scathing report that demanded a moratorium on the financing of all pulp and paper processing capacity in Indonesia and Malaysia, and asked financial institutions to subject APP's supply chain to independent review and verification.<sup>442</sup> In the United Kingdom, Barclays Bank, Royal Bank of Scotland (RBS) and HSBC became targets

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<sup>440</sup> In a glaring cover story, Business Week labeled the company 'Asia's Worst Deal', describing its financial implosion as 'a cautionary tale of greed and blind optimism.' ('Asia's Worst Deal', Asia Cover Story, Business Week, August 13, 2001)

<sup>441</sup> According to FOE, Barclays Bank, Morgan Stanley Dean Witter, Credit Suisse First Boston, Goldman Sachs, Franklin Templeton, Merrill Lynch, Bank of America, Deutsche Bank, ABN Amro and Bank of China were all involved in providing financing for APP. (FOE 2001)

<sup>442</sup> FOE (2001).

of a domestic campaign that appealed to the environmental consciousness of bank customers. Among them, Barclays had perhaps the strongest financial links to the struggling company, having helped to arrange loans of over £200 million to APP and its subsidiaries. In February 2002, FOE organized nation-wide demonstrations against Barclays' retail branches, alleging that the bank was using customer deposits to knowingly facilitate deforestation and social conflict in Indonesia. In April that year, protesters targeted Barclays' annual shareholders meeting, pressuring the bank to introduce a forestry policy that ensured that investments in the sector would be sustainable and respectful of indigenous people's rights.

### *The Campaign Expands: Oil and Gas Pipelines in Tropical Forests*

Several large-scale projects involving oil and gas pipelines and associated production facilities had attracted attention from North American and German advocacy groups campaigning against commercial banks in their home countries. The significant involvement of multilateral lenders, alongside bilateral export-credit agencies and commercial banks, also allowed a direct comparison of their lending policies and how they decided to implement them in a controversial project. In Peru, numerous financial institutions were debating whether to finance the Camisea natural gas development project encompassing four drilling platforms, two pipelines and distribution systems in Lima and Callao, some of which are situated in either protected lands or fragile eco-systems. Following public pressure, concerns about unacceptable risk eventually prompted Citigroup, OPIC and the Export-Import Bank of the U.S to decline financing for the Camisea project. Yet, the negative assessment made by these three financial institutions was not shared by others, most notably the IDB, which decided to finance the development project despite these risks.<sup>443</sup>

In 2000, West Deutsche Landesbank (WestLB), the quasi-public German bank, was heavily criticized by Urgewald and Greenpeace Germany for arranging a 17-year syndicated bank loan of £450million to finance the Oleoducto de Crudos Pesados (OCP) pipeline, operated by a multinational consortium and involving the construction of a 500 kilometer-long heavy crude pipeline cutting protected ecological areas, meant to facilitate the transport of heavy crude oil from hitherto inaccessible areas of the Ecuadorian Amazon over the Andean mountains to a coastal port facility. The additional involvement of Citigroup, JP Morgan Chase and Deutsche Bank in the project ensured that the advocacy coalition campaigning against would be transatlantic, in addition to the significant local resistance.

WestLB had made compliance with World Bank standards a condition for the loan, and insisted the operators had met it, whereas advocacy groups in Germany and North America argued to the contrary. And for a significant period, WestLB refused

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<sup>443</sup> The project has received financing from the Inter-American Development Bank (IDB), the Andean Economic Development Corporation, the Brazilian Development Bank, as well as the Italian, Argentinian and Belgian export credit agencies. In an irony of sorts, IDB's involvement was awarded the 'Latin American Project Finance Deal of the Year' Award by Project Finance Magazine in 2004.

to comment on the mounting criticism, standing by its own assessment, despite having also been rebuked by the World Bank.<sup>444</sup> Meanwhile, in the German state of North Rhine Westphalia, which held a 43 percent stake in WestLB, concerned policy-makers from a red-green coalition were holding parliamentary hearings on the project, and several delegations were sent to Ecuador to assess the pipeline construction, confirming the views of critics. The German press covered the controversy extensively.

Amidst the environmental controversy, WestLB also experienced its first financial losses in part due to a bad loan provided to Boxclever, the UK-based TV-leasing company. The financial crisis sparked criticism over its corporate governance, which was an element in a decision to create a separate commercial division within the bank. At the same time, the controversy over the OCP pipeline had peaked, inducing WestLB to climb down from its previous position not to engage with critics. In August 2002, the OCP president was forced to resign. A month later, Dr. Robert Goodland, a tropical ecologist and former World Bank environmental specialist, released an assessment report of the project, uncovering 'substantial violations' of the four World Bank *Safeguard Policies* that were relevant to the project.<sup>445</sup> In the end, the project was completed despite costly delays caused by local protests, and leaving WestLB and other financiers with damaged reputations.

But the biggest controversy erupted over two significantly larger pipeline projects that mobilized a broad international coalition of civil society groups, and prompted financial institutions to undertake unprecedented environmental and social studies to document the impacts on local communities and the environment. The most notable was the Chad-Cameroon pipeline project, the first large-scale infrastructure project spearheaded by the World Bank since the Narmada Dam. The main operator, Exxon Mobile, received financing predominately from multilateral and bilateral agencies for operating the 1000-kilometer pipeline and three oil fields in Chad, and the World Bank provided political cover for them by gaining the necessary assurances of stability from the Chadian government. In addition, two commercial banks participated as arranger banks for export credit agency facilities; ABN Amro for the US-Exim Bank and Crédit Agricole Indosuez (now Calyon) for COFACE, the French agency.

For the World Bank, the pipeline provided an opportunity for Chadians to escape poverty by extracting and exporting their only source of wealth to global markets, and they applied unprecedented safeguards, including a revenue management plan, to ensure that the original objectives would be fulfilled.<sup>446</sup> Similarly, the IFC viewed the project as an opportunity to demonstrate how private sector financing could promote

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<sup>444</sup> 'Sustainability Management at the WestLB', by Anke Hassel and Ulrike Lexis and commissioned by the Bertelsmann Foundation, at [http://www.hertie-school.org/en/7\\_faculty/Hassel/Teaching\\_Cases/Dateien/WestLB-Case-060906.pdf](http://www.hertie-school.org/en/7_faculty/Hassel/Teaching_Cases/Dateien/WestLB-Case-060906.pdf)

<sup>445</sup> 'Ecuadorian Pipeline Fails to Meet Bank Standards', Environmental News Services, September 13, 2002.

<sup>446</sup> For a discussion of these institutional measures and a critique of them, see 'Chad's Oil: Miracle or Mirage? Following the Money in Africa's Newest Petro-State', by Ian Gary (Catholic Relief Services) and Nikki Reisch (Bank Information Center), February 2005.

economic growth while providing direct benefits to the poor.<sup>447</sup> Meanwhile, critics argued the project would ultimately benefit the elites and solidify their positions of power, exacerbate climate change, and harm local communities that inhabited areas along the pipeline course. For both, it represented a test case as to whether oil exports could help reduce poverty in a developing country context.

In 1999, a group of U.S.-based NGOs, including the Bank Information Center, the Environmental Defense Fund and RAN, criticized the World Bank's faith in the Chadian government, given its record of corruption and human rights abuses. They focused their allegations on the pipeline's destructive impact on rain forests and the indigenous people that depended on them. Shortly thereafter, Shell and Elf withdrew from the consortium, but Exxon swiftly replaced them with Malaysia's Petronas and Chevron. The controversy peaked just before the World Bank's board was to vote for its £95 million financing package, which included an oil revenue fund that would be independently managed to ensure that a share of the oil wealth would benefit projects aimed at reducing poverty.<sup>448</sup> But the project was approved amidst external criticism, and oil started flowing through the pipeline in 2003.

#### **6.4 The Industry Response: Business Principles and Environmental Guidelines**

The previous section focused on the process by which the adverse environmental and social impacts of development financed by major commercial banks received public attention in Western Europe and North America. It illustrated how transnational advocacy groups were able to put the environmental and social impacts of commercial project lending in the public eye by networking with local community groups, exploiting the interest in environmental issues among bank customers, and releasing research and advocacy reports that were widely referenced in the media. Overall, the growing role of transnational private capital in financing large-scale development projects in environmentally-sensitive sectors, combined with a growing concern for reputational risks, provided transnational advocacy groups with a channel of influence over corporate practices.

Yet, in parallel with these developments, and indeed often in response to them, financial institutions were increasingly seeking to demonstrate their commitment to corporate responsibility. In the past decade, corporate responsibility has become an industry in itself, with a vibrant business press validating the environmental and social activities of TNCs, a booming environmental consulting industry, the birth of environmental management and reporting tools, and the near universal corporate

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<sup>447</sup> IFC-04. The project also received financing from ABN AMRO and Credit Agricole Indosuez (now Calyon), as well as COFACE, the European Investment Bank, and the U.S and African Ex-Im Banks.

<sup>448</sup> In December 2005, the Chadian government passed legislation to abolish the fund, prompting the World Bank to suspend loan payments. In April 2006, the World Bank and the Chadian government reached an agreement whereby loan disbursements would continue provided they benefited projects in education, health, community development, HIV/AIDS, agriculture, electricity, water and infrastructure. In return, the Chadian government promised to pass a budget law that required 70 percent of oil revenues in the 2006 budget to be used for poverty reduction projects.

practice of annual sustainability reporting. It has coincided with a steady stream of corporate environmental commitments, ranging from philanthropic donations to internal waste reduction and resource efficiency targets.

In terms of environmental and social risk management, most large commercial banks had developed internal environmental credit risk policies in the early to mid-1990s, in response to concerns about environmental liabilities, particularly in OECD countries.<sup>449</sup> The policies were meant to identify and manage credit and security risks, or those directly related to the financial viability of the investment. Yet, with regards to developing countries, commercial project financing prior to the Equator Principles was often provided to project clients without a formal requirement to comply with the *Safeguard Policies* or the World Bank's environmental standards.<sup>450</sup> While many commercial banks state that these standards were often used as a reference, and compliance was formally required in some instances, by their own admission the practice was largely piecemeal and not embedded in specific policies.<sup>451</sup>

In this context, according to one senior project finance executive, a decision to finance a questionable project was based on subjective judgement by risk officers as to whether it was 'ethically acceptable' to them.<sup>452</sup> In many cases, this would be made solely on the basis of information provided by the client or a consultant working on its behalf, which by virtue of the apparent conflict of interest was a practice susceptible to failure. Indeed, in the case of WestLB and the OCP pipeline, it was its trust and faith in environmental consultants hired by the client that triggered the bank's downfall, as its contention that the project was in compliance with the *Safeguard Policies* was rejected by the public, and later proven false by an independent expert.

In most cases, project financing represents a marginal share of overall business for the vast majority of commercial banks. Yet, the fact that stakeholders can easily connect investment decisions to particular projects effectively made project financing the Trojan horse of corporate environmentalism in commercial banking, in the sense that it represented the channel through which stakeholders placed demands on them to tackle the adverse impacts of investments.<sup>453</sup> In fact, media coverage of large project finance investments has become the primary basis upon which the public forms impressions about the ethical dimensions of the international financing practices of commercial banks. To manage such public impressions, it is therefore not surprising that it was in the area of project finance that commercial banks first released policy guidelines aimed to reduce the risk of financing harmful projects.<sup>454</sup>

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<sup>449</sup> ISIS (2002), pp.8-10.

<sup>450</sup> In contrast, under the Equator Principles, commercial banks are required to integrate any environmental and social conditionalities into the loan agreement with the borrower.

<sup>451</sup> EPFI-06; EPFI-01; EPFI-03; EPFI-08; EPFI-14.

<sup>452</sup> EPFI-03.

<sup>453</sup> IFC-04.

<sup>454</sup> According to ABN Amro, its approach has been to try and develop policies in response to developments in sensitive industry sector, such as a forestry policy in response to the palm oil issue in Indonesia', (EPFI-01).

For most commercial banks, responding to growing reputational pressures meant expanding existing environmental and social risk management policies so as to include a wider scope of non-financial impacts in developing country investments.<sup>455</sup> In October 2001, in the aftermath of the controversy over the Indonesian palm oil plantations, ABN Amro released a Forestry Policy that is widely perceived as a milestone within the industry. To prepare the policy, ABN Amro hired a forestry specialist, and consulted corporate clients in the sector that would be subjected to the policy. While ABN Amro also solicited input from a technical specialist at the IFC, its aim was to formulate a policy that addressed the concerns of advocacy groups while being accepted by its regular clients in the sector.<sup>456</sup> It was released for public consultation, and the input from advocacy groups significantly informed the eventual outcome. The policy would govern its investments in forestry and tree plantations, and restricted ABN Amro from financing activities related to illegal or unsustainable resource extraction from primary or high- conservation value forests, and required borrowers to have an explicit policy of respecting human or indigenous rights. It also declared it would require borrowers to produce environmental management plans, and use monitoring and certification schemes to ensure compliance.

In 2001, following the release of its Forestry Policy, ABN Amro published a set of Business Principles that mixed promises to conduct business in an accountable and transparency manner and protect the environment and human rights, with a continued commitment to confidentiality and shareholder value. It introduced a Mining Policy and an Oil and Gas Policy that stated it would not finance projects located in World Heritage Sites. In addition, the former included a commitment to prevent tailings from being directly released into riverine environments, which can be read as a direct response to the public criticisms of the Freeport mining operations in Papua New Guinea. And in 2002, it developed a Client Assessment Tool for oil, gas and mining projects, aimed at screening the capacity and commitment of borrowers to manage environmental and social risks, and providing the basis for adjusting due diligence to the level of project risk identified.

Other commercial banks followed the same path, first developing existing internal environmental risk policies, and gradually expanding internal capacity. More broadly, these policies reflected a broader attention to the role of financial institutions in causing and helping to solve a wide variety of environmental and social problems. Numerous financial institutions sponsored studies, organized conference or joined public-private partnerships, sustainable business networks and industry working groups that aimed to define the appropriate role of financial institutions in sustainable development. In 2001, eleven financial institutions, under the auspices of the WBCSD, issued a statement committing them to integrate sustainable development into decisions about client selection and relationship management, whilst stressing the need to define the boundaries of responsibilities between financial institutions and their clients. In the United Kingdom, the asset management firm ISIS (now F&C)

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<sup>455</sup> ISIS (2002), p.8.

<sup>456</sup> IFC-04 and EPFI-02

released a survey of British banks that considered if and how human rights were addressed in project financing.<sup>457</sup>

National governments also entered the debate over the role of financial institutions in sustainable development, particularly in the period leading up to the World Summit on Sustainable Development.<sup>458</sup> In 2000, OPIC published a report on its investments in fossil fuels, marking the first public acknowledgment by a financial institution of the potential climate impacts of project financing. The same year, the FORGE group comprised of British financial institutions, issued the first industry-led guidelines for environmental management and reporting, supported by the Association of British Insurers (ABI), the British Bankers Association and three government ministries.<sup>459</sup> In April 2002, the group began drafting Guidance on Corporate Social Responsibility Management and Reporting for the Financial Sector, in consultation with Government, socially responsible investment funds and advocacy groups. In South Africa, the Government-commissioned report recommended a set of corporate governance and reporting guidelines that would include a requirement for financial institutions to implement so-called triple bottom line reporting in line with the standards laid out in the Global Reporting Initiative.<sup>460</sup>

International organizations also contributed to the growth of voluntary guidelines, by increasingly partnering with the private sector to produce institutional responses to environmental and social problems. The U.N Global Compact and the UNEP Finance Initiative were growing in membership, and the OECD revised its *Guidelines for Multinational Enterprises*. Public financial institutions supporting private sector projects in developing countries were expanding their engagement with environmental and social issues. The same year as the IFC adopted the World Bank's *Safeguard Policies*, it began advocating the commercial benefits of applying them in private sector projects, official export-credit agencies in OECD countries committed to develop environmental and social standards for export credit support to projects in developing countries. A working group of export-credit agencies was formed, and two years later, the OECD issued a voluntary framework of environmental standards aimed at facilitating a convergence among export-credit agencies.<sup>461</sup>

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<sup>457</sup> ISIS (2002).

<sup>458</sup> In 2002, a report by the German Federal Ministry for Environmental Protection, Conservation and Nuclear Reactor Safety (BMU) surveyed the environmental practices of German banks. (see BMU 2002) The same year, the City of London commissioned Forum for the Future to partner with financial institutions to create the London Principles, a framework with aspirational statements about how the financial sector should respond to sustainable development challenges. It was launched at the WSSD.

<sup>459</sup> The group consisted of Abbey National AVIVA (Chair), Barclays Bank, Lloyds TSB Legal & General, Royal & Sun Alliance, Royal Bank of Scotland, and Zurich Re. (see, 'Corporate Social Responsibility: Guidance for the Financial Services Sector', the FORGE Group, November 15, 2001).

<sup>460</sup> The King Committee on Corporate Governance was formed in 1992 to consider corporate governance in the context of South Africa. It has issued two reports with recommendations, in 1994, and again in 2002.

<sup>461</sup> 'Draft Recommendation on Common Approaches on Environment and Officially Supported Export Credits', drafted by the Working Party on Export Credits and Credit Guarantees, OECD Trade Committee, TD/ECG(2000)11/REV6, December 17, 2001. The document was formally released and adopted in December, 2003, and then revised in November, 2005.



And last but not least, several international commissions on sustainable development issued policy recommendations relevant to project financing. In 2000, the World Commission on Dams released a set of recommendations on planning and building large-scale hydropower dams in developing countries.<sup>462</sup> It concluded that the ecological and social considerations had been marginalized in the vast majority of dams built in developing countries, and urged financial institutions and project operators to improve the accountability and transparency of decision-making when considering such projects. The same year, James Wolfensohn, the World Bank president, commissioned the *Extractive Industries Review*, which was mandated to consider whether it should continue to invest in oil, gas and mining projects in developing countries. Both processes promoted the integration of environmental and social issues with commercial objectives as central to increasing the development impact of projects.

Collectively, these national and transnational initiatives contributed to increasing the public awareness of the role of financial institutions in promoting sustainable development. In particular, they helped define the environment as perhaps the most effective arena of public debate for financial institutions to positively differentiate themselves from their competitors. A regard for protecting the environment, and support for renewable energy and energy efficiency, became almost synonymous with ethical banking, creating a corporate race to the top in environmental commitments. In turn, this broader institutional environment proved favorable for inducing commercial banks under growing reputational pressures to coalesce around a set of progressive lending standards that were recognized as an important element of responsible project finance.

## Conclusion

The chapter has illustrated how transnational advocacy groups have significantly influenced the 'greening' of commercial project finance, and more generally, the emergence of corporate environmental policies and strategies in the financial sector. By collecting information from project-affected people and sharing their grievances with bank customers in developed countries, transnational advocacy groups both facilitate exchanges in ideas and knowledge across national boundaries, empower local communities, and put pressure on transnational commercial banks to ensure that financing does not adversely affect the environment and the poor. The sources of their power stem from the advancements in information and communications technologies that have enabled transnational networking and information-sharing at minimal cost, combined with a growing public concern in developed countries of the adverse impacts of globalization. The confluence of these two developments has increased the legitimacy and effectiveness of their political messages, and by extension, their power and leverage in world politics.

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<sup>462</sup> See Dingwerth (2005).

The now familiar dynamic between financial institutions and transnational advocacy groups triggered the emergence of the Equator Principles. Just as public campaigns had induced both the World Bank and the IFC to institutionalize these norms in operational policies, so did commercial banks seek to accommodate the political demands of advocacy groups. And just as the former were concerned with maintaining their reputations as responsible development institutions, so were commercial banks concerned that adverse media publicity could harm their reputations as responsible lender, and thereby indirectly impact the profitability of their project finance business. Thus, closing the gap between public expectations and actual lending practices became a key objective, alongside the importance of remaining competitive by not alienating clients in the most important industries.

The next section presents original research on the actual drafting process that preceded the launch of the Equator Principles, highlighting how the most targeted commercial banks eventually came together to discuss and create a common industry framework for managing environmental and social risks in project finance transactions. In explaining how and why this occurred, the dual role of the IFC as a neutral convener, discussion facilitator, and perhaps most importantly, provider of international legitimation, is an important finding. In addition, as with the World Bank and the IFC, quelling public criticisms was an important objective throughout, as commercial banks were eager to produce a framework that allowed them to continue financing large-scale development projects in developing countries, yet avoid the public controversies over adverse environmental and social impacts.

## ***7. The Equator Principles***

### **Introduction**

This chapter will explain how the increasingly contentious politics over the management of environmental and social risks in project financing induced cooperation between commercial banks. The public scrutiny of large-scale project financing surpassed the attention given to investors in any other financial market, and to the detriment of commercial lenders, it was largely negative. By implication, the adverse media publicity not only undermined the projects in questions, but also the broader corporate reputations of the financial institutions involved. Therefore, the ability to better predict, manage and mitigate the likelihood of project controversies became an important imperative for project finance executives, and more broadly, executive management within leading commercial banks. This commonality in purpose provided the foundation for exploring the formulation of a common industry standard.

The institutionalization of environmental and social norms in the commercial project financing has important parallels with the previous socialization of both the World Bank and the IFC. Just as these public lenders were forced to eventually make tactical concession as a means to restore their legitimacy as responsible development organizations, so did ABN Amro and other commercial banks seek to appease advocacy groups in an attempt to reduce negative media publicity and declining corporate reputations. However, whereas transnational advocacy groups turned to governments for leverage against the World Bank and the IFC, they sought to mobilize market participants, such as consumers, investors and shareholders, to increase their political influence over commercial banks. And as the final analysis will hold, norm diffusion through markets, rather through states and international relations, proved in many cases to be just as effective in soliciting concessions from target actors.

This chapter will be divided into four sections. The first section identifies the institutional context which gave rise to the first discussions about a potential common industry framework, and follows the evolution of this idea until the launch of the Equator Principles in June 2003. It provides a detailed account of a series of meetings that took place between the IFC and leading commercial banks in the project finance market, and the responses to this process among transnational advocacy groups. The second section briefly describes the aftermath of the Equator Principles, notably how it changed relations between transnational advocacy groups and commercial banks, and which issues remain contentious. The final section provides a detailed overview of the content of the framework, and how the standards and procedures would be integrated into a typical project cycle in the commercial banking industry.

## 7.1 An Industry under Siege and the Making of a Common Framework

During the 1990s, the growth of commercial project financing meant commercial banks were increasingly financing projects in developing countries with significant environmental and social dimensions. The negative media coverage that could be generated by a controversial project meant project financing emerged as a potential source of reputational risk for commercial lenders. It became particularly apparent in the context of project financing of large-scale development projects in ecologically-sensitive areas, which by virtue of their sheer size and significance solicited considerable public scrutiny.<sup>463</sup> The growing perception that commercial banks were failing to lend responsibly was fueled by transnational advocacy groups, who directed public advocacy campaigns against domestically-based financial institutions, holding them responsible for the adverse environmental and social impacts of projects they had financed.

This was the context within which the earliest discussions between leading commercial banks over developing a set of common environmental and social standards for project financing emerged. In mid-2002, commercial banks with significant project finance portfolios in developing countries were almost uniformly under pressure to demonstrate that their investment did not harm the environment or local communities. At the same time, international organizations, transnational business networks and several advocacy groups offered a way for many of them to positively differentiate themselves in the marketplace of corporate reputation, by inviting them to join public-private partnerships that worked towards enhancing corporate responsibility in the financial sector.

In 2001, ABN Amro was still under considerable pressure from advocacy groups, consumers and shareholder activists for its continuous involvement in several controversial projects. Mulder invited two environmental specialists from the IFC to meet with ABN Amro executives in a two-day workshop to present the IFC's environmental and social policies and practices, and its experience with applying standards to project finance investments.<sup>464</sup> They were Glen Armstrong, a senior environmental consultant who had been hired by the IFC in 1997 to help strengthen environmental and social risk management in project operations, and Leo Johnson, a consultant in charge of IFC's environmental and social risk management training for financial institutions. According to Armstrong, Mulder had already demonstrated a strong interest in environmental and social risk management, given ABN Amro's Forestry Policy and his role in the group-wide risk committee that was governed the centralized project approval process.<sup>465</sup>

Shortly thereafter, ABN Amro was bidding to be the lead arranger for an oil project in Venezuela. At the time, it claimed to have an internal policy of applying the World Bank's standards to extractive industries projects in developing countries. According

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<sup>463</sup> Miller and Hobbs (2005).

<sup>464</sup> IFC-04.

<sup>465</sup> IFC-04.

to Mulder, a U.S bank had approached the Venezuelan project operator and offered to provide project financing without a requirement to comply with these standards, and ended up getting the deal.<sup>466</sup> By coincidence, Mulder had scheduled a breakfast meeting the next day in Amsterdam with Peter Woicke, the Executive Vice President of the IFC. In the meeting, Mulder spoke about the incidence where ABN Amro's desire to apply World Bank standards had proven detrimental to securing a lucrative project finance deal, since a competing bank was willing to finance the project without applying the relevant standards. He also expressed his concern that project finance investments in sensitive industries were being increasingly affected by advocacy campaigns and negative media publicity. In response to this concern, Woicke suggested they organize a workshop of commercial banks in the project finance market to share experiences about managing environmental and social risks in project financing.

In the spring of 2002, Mulder and Woicke decided to co-chair a workshop at ABN Amro's offices in London later that year. The decision was to persuade as many project finance executives of major project finance banks as possible to discuss the significance of environmental and social issues in project financing.<sup>467</sup> According to Mulder, the invitation list was produced by identifying the top dozen project finance banks in the world by lending volume, reflecting a desire to include industry leaders in all regions and sector. In the summer of 2002, Mulder and Woicke decided to jointly approach the banks, a deliberate strategy to maximize their leverage and give the impression that neither the IFC nor ABN Amro was solely behind the initiative. Given the sensitivity that commercial banks attached to discussing the terms and conditions of individual project finance transactions, providing the necessary reassurances proved critical to soliciting interest from the industry.

The timing of the invitation proved conducive to securing a high response rate. According to Armstrong, numerous projects at the time 'were coming off the rails because of environmental and social issues', and 'banks were feeling the pressure and did not know quite what to do.' Most prominently perhaps, WestLB was in the midst of a financial and public relations crisis, and it was awaiting the independent assessment report on the OCP pipeline commissioned by several advocacy groups, and widely anticipated by its shareholders. Meanwhile, Barclays and RBS were targets of consumer boycotts and public advocacy campaigns and negative press reports following the financial collapse of APP, linking them to deforestation in Indonesia.<sup>468</sup> In the United States, RAN's campaign against Citigroup was escalating, manifesting itself in organized consumer demonstrations and full-page advertisements in national newspapers. In the summer of 2002, public relations battles intensified as the bank became embroiled in the corporate scandals involving Enron and WorldCom, and the target of a public investigation.<sup>469</sup> Yet, these commercial banks were not alone. Given the fact that project financing is commonly

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<sup>466</sup> EPFI-02.

<sup>467</sup> IFC-04.

<sup>468</sup> 'Indonesian rainforests pulped to extinction', *The Guardian*, February 11, 2002.

<sup>469</sup> See, 'Crisis at Citi', Special Report, *Business Week*, September 9, 2002.

organized in loan syndications, the reputation of virtually every major project finance bank had become tarred by being linked to a controversial project.

### *The First London Workshop*

At the outset, the objective was to get a critical mass of commercial banks together to share experiences with projects in which environmental and social issues had emerged as significant project risks. In all other contexts, these banks were fierce competitors, reluctant to share information with each other about particular projects, much less admit that some had been poorly managed and proved to be more costly than predicted.<sup>470</sup> Woicke and Bernie Sheahan, IFC's Director of Operational Strategy, had asked Armstrong to produce an agenda for the workshop. They had chosen to approach four specific banks - ABN Amro, Barclays, Citigroup and WestLB - to present experiences with particular projects that had been problematic early in the meeting, meant to ensure that substantive discussions would emerge by lunchtime, when Woicke was scheduled to leave.

Nine commercial banks attended the meeting. During the morning session, ABN Amro, Barclays, WestLB and the IFC presented case studies on past projects which had attracted controversy because of local community protests amplified by transnational advocacy campaigns. Subsequently, Citigroup proposed that the banks try to develop a common framework to deal with these issues. Early on, according to Armstrong, 'the common understanding was that this is bigger than any one bank', and by the end of the morning session, the overarching question had moved from whether environmental and social issues were relevant to project financing, to discussing what the banks could do about it together.<sup>471</sup> During the afternoon, discussions ensued about formulating a collective solution to the problem. While the project finance portfolios of the banks varied widely in size and sectoral composition, they shared a desire to avoid a 'race to the bottom' in environmental and social risk management standards. The assumption was that allowing environmental and social issues to remain a competitive issue would not only undermine the reputation of the commercial banks that failed to lend responsibly, but the industry as a whole.

At the end of the meeting, it was decided that four banks – ABN Amro, Barclays, Citigroup and WestLB – would form an informal working group to explore a common set of standards could agreed upon that catered to commercial project lending, particularly in high-risk sectors. Armstrong of the IFC served as a facilitator and technical advisor to the working group. During the next four months, it met once in London, and working group members held various telephone conferences to discuss broad questions about the scope of the standards, including the types of

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<sup>470</sup> As one bank official close to drafting process noted, 'it was not common practice to have joint initiatives among competitive banks. We were not used to sit in a room with each other. We only interacted on the project-level in the context of loan syndications, not over internal policy matters.' (EPFI-14)

<sup>471</sup> IFC-04.

financing and industrial sectors that should be covered. While not a participant in all of the interactions, Armstrong presented to the working group how the IFC applied its *Safeguard Policies* to high-risk projects.

At the outset, the banks considered adopting their own standards on the assumption that they needed to produce something uniquely tailored to the needs of commercial lenders.<sup>472</sup> In addition, the working group considered focusing on developing standards for the extractive industries sector only, given that oil pipeline and mining projects had attracted the most scrutiny and criticism. Yet, the recognition that drafting a set of global standards from scratch would be time-consuming and be susceptible to considerable disagreement over individual provisions eventually led them to consider basing a voluntary framework on the IFC's *Safeguard Policies* and the World Bank's environmental standards.<sup>473</sup> The former was seen as especially strong on social issues, such as managing relations with indigenous people and handling resettlement disputes, whereas the latter were the most well-recognized environmental standards for industry.<sup>474</sup> According to Armstrong, the IFC did not force this decision, saying his view at the time was that 'it had to be their decision, something that they wanted to do.' Yet, given the common objective of producing standards that could be applied to all projects, globally, and that would be perceived as legitimate by advocacy groups and TNCs alike, the IFC's policies were not only a logical choice, but perhaps the only one.

### *The Second London Workshop*

In February 2003, a second workshop was hosted by Citigroup to discuss a set of draft standards named the 'Greenwich Principles', in reference to the meeting location's proximity to Greenwich, near Central London.<sup>475</sup> The objective was to present the standards to commercial banks and discuss how it would impact their project financing business, identify and discuss particular pressure points, and convince a critical mass to commit to applying them to project financing. According to one bank official in attendance, most of the key protagonists were commercial banks that had been the most strongly impacted by a number of advocacy campaigns, which gave them a more pressing need to take action to mitigate reputational pressures.<sup>476</sup> By extension, the challenge was to create a sense of urgency that something needed to be done, particularly for those financial institutions where this was very much a latent risk.

Reportedly, discussions during the meeting were quite heated, with several participants expressing concerns about the legal implications they would have for

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<sup>472</sup> Lazarus (2004).

<sup>473</sup> IFC-04.

<sup>474</sup> EPFI-12.

<sup>475</sup> Lazarus (2004).

<sup>476</sup> The bank official noted that many commercial banks that had not been heavily impacted by NGO campaigns would ask, in reference to their internal credit risk procedures, 'if it is not broken, why fix it?' (EPFI-06)

their project finance business. At that stage, some observers predicted it would be difficult for commercial banks to reach a consensus on the choice of using the *Safeguard Policies* as a starting point, as it was unclear whether a framework that has been used within the 'government structure' of the IFC was suited for commercial project lending.<sup>477</sup> During the meeting, it was decided that the IFC's annual Bankers Meeting in June 2003, in which it invites hundreds of financial institutions to discuss its Loan Syndications Program and topical financing issues in developing countries, would be the deadline for individual banks to decide whether or not to voluntarily commit to adopting a new framework

In the ensuing three months, discussions were held within financial institutions between project finance units, risk management committee, legal departments and corporate boards over whether to adopt the framework. Many also consulted with their most regular corporate clients in high-risk sectors that would be subjected to the standards, to ensure that the adoption of the framework would not alienate them. As one project finance executive at a large British bank noted;

'There were good reasons for why the launch of the framework could be misunderstood among financial institutions. So we had to start thinking quite strategically in terms of communicating this, how to reach out to other institutions, bringing them on board, and get them to understand that it is not an anti-business charter.'<sup>478</sup>

Alongside these consultations, the draft standards were circulated to a group of advocacy groups that had spearheaded the advocacy campaigns against many of the commercial banks. During these consultations, NGO were reportedly told by commercial bank officials that the launch of the framework would be the first step in a process, and that the pace and nature of implementation would vary from bank to bank depending on their existing capacity and resources, as well as the characteristics of their project finance portfolios.<sup>479</sup> Overall, they were told, the intent of the framework was to define a common framework and vocabulary in managing environmental and social issues in project financing. In response, they highlighted several shortcomings, including the lack of a reporting requirement or compliance mechanism to ensure transparency and accountability, and the absence of a secretariat to facilitate communication between the banks and stakeholders.

These concerns were also articulated in the *Collevocchio Declaration on Financial Institutions and Sustainability*, a policy statement issued jointly by over 100 civil society groups in January 2003.<sup>480</sup> Broadly, the declaration reflected the deep skepticism among advocacy groups that export-oriented private sector development and growth can help mitigate or prevent degradation of environmental resources and improve the economic welfare of local communities, particularly indigenous people. (see Box 7.1) Reflecting the moral claims and political demands levied at the World Bank and the IFC previously, the declaration emphasizes the need for corporate

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<sup>477</sup> EPFI-06.

<sup>478</sup> EPFI-06.

<sup>479</sup> Focus on Finance (2003), p.1

<sup>480</sup> Missbach (2004).



accountability, or transparent and inclusive decision-making that provides local communities with legal rights to approve projects that may affect them. In terms of integrating environmental and social concerns into investment decisions, the declaration emphasizes that a holistic approach is necessary, which not only focuses on impact mitigation, but also allows for particular projects likely to cause significant harm to be rejected in the project approval stage.

### **Box 7.1 The Collevocchio Declaration**

#### **1. Commitment to Sustainability**

Financial institutions must expand their missions from ones that prioritize profit maximization to a vision of social and environmental sustainability. A commitment to sustainability would require financial institutions to fully integrate the consideration of ecological limits, social equity and economic justice into corporate strategies and core business areas (including credit, investing, underwriting, advising), to put sustainability objectives on an equal footing to shareholder maximization and client satisfaction, and to actively strive to finance transactions that promote sustainability.

#### **2. Commitment to 'Do No Harm'**

Financial institutions should commit to do no harm by preventing and minimizing the environmentally and/or socially detrimental impacts of their portfolios and their operations. Financial institutions should create policies, procedures and standards based on the Precautionary Principle to minimize environmental and social harm, improve social and environmental conditions where they and their clients operate, and avoid involvement in transactions that undermine sustainability.

#### **3. Commitment to Responsibility**

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 social and environmental costs that are borne by communities.

#### **4. Commitment to Accountability**

Financial institutions must be accountable to their stakeholders, particularly those that are affected by the activities and side effects of companies they finance. Accountability means that stakeholders must have an influential voice in financial decisions that affect the quality of their environments and their lives -- both through ensuring that stakeholders rights are protected by law, and through practices and procedures voluntarily adopted by the financial institution.

#### **5. Commitment to Transparency**

Financial institutions must be transparent to stakeholders, not only through robust, regular and standardized disclosure, but also through being responsive to stakeholder needs for specialized information on financial institutions' policies, procedures and transactions. Commercial confidentiality should not be used as an excuse to deny stakeholders information.

#### **6. Commitment to sustainable markets and governance**

Financial institutions should ensure that markets are more capable of fostering sustainability by actively supporting public policy, regulatory and/or market mechanisms which facilitate sustainability and that foster the full cost accounting of social and environmental externalities.

**Source:** [www.banktrack.org](http://www.banktrack.org), see also Missbach (2004)

Yet, the desire among commercial banks for a framework that did not have any major legal implications, and that did not significantly undermine their decision-making autonomy, led these recommendations to be largely ignored. In particular, their argument that client confidentiality could not be infringed upon severely limited the scope for including the transparency and disclosure provisions that governed multilateral lenders. In April 2003, the four commercial banks that made up the

working group formally announced that they would adopt the framework ahead of a consultation meeting with other financial institutions, the IFC and several NGOs.<sup>481</sup> According to one official working at a bank that did not adopt the Equator Principles at its launch, Citigroup had taken a leading role in advancing the framework at that stage, and was largely ‘running the process’, with speculation that it wanted to demonstrate its ethical credentials at a time when it was increasingly confronted with allegations of improper business conduct in the aftermath of the Enron scandal.<sup>482</sup> Among the remaining commercial banks mulling over the decision to adopt the framework, one of the points of contention was whether adopting the Equator Principles would potentially put them at a competitive disadvantage in the market place. For advocacy groups, most were cautiously saluting the initiative, although many questions regarding transparency, accountability and governance were raised, most of which have persisted to this day.<sup>483</sup>

### *The Dusseldorf Meeting and the Launch*

In May 2003, a fourth meeting was held in Dusseldorf, Germany at the headquarters of WestLB. At this stage, the number of financial institutions in attendance had increased, primarily as a result of the outreach efforts of the IFC and the four leading commercial banks. Citigroup chaired the meeting, and the IFC gave a series of presentations on the process of environmental screening and the application of its environmental and social policies and procedures to particular projects.<sup>484</sup> The IFC also affirmed its interest in providing environmental management training to adopting banks, in order to help them gain internal capacity to implement their new commitments, which was important for many of the commercial banks lacking internal expertise in assessing compliance with the *Safeguard Policies*.<sup>485</sup>

In the meeting, there was a general consensus that producing a ‘level-playing field’ in which environmental and social issues would no longer be an element of competition between commercial banks was the overarching goal. In addition, several banks, including Citigroup and Barclays, stressed the importance of inducing as many commercial banks as possible to join the initiative for it to be successful. Several bank officials noted that the critical mass that the four leading banks aimed for was

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<sup>481</sup> ‘Four Bank Adopt IFC Agreement’, by Demetri Sevastopulos, *Financial Times*, April 9, 2003.

<sup>482</sup> EPFI-17.

<sup>483</sup> See Missbach (2004) and WWF (2005) for a summary of criticisms of the Equator Principles among transnational advocacy groups tracking the project finance investments of commercial lenders.

<sup>484</sup> EPFI-12. Chris Beale, Managing Director and Global Head of Project Finance, was Citigroup’s representative at the meeting. Leo Johnson, a consultant that had long held the IFC’s Environmental Advantage Workshops for financial institutions in developing countries, gave the presentation on environmental risk management. He had also co-authored the report, *Beyond Risk*, together with other IFC environmental staff, which provided survey data on environmental risk management practices of the participants of the IFC workshops. The report was to be released a month after the Dusseldorf Meeting. (See IFC 2003c)

<sup>485</sup> IFC-04.

ten banks or more.<sup>486</sup> Given these objectives, the meeting was characterized by finding compromises that were acceptable to largest number of participants, and forging consensus around definitions of particular issues.<sup>487</sup> A discussion erupted over, on the one hand, making the standards less specific and thereby giving adopting banks more discretion in applying them to their project financing, and on the other hand, being more precise and strict and thereby ensuring that adopting banks would interpret and apply the framework in similar ways.<sup>488</sup> A specific point of contention was whether the framework should not apply to projects with total project costs that were less than US\$50 million, with some banks claiming this would simply add complications, while others stated it was necessary condition for them to join.<sup>489</sup>

By then, the standards had been renamed the Equator Principles so as to reflect the joint intention among adopting banks to produce a global framework applicable to all industry sectors.<sup>490</sup> Less than a month later, the Equator Principles were launched, fittingly, at the IFC's annual Bankers Meeting, in a panel session scheduled on the second day of the two-day conference. Peter Woicke of IFC was joined on the panel by senior project finance executives of ten commercial banks to make the announcement.<sup>491</sup> It was the first financial sector initiative of its kind, attempting to harmonize environmental and social risk management practices of commercial banks within a specific financial market, and getting a strong endorsement from a majority of industry leaders.

## 7.2 The Aftermath: The Battle over Implementation

In an interesting parallel to the emergence of institutionalized cooperation between commercial banks, many of the advocacy groups behind the *Collevocchio Declaration* decided to create and join a formal advocacy network, Banktrack, in November 2003. The network would spearhead and coordinate a transnational campaign to pressure commercial banks to integrate environment and social concerns into their project finance activities, as well as other kinds of transnational investments. It would facilitate information sharing, coordinate campaigns and handle press inquires, all in an effort to amplify the influence of individual advocacy groups. Whereas the emergence of the Equator Principles was widely seen as a watershed event, Banktrack's response was notably cautious, praising the intention yet pointing out the discrepancies between the framework and the practices of other project

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<sup>486</sup> IFC-04; EPFI-08. As late as a month before the launch, reaching double-digits was merely a 'hope' for the main advocates of the framework, and not an expectation. (EPFI-06)

<sup>487</sup> EPFI-06.

<sup>488</sup> EPFI-12.

<sup>489</sup> EPFI-12. The main argument in favor of the US\$ 50 million threshold, which was eliminated when the Equator Principles were revised in July 2006, was that the administrative costs associated with assessing and verifying compliance small projects was unjustifiably high relative to cost of the project.

<sup>490</sup> According to numerous sources, there were also some concerns among the banks that 'Greenwich Principles' could be too easily misread or deliberately referred to as the 'Greenwash Principles.'

<sup>491</sup> Citigroup, as the only commercial bank participating in the launch, was represented by its Chief Executive Officer, Chuck Prince.

finance lenders, notably the World Bank and the IFC. It has been Banktrack's view from the beginning that the act of adopting the code of conduct is inconsequential unless Equator banks are 'transparent and accountable in their implementation of and compliance with the Equator Principles.'<sup>492</sup> In the absence of this information, they argue, it is difficult (for them) to assess whether the Equator Principles are actually changing the way individual projects are prepared and implemented.

Yet, for the first time, commercial banks had agreed to apply environmental and social standards to project finance investments, a decision that only a few years earlier would have seemed unthinkable. This provided an institutional context for Banktrack to engage with commercial banks and discuss their environmental and social risk management practices. It certainly increased its leverage, as those commercial banks that declined to adopt the framework could be more effectively scrutinized than was the case before it existed. And for those commercial banks that declared an intention to apply the IFC's *Safeguard Policies* and the World Bank's environmental and social standards to their project finance activities, as part of adopting the Equator Principles, they paradoxically became more vulnerable to scrutiny, as advocacy groups were eager to assess whether they had acted on these commitments.

Therefore, following the initial euphoria in the media of this event, controversy reemerged over the management of environmental and social impacts in conjunction with the proposed Baku-Tblisi-Ceyhan oil pipeline, which Banktrack claimed was in violation of the Equator Principles. The project, which included an oil field and a pipeline stretching 1760 km from Azerbaijan to Turkey, had a total project cost of £1.8 billion and was financed by syndications which included the IFC and the EBRD, seven export credit agencies, and fifteen commercial banks, many of which had adopted the Equator Principles. Thus, the project marked the first test of the voluntary framework, and predictably, Banktrack and the Equator banks disagreed on whether it passed it. The project marked the first of a string of projects in which compliance with the Equator Principles was central to disagreements between transnational advocacy groups and various Equator banks. Some of these projects, such as the development of the Sakhalin II oil fields in the Russian Far East, had been planned and partly constructed prior to 2003, prompting the question as to whether the framework would apply retroactively in cases where projects were already under way.

Alongside continued campaigns against individual projects, the evolution of environmental and social standards in project financing during the next three years would be driven by three developments; the IFC's revision of its *Safeguard Policies* in 2006, the growing number of commercial banks that decided to adopt the Equator Principles in their project financing, exceeding sixty by 2008, and the continued public pressure on commercial banks for providing project financing to development projects allegedly in violation of the Equator Principles.

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<sup>492</sup> Banktrack (2005), p.1

Already prior to the launch of the Equator Principles, the IFC had announced it was going to revise and update the *Safeguard Policies* and replace them with a new set of standards. Therefore, there was an acknowledgement among commercial banks that the Equator Principles would have to be revised in the future in line with changes to IFC's policies. In January 2003, IFC's Office of the Compliance Advisor/Ombudsman (CAO) released a report that reviewed the implementation and impact of the IFC's *Safeguard Policies* since their formal adoption in 1998.<sup>493</sup> It observed that many clients found them difficult to interpret and implement, and many of its own staff did not even regard them as part of the IFC's core business.<sup>494</sup> In cases where potential clients lacked the capacity or commitment to address environmental and social concerns and had access to multiple sources of finance on reasonable terms, there was some concern among internal staff that the IFC was losing business because other banks were more 'pragmatic' in addressing environmental and social issues.<sup>495</sup> This could potentially mean that placing environmental and social requirements on clients that regarded these as administrative or political burdens would induce them to pursue other sources of finance.

The recommendations made in the CAO's report informed a comprehensive revision of three policy frameworks; *the Safeguard Policies, the Policy on Disclosure of Information, and the Environment, Health and Safety Guidelines*. Launched in October 2004, the stated objective of the policy revision process was to produce a due diligence framework better suited for the private sector context. And wanting to break with the past, it was perhaps no coincidence that the concept of 'safeguards' was not retained. After a tumultuous and delayed policy revision process, in which both civil society groups and a selection of multinational commercial banks voiced their dissatisfaction with the consultation process, the IFC released its new *Policy and Performance Standards on Social and Environmental Sustainability* in March 2006.

#### *Equator Bank-Banktrack Consultations*

Meanwhile, a series of semi-annual dialogue meetings between Equator banks and Banktrack members have been held since the launch of the Equator Principles, mainly to discuss issues of implementation. One of their main expectations was that communication with commercial banks would be simplified with the emergence of the framework, as bilateral talks and discussions could be replaced by a multilateral setting. At the first meeting in London on the one-year anniversary of the Equator Principles, there was a discussion about the purpose and functions of the official website of the framework.<sup>496</sup> Banktrack noted that while the established website allowed the Equator banks to collectively share information with the public through a shared email address, it did not facilitate two-way communication that would allow advocacy groups to contact all the Equator banks simultaneously. Overall, they hoped

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<sup>493</sup> IFC (2003a).

<sup>494</sup> IFC (2003a), p.7 and p.39, respectively.

<sup>495</sup> IFC (2003a), p.38.

<sup>496</sup> [www.equator-principles.com](http://www.equator-principles.com). See also Appendix 1.

Equator banks would use the website as a vehicle to improve internal governance by facilitating information sharing amongst themselves, and with the public. Ultimately, it was hoped that better governance would increase coordination and compliance, and by extension, reduce the free-riding problem.

A second meeting was held in February 2005, hosted by Credit Suisse First Boston near Zurich, Switzerland. Compared to the first meeting, both the participation of Equator banks and advocacy groups increased, with the latter also including two non-Banktrack members. The discussions with the banks centered on three issues, the implications of the IFC's policy revisions for the Equator Principles, the expansion of NGO-Equator bank consultations, and the disclosure of information on implementation. As the IFC was in the midst of replacing the *Safeguard Policies* with a new set of *Performance Standards*, there were discussions about what implications it would have for the Equator Principles. Specifically, the question was whether the framework be automatically updated in accordance with the IFC, or would the Equator banks remain wedded to the *Safeguard Policies*.

First, with regards to the new IFC standards, Banktrack argued the consultation drafts released by the IFC indicated that the new standards would be weaker than the original *Safeguard Policies*, and the network was able to press a few Equator banks into making a commitment not to revise the Equator Principles if it meant adopting a weaker set of standards. However, against this aim, a vast majority of Equator banks stated that ensuring a 'level-playing field' by coordinating standards across all institutions was the ultimate goal.

Secondly, Banktrack continued to press for more consultation with Equator banks and specific implementation issues. They called for continuing the semi-annual meetings, but also creating working groups with a selection of banks on particular topics that would make consultation more continuous. In response, several banks expressed resistance to the idea of formalizing the framework and organizing the Equator banks into a collective, arguing that each bank should retain discretion in deciding how to implement the standards in their project financing.

And third, Banktrack reiterated their desire for more transparency, particularly with regards to how individual banks applied the standards to particular transactions. The background was their contention that several projects approved by Equator banks since the launch of the framework were in violation of it. In return, many Equator banks argued that stricter confidentiality obligations in commercial banking relative to multilateral lending would place considerable constraints on transparency, particularly with regards to project-level disclosure.

In March 2006, the IFC released its new *Policy and Performance Standards on Social and Environmental Sustainability* to replace the *Safeguard Policies*, upon which the original *Equator Principles* were based. Later that month, a selection of Equator banks met in Vienna to discuss a corresponding revision of the Equator Principles. In the press release announcing the meeting and the draft version of the new framework,

the signatory banks identified themselves as the Equator Principles Financial Institutions (EPFIs), the first instance where signatory banks publicly declared a collective identity that set them apart from non-signatory banks.

For the commercial banks, there was hope that the release of the IFC's policy revisions would trigger some additional commercial banks to join the framework, as a major uncertainty about the future content of the Equator Principles had been removed.<sup>497</sup> In particular, there was a desire to bolster the regional representation beyond Western Europe and North America. According to one bank official, the Equator banks needed to have an open dialogue with major project lenders based in emerging markets, and discuss whether the evolution of environmental laws and regulations in those countries provided an incentive for them to sign the Equator Principles.<sup>498</sup>

Following the meeting, a public consultation period was announced, during which external stakeholders and EPFIs could provide comments on the revised draft. In April 2006, a consultation meeting between the EPFIs and a group of Banktrack members was hosted by HSBC in London. And in July 2006, the new *Equator Principles* (EP2 hereafter) replaced the old (EP1 hereafter), and were adopted by the vast majority of the commercial banks that had pledged their commitment to the original framework.

### **7.3 The Equator Principles: A Framework for Managing Non-Financial Risks**

As noted in chapter 4, commercial banks consider environmental and social issues in project finance transactions in the context of 'risk'. While commercial banks engaged in project financing in developing countries had long assessed the environmental risks of project finance transactions, it had largely been limited to those adverse environmental impacts that may have directly undermined debt-servicing or devalued securitized assets. But the growing public scrutiny of transnational economic and financial activity has made environmental risk management an element of corporate-wide risk strategies, driven by a desire to identify and manage public impressions and expectations of corporate behavior. As mentioned in chapter 6, commercial banks targeted by public campaigns principally viewed them as a potential source of reputational risk, as transnational advocacy groups demonstrated their capabilities to mobilize banking customers, shareholders and in some cases, government officials.

To address this risk to their brand value and overall reputation in the market, commercial banks expanded their risk assessment practices to include project-related impacts that could generate adverse reactions in their home countries, and negatively influence their retail banking operations. In addition, as an element of ensuring that projects would not be subject to criticism, commercial banks increased their interactions with key advocacy groups in order to learn about the moral and political

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<sup>497</sup> EPFI-07; EPFI-08.

<sup>498</sup> EPFI-07.

concerns. In turn, this allowed them to retain or regain some control of the public discourse on project financing by influencing the terms upon which debate took place.

Thus, initially, the Equator Principles can be viewed as a framework for managing stakeholder expectations, and reducing the reputational risk of project financing. By adopting the Equator Principles, many commercial banks assumed they could no longer be accused of not adhering to standards of good corporate conduct, as the standards and procedures embedded in the framework were widely recognized as such. Yet, notwithstanding public declarations in support of the World Bank and IFC frameworks, the Equator Principles does not embed commercial banks into a legal structure that gives rights and entitlements to project-affected communities. In fact, the formal existence of the framework is limited to a publicly available document that spells out the normative and business rationale for undertaking environmental and social risk management (the Preamble), and the specific provisions that would define the common approach among signatory banks. (the Principles)

Yet, despite being non-binding, and the lack of public information about how the Equator Principles are implemented in the context of individual projects, the specificity of the individual provisions do allow external observers to consider whether particular projects are in compliance, by for example monitoring public consultation process, environmental impact studies, and mitigation and prevention measures. Thus, it is the content of the framework - short on aspirational statements and long on specific standards of conduct - which sets it apart from most other voluntary initiatives in the private sector, and invites public scrutiny on implementation. As illustrated in the preceding two chapters, the standards originated within the World Bank, with the introduction of environmental review guidelines in the early 1970s. Since then, they have evolved in scope and specificity, becoming institutionalized in the formal project cycles of multilateral development banks, and many bilateral development and export credit agencies. As such, they are uniquely tailored to the nature of project financing, and the process by which a project is identified, assessed, negotiated and eventually approved. In turn, while the credit risk processes of commercial banks can vary greatly depending on the size of their business, organizational culture, level of centralization and environmental management capacity, compliance with the Equator Principles affects every stage of the project cycle, as schematically outlined in figure 7.1.

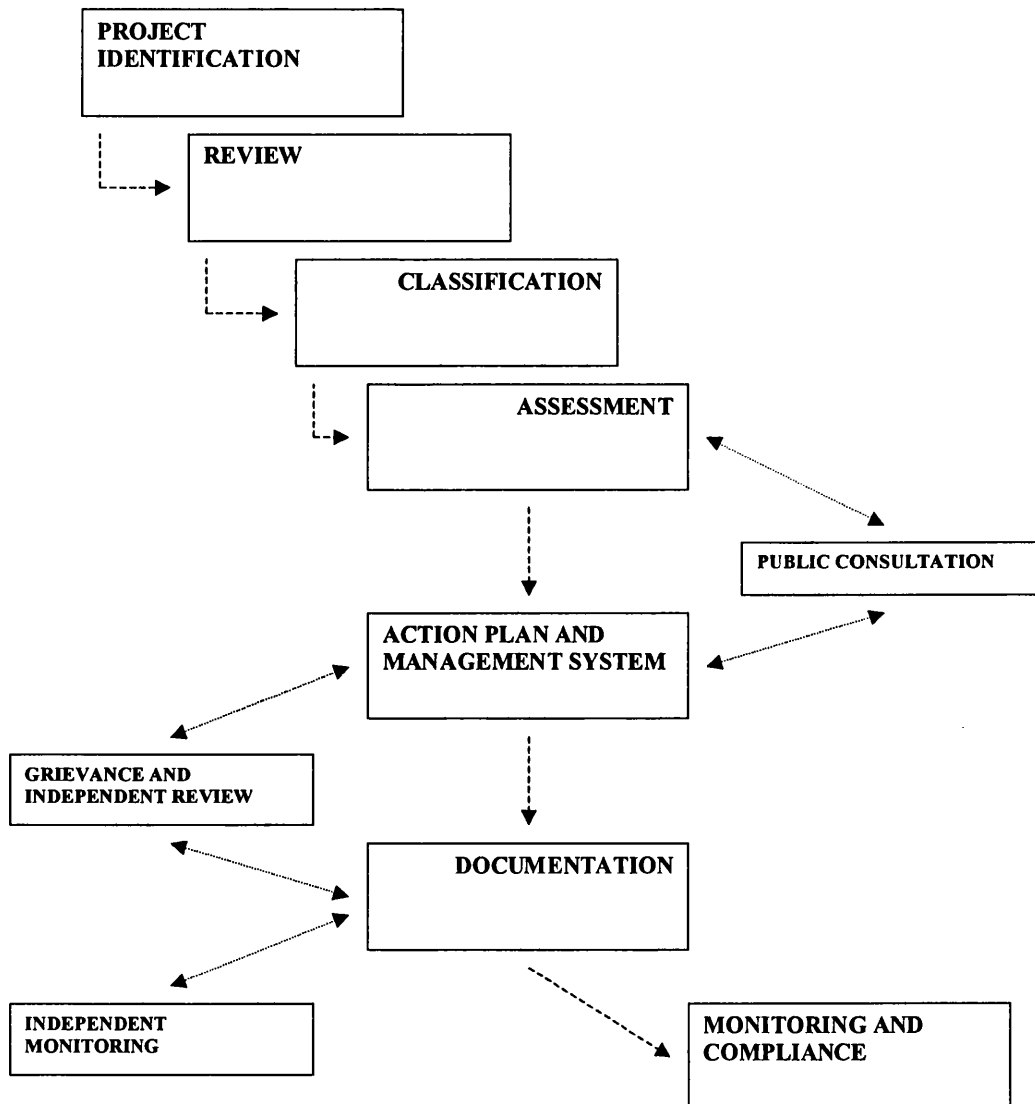
### *Project Identification*

At the stage when a project finance investment is identified, the first step is to determine whether it falls within the qualification parameters of the Equator Principles. EP1 applied to all projects with total project cost above US\$50 million. In EP2, these parameters were widened as the threshold was lowered to US\$10 million, and also covering expansions or upgrades of existing facilities that may create



significant environmental and/or social impacts or significantly change an existing impact.

**Figure 7.1 The Project Cycle and Environmental Risk Management**



Source: Adopted from Arthur Allen Robinson (2006), p.3.

### *Initial Project Review*

During the review process, project proposals are classified in two ways. First, according to the magnitude of potential social and environmental impacts and risks.

The purpose is to separate relatively benign projects not likely to produce adverse environmental and social impacts. And secondly, as part of EP2, they are also classified according to the location of the project. In particular, projects in high-income OECD countries are accorded different treatment than those in developing countries. The additional provision was meant to appeal to commercial banks whose project finance portfolios are concentrated in high-income OECD countries.

### *Assigning Environmental Screening Categories*

The categorization of project proposals is the basis for a tiered assessment process following project screening, in which the specific category assigned to a project proposal determines the scope and scale of the ensuing assessment process. This means a project proposal expected to generate significant adverse environmental and social impacts triggers a more comprehensive and rigorous review process than one expected to have negligible impacts.

To implement this differentiated review process, EP 1 adopted the IFC's environmental screening procedures that assigns an environmental screening category, 'A', 'B' and 'C', to each project proposal under consideration, based on the significance and sensitivity of their projected adverse environmental impacts. In EP1, projects are classified as category 'A' if they are 'likely to have significant adverse environmental impacts that are sensitive, diverse, or unprecedented.' In this context, 'sensitive' refers to irreversible impacts, as in significant the loss of natural habitat, and often affecting the environment beyond the narrow confines of the project area. Category 'B' is assigned to project proposals if their 'potential adverse environmental impacts on human populations or environmentally important areas—including wetlands, forests, grasslands, and other natural habitats—are less adverse than those of Category A projects.' Typically, these are site-specific and predominately reversible impacts that can be mitigated by environmental management interventions. Projects expected to have no, or minimal adverse impacts, are assigned category 'C'.

### *The Assessment Process*

For all projects classified as 'Category A' or 'Category B', the signatory bank must require the borrower to conduct an environmental assessment (an assessment hereafter) that addresses relevant impacts and risks, including proposals for mitigation and management.<sup>499</sup> Commonly, this includes establishing baseline conditions, identifying relevant host country laws and regulations and applicable international agreements and treaties, and evaluating project design in a number of areas, including resource efficiency, environmental health and safety, biodiversity

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<sup>499</sup> In the March 2006 draft version of EP2, this statement had been slightly amended. Specifically, borrowers were required to 'complete and disclose' the assessment, rather than simply 'conduct it'. In the final version, the requirement to 'disclose' was removed.

protection, and involuntary settlement. And significantly, the assessment needs to consider the industry-specific standards of the *World Bank and IFC Pollution Prevention Handbook*, and for projects located in low- and low-middle-income countries, the applicable *IFC Safeguard Policies*.<sup>500</sup> In EP2, this requirement was slightly relaxed, by the stating that ‘the project’s overall compliance with, or justified deviation from, the IFC and World Bank policies’, should be done at ‘the satisfaction’ of the signatory bank.

For a ‘Category A’ project, a more comprehensive assessment is required that examines the project’s potential negative and positive environmental impacts, compares them with those of feasible alternatives (including, the ‘without project’ scenario), and recommends any measures needed to prevent, minimize, mitigate, or compensate for adverse impacts and improve environmental performance. For ‘Category B’ project, the assessment is broadly similar, except that its scope is commonly narrower. And for projects assigned a ‘Category C’, no further EA is required beyond the initial screening process.

#### *Action Plan and Management System*

On the basis of the conclusions of the assessment, the borrower or a commissioned third party has to prepare an Action Plan that addressed mitigation, action plans, monitoring, management of risk and schedules. For EP1, the Action Plan was a requirement for all ‘Category A’ projects, and at the discretion of the signatory bank, for ‘Category B’ projects as well.<sup>501</sup> For EP2, this discretion was removed, meaning the requirement covered all ‘Category B’ projects. In addition, EP2 clarifies that in cases where the borrower already has an internal Social and Environmental Management System in place, they were required to use the assessment to ‘build on or maintain’ it.

Prior to completing an Environmental Management Plan (EMP), the borrower or commissioned third party has to provide a summary of the assessment ‘for a reasonable minimum period in the local language and in a culturally appropriate

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<sup>500</sup> Country categories by income as defined by the World Bank Development Indicators Database. The methodology classifies categories as belonging to either low-income economies, lower-middle-income economies, upper-middle-income economies, high-income economies or high-income OECD members.

<sup>501</sup> In EP1, the Action Plan refers to an Environmental Management Plan (EMP), whereas in EP2, the EMP is renamed the Action Plan and Management System, in conformance with the new IFC Performance Standards. In this context, the Action Plan refers to a plan for addressing project-specific impacts, and is defined much broader than previously, and may include, as applicable, a resettlement action plan, an indigenous peoples plan, an emergency preparedness and response plan, and a decommissioning plan. The Management System refers to a Social and Environmental Management System that incorporates the following elements: (i) Social and Environmental Assessment; (ii) management program; (iii) organisational capacity; (iv) training; (v) community engagement; (vi) monitoring; and (vii) reporting.

manner.’<sup>502</sup> In EP2, the borrower is required to disclose the entire assessment or a non-technical summary of it. Furthermore, it has to consult with project-affected groups, including indigenous people and local NGOs, ‘in a structured and culturally appropriate way’, to the satisfaction of the signatory bank. In EP2, an additional clause was added, declaring that the consultation process was meant to ensure ‘their [affected communities] free, prior and informed consultation and facilitate their informed participation as a means to establish, to the satisfaction of the [signatory bank], whether a project has adequately incorporated affected communities’ concerns.’ EP2 also clarified that for adverse impacts, disclosure should occur ‘early in the assessment process and in any event before the project construction commences, and on an ongoing basis.’

The Action Plan would document and take account of the outcomes of these consultations. In EP1, the EA and Action Plan of all ‘Category A’ projects would be subject to independent expert review, whereas EP2 extended this to ‘Category B’ projects as well, if deemed appropriate by the signatory bank. In addition, EP2 added a requirement to establish a ‘grievance mechanism... scaled to the risks and adverse impacts of the project’, meant ‘to ensure that consultation, disclosure and community engagement continues throughout construction and operation of the project.’<sup>503</sup> The mechanism allows ‘the borrower to receive and facilitate resolution of concerns and grievances about the project’s social and environmental performance raised by individuals or groups from among project-affected communities’, and information about it should be publicly disclosed during the consultation process.

Under EP2, projects in high-income OECD countries are not required to adhere to the IFC and World Bank policies and guidelines, as compliance with host country laws and regulation on environmental assessment, information disclosure and public consultation is deemed sufficient.

### *Documentation and Reporting*

Perhaps the most significant aspect of both EP1 and EP2 is that the Action Plan is covenanted in loan agreements with borrowers. In EP2, this was clarified to only apply to ‘Category A’ and Category B’ projects, as ‘Category C’ do not require an Action Plan anyway. But making the Action Plan binding, means that, in principle, signatory banks can hold back or cancel loan tranches in cases where the borrower fails to comply with the Action Plan.

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<sup>502</sup> In EP2, this public disclosure had to be done in a ‘relevant local language’ (emphasis added), an amendment that made in response to comments received during the public comment period between March and May of 2006.

<sup>503</sup> The ‘grievance mechanism’ clause was lengthened and clarified after the public consultation period in 2006. However, the clause ‘scaled to the risks and adverse impacts of the project’ was added, thereby providing the signatory bank with more discretion in how this requirement would be implemented in the context of particular projects.

As a result of these legal obligations, both EP1 and EP2 requires borrowers to provide regular reports to signatory banks on compliance with the EMP during the construction, operation and decommissioning of the project facility. In EP2, the reporting clause was further tightened, stating that the reports have to be provided frequently, at a minimum annually, based on the ‘the severity of impacts, or as required by law.’ In terms of content, the reports have to ‘provide representation of compliance with relevant local, state and host country social and environmental laws, regulations and permits.’

At the discretion of signatory banks, EP1 states that the borrower ‘*may* be required to appoint an independent environmental expert to provide additional monitoring and reporting services’ (emphasis added). In EP2, this was made an explicit requirement, but it was also noted that these external experts should simply be ‘qualified’ and ‘experienced’, presumably allowing for non-independent experts to be used.<sup>504</sup>

Neither EP1 nor EP2 adopted the IFC’s *Policy on Disclosure of Information*, which governs the public release of policy and project information by banks. Instead, public disclosure of information is done at the discretion of third parties, in accordance with what is legally required by host country laws and regulations. However, EP2 added an annual public disclosure requirement in response to pressure from NGOs, in which each signatory bank is obliged to ‘report publicly *at least annually* about its Equator Principles implementation processes and experience, taking into account appropriate confidentiality considerations.’<sup>505</sup> (emphasis added)

### *Managing Cases of Non-Compliance*

In both EP1 and EP2, if incidences of non-compliance with the EMP are uncovered, the debt financing would technically be in default. In such cases, EP1 states ‘we [signatory banks] will engage the borrower in its efforts to seek solutions to bring it back into compliance with its covenants.’ In EP2, this obligation to remedy cases of non-compliance was ostensibly relaxed. It stated that in cases of non-compliance, the signatory banks would work with the borrower ‘to bring it back into compliance *to the extent feasible*, and if the borrower fails to re-establish compliance within an agreed grace period, [signatory banks] reserve the right to exercise remedies, *as they consider appropriate*.’<sup>506</sup> (emphasis added) As such, the amended statement in EP2 inserted a condition of ‘feasibility’ and provided signatory banks with more discretion in addressing cases of non-compliance.

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<sup>504</sup> This discretionary language was removed in response to comments made by NGOs during the public comment period in 2006.

<sup>505</sup> The clauses ‘at least annually’ was added in response to comments made by NGOs during the public comment period in 2006. They were concerned that a failure to specify the frequency of reporting would be exploited by signatory banks.

<sup>506</sup> The clause ‘within an agreed grace period’ was added in response to comments made by NGOs during the public comment period in 2006. They were concerned that cases of non-compliance would persist indefinitely, and not be subjected to a timetable.

### *Some Comments on the Governance Structure*

Because it was based on the binding operational policies, the Equator Principles are much more ‘operational’ than other voluntary codes of conduct for the financial sector, in the sense that the framework is designed to inform decision-making in a particular financial market, project financing, with unique and distinct characteristics. In fact, the nature of the rules means the framework is more or less meaningless to financial institutions that are not engaged in project financing, as risk management in other financial markets does not focus on project risks, but rather investment risk associated with the balance sheet of a particular company. The extent to which it is tailored to project finance manifests itself in specific rules about screening project proposals, undertaking environmental impact studies (of the project), consulting project-affected communities, and embedding environmental action plans into loan agreements. Thus, in addition to giving recognition to broader norms concerning the need to identify and mitigate the environmental and social impacts of investment decisions, as most voluntary codes of conduct do, the Equator Principles also contain specific rules for how this should be done in the context of specific kinds of investments

Yet, a tension built into the framework is that it seeks to induce convergence in environmental and social risk management in project financing while providing Equator banks with significant discretion and flexibility in deciding how to implement the framework into their project financing activities. As stated in the preamble, ‘we [Equator banks] recognize that our role as financiers affords us significant opportunities to promote responsible environmental stewardship and socially responsible development’, and furthermore, commit themselves ‘to ensure that financed projects are developed in a manner that is socially responsible and reflect sound environmental management practices.’ The stated intention is for the individual management standards to ‘serve as a common baseline and framework for the implementation of our [the Equator banks’] individual, internal environmental and social procedures and standards for our [the Equator banks’] project financing activities across all industry sectors globally.’ And to ensure that they are given teeth in the internal credit risk processes of individual banks, each Equator bank declares it ‘will not provide loans directly to projects where the borrower will not or is unable to comply with [its] environmental and social policies and processes.’<sup>507</sup>

Such language is balanced by several provisions that protect the decision-making autonomy of individual Equator banks. Specifically, while the framework contains specific procedures for how Equator banks should identify, assess and manage the environmental and social impacts of projects, Equator banks are only required to introduce internal policies and processes that are ‘consistent’ with the Equator Principles, and as is clarified, that ‘this can be done at any time.’<sup>508</sup> Furthermore, both

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<sup>507</sup> See Appendix 1.

<sup>508</sup> see, <http://www.equator-principles.com/join.shtml>.

EP1 and EP2 end with a legal disclaimer that explicitly disassociates individual banks from each other and the framework, securing their legal independence.

'The adopting institutions view these principles as a framework for developing individual, internal practices and policies. As with all internal policies, these principles do not create any rights in, or liability to, any person, public or private. Banks are adopting and implementing these principles voluntarily and independently, without reliance on or recourse to IFC or the World Bank.'

- EP1, p.4

In addition, whereas the specificity of rules suggest that the code may have some teeth, as it allows observers to clearly ascertain levels of compliance, the voluntary nature of the framework potentially negates this feature. More specifically, whereas the rules embedded in the Equator Principles are both mandatory and enforceable in the context of World Bank and IFC financing, they become entirely voluntary and unenforceable when applied to projects by commercial banks. For example, in the context of EP2, language in the *Performance Standard on Labor and Working Conditions* makes strong references to various ILO Conventions, yet under the framework, the requirement to adhere to these basic labor rights is not enforceable.<sup>509</sup> Therefore, while the Equator Principles reaffirms the legitimacy of well-recognized international environmental and social norms, the framework does not recognize the how these norms need to be embedded in a legal, enforceable framework to retain their original meaning and purpose.

Thus, the institutional design of the Equator Principles, and how it differs from the operational policy frameworks of multilateral, perhaps reflects an important distinction between public and private forms of governance. This will be an issue for discussion in the final chapter.

## Conclusion

Industry leaders often dominate standard-setting exercises in the private sector, as they stand to gain the most from standards that serve their commercial interest in the market, and can effectively veto any standard they disagree with through their market power and behaviour.<sup>510</sup> In the case of the Equator Principles, the analysis found its main proponents in the market place were commercial banks with the largest project finance portfolios in developing countries, and in many cases, heavily invested in environmentally-sensitive sectors, such as the extractive industries and infrastructure.<sup>511</sup> These industry leaders, notably Citigroup, ABN Amro, Barclays and

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<sup>509</sup> See IFC's Performance Standard 2: Labor and Working Conditions. Date of Access: July 2, 2007, [http://www.ifc.org/ifcext/enviro.nsf/AttachmentsByTitle/pol\\_PerformanceStandards2006\\_PS2/\\$FILE/PS\\_2\\_LaborWorkingConditions.pdf](http://www.ifc.org/ifcext/enviro.nsf/AttachmentsByTitle/pol_PerformanceStandards2006_PS2/$FILE/PS_2_LaborWorkingConditions.pdf)

<sup>510</sup> Drahos and Braithwaite (2000) and Muchlinski (1997).

<sup>511</sup> Indeed, the four commercial banks that comprised the working group were among the largest commercial project finance lenders in developing countries. In 2001, ABN Amro, Barclays, Citigroup and WestLB arranged more than £7 billion in project financing, or 17.5 percent of the market occupied

West LB, often arranged loan syndications, and thereby determined the risk management framework to be used in individual project finance transactions. Given their public visibility, they were also the most frequently targeted by transnational advocacy groups, and therefore had perhaps the largest stake in the outcome of the standard-setting process. As a result, they were instrumental in forming the working group and played a role in recruiting other market participants to adopt the framework.

The IFC's involvement as a technical advisor in the drafting stages of the Equator Principles reflects the extent to which leading commercial banks identified with its operational experiences as a project lender in developing countries, and considered it as a valuable source of expertise for managing environmental and social risks in developing country projects.<sup>512</sup> Combined with the legitimacy of its operational policies, particularly with transnational advocacy groups, the IFC possessed and exerted significant moral, convening and technical authority during the drafting stages of the Equator Principles, legitimating corporate environmentalism, facilitating information-sharing among commercial banks, and providing technical expertise in environmental and social risk management. In performing these roles, the IFC also drew on the trust it enjoyed as a result of its long-standing operational relationships with private financial institutions, as a provider of debt or equity financing, and as a lead arranger of loan syndications in support of large development projects. Thus, the authority of the IFC as an international organization in the emergence of the Equator Principles stems from its reputation as a neutral facilitator of cooperation and coordination, and as a market actor mandated to identify and finance profitable investment projects.

In terms of transnational advocacy groups, the last set of actors identified as critical to the emergence and diffusion of environmental and social norms, they played a relatively minor role in the drafting process. Once their advocacy campaigns had induced commercial banks to collectively discuss their environmental and social practices and ways to harmonize them as to avoid a 'race to the bottom', transnational advocacy groups did not significantly influence the governance formation process. Most of the crucial decisions, such as the scope of the standards, the choice of standards, the institutional design of the framework, and the nature of the governance structures, were decided upon with very little direct input from transnational advocacy groups. In fact, apart from the technical advisory role performed by the IFC, the framework was by and large created by commercial banks, for commercial banks. Moreover, the negotiators representing the various commercial banks were not principally corporate communications or environmental officials, as is common with

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by the 20 largest arrangers. See 'Four Bank Adopt IFC Agreement', by Demetri Sevastopulos, *Financial Times*, April 9, 2003.

<sup>512</sup> The gradual addition of environment specialists in the 1990s, the establishment of an environmental unit, the formal adoption of the Safeguard Policies, and the hiring of social specialists all contributed to building the IFC's organizational expertise in managing environmental and social issues in projects, including public consultations. Overall, the IFC brought its expertise, experience and resources to bear, all of which proved important to advancing policy discussions and quelling some of the skepticism that existed among project finance executives in some commercial banks. ( EPFI-06; IFC-04 )



aspirational voluntary codes of conduct. Instead, they were project finance executives that were closely tied to the identification, preparation and implementation of project finance loans. As such, the framework had both an operational focus and a clear commercial purpose; to allow project finance lenders in environmentally-sensitive industries to continue financing projects in a political and social atmosphere characterized by growing public scrutiny and assessment of investment practices in developing countries.

## ***8. Understanding Private Governance Formation: Main Findings***

### **Introduction**

The preceding three chapters identified how the issue of environmental and social loan conditionalities in project financing has moved from being an internal matter at the World Bank, closely associated with its public sector operations and mandate, to an imperative viewed as an element of prudent risk management in commercial project financing. In terms of the World Bank and the IFC, the debate over their respective environmental and social agendas is no longer simply a matter discussed between them and their principal shareholders. Instead, it is mediated within a process of 'complex multilateralism', in which non-state actors are influencing policy development in the multilateral system.<sup>513</sup> By extension, multilateral governance in this area is moving away from both state-based forms of authority and nationally-driven policy initiatives, to being increasingly shaped by transnational non-state actors and sources of authority.

Two trends are underlining this transformation. First, structural changes in the global economy, notably the growth of private capital flows to developing countries, has placed commercial bank lending at the center of debates over sustainable development. By arranging loan syndications and financing projects without the support of multilateral lenders, commercial banks are in position to determine the environmental and social lending conditions of project finance investments. Secondly, these developments, alongside the growth of official assistance from large developing countries, have not only changed the competitive environment of multilateral lending, but also attracted attention from an increasingly well-organized transnational network of advocacy groups. Helped by advances in communications technologies and a greater awareness of the impacts of TNCs in developing countries, these groups staged consumer boycotts, organized petitions and lobbied shareholders as a means to pressure the commercial banking industry to integrate environmental and social norms in project finance lending.

This concluding chapter summarizes the main findings of thesis, and makes some general remarks on its implications for understanding private governance formation. It attributes the emergence and adoption of the Equator Principles to a growing level of reputational risk among leading commercial banks active in the global project finance market. The threats to their individual and collective reputation caused by the adverse media publicity that followed the growth of transnational advocacy campaigns provided the impetus for leading commercial banks to discuss a collaborative framework. In this context, the preexistence of the IFC's policy framework essentially constituted the governance problem, as the legitimacy of environmental and social norms related to environmental impact assessment, public

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<sup>513</sup> For this argument, see O'Brien et.al (2000), pp.206-234.

consultation and transparency highlighted the extent to which commercial banks were not engaging in responsible financing practices. In turn, the eventual selection of the IFC's policy framework as a blueprint for the Equator Principles reflects both the extent to which reputational risk was the central motivation of commercial banks for creating a common industry framework, and the constitutive role of these norms in the global project finance market.

The first section will revisit the 'spiral model' introduced in chapter three, and summarize the main arguments made in the thesis regarding how norm entrepreneurs pressured commercial project lenders into committing to complying with the IFC's environmental and social policy framework by virtue of adopting the Equator Principles. The subsequent six sections will revisit the six aspects of private governance formation identified in chapter three, and summarize the empirical findings of the research. The concluding section will consider the explanatory power of realism, neo-liberal institutionalism and constructivism relative to this case, and the implications that these findings have on our understanding of how and why private governance emerges.

## **8.1 Revisiting the 'Spiral Model' – Main Findings**

Chapter three presented the thesis' two primary objectives: to evaluate the explanatory power of the three dominant perspectives on institutional change in international relations theory against this case study, and to consider whether the norm evolution framework presented by Risse and Sikkink (1999) could be usefully applied to studying the diffusion of environmental and social norms among private actors in transnational markets. The amended 'spiral model' is a hypothesis for how norm entrepreneurs influence corporate behavior through the diffusion of norms. Over the course of the process, the dynamic between norm entrepreneurs and target actors moves from being very confrontational to reconciliatory, and ultimately, mutually supportive. As per Risse and Sikkink (1998), each phase of the 'spiral model' – repression, denial, tactical concession, prescriptive status and rule-consistent behavior - is associated with a particular mode of interaction that characterizes interactions between actors, as either instrumental adaptation, arguing or institutionalization.

Table 8.1 identifies the main findings of the thesis relative to this hypothesis. It outlines the amended 'spiral model' introduced in chapter three, and supplements this with additional observations made in the case study. In addition to identifying the main actors and the mode of interaction that characterizes relations between them, it also identifies the main sources of power and authority available to the actors engaged in the norm contests at each stage of the model. And finally, it identifies which institutional conditions that need to be present at each stage in order for norm entrepreneurs to be successful. This underscores the point that norm entrepreneurs are not always successful, and that the diffusion of environmental and social norms may therefore succeed in some industries and markets, but not in others.

**Table 8.1 Norm Evolution and Corporate Behavior – Main Findings**

	<b>1. Repression</b>	<b>2. Denial</b>	<b>3. Tactical Concession</b>	<b>4. Prescriptive Status</b>	<b>5. Rule-Consistent Behavior</b>
<b>Main Actors Moving Process to Next Stage</b>	Transnational Advocacy Networks	Transnational Advocacy Networks	Transnational Advocacy Networks, Home Country Consumers, and Shareholders	TNCs and Home Country Society, <i>and international organizations</i>	TNCs and Home Country Society, <i>and international organizations</i>
<b>Main Mode of Interaction</b>	Instrumental Rationality	Instrumental Rationality	Instrumental Rationality / Argumentative Rationality	Argumentative Rationality and Institutionalization	Institutionalization and Habitualization
<b>Main Sources of Influence</b>	<i>Moral authority and corporate power</i>	<i>Moral authority and corporate power</i>	<i>Moral authority and technical authority</i>	<i>Moral authority and technical authority, and state power</i>	<i>Moral authority and technical authority, and state power</i>
<b>Favorable Conditions for Norm Diffusion</b>	<i>Evidence of environmental and social harm</i>	<i>Evidence of corporate wrong-doing</i>	<i>Private actors fear reputational damages</i>	<i>No collective action problems among private actors</i>	<i>Organizational culture and structure not resilient to new norms</i>

**Source:** The table is an amended version of Risse and Sikkink (1999), p.32, hypothesizing how norms emerge, diffuse and are adopted by private actors in transnational markets. The main findings in the thesis relevant to this table are in *italics*.

In terms of applying the emergence of the Equator Principles to this model, the research suggests that the decision to adopt should be considered a tactical concession on the part of most banks, and a reaffirmation of their commitment to the World Bank's standards and procedures on the part of a small minority. As such, the research did not find evidence that the environmental and social norms have been internalized by the adopting banks in the way that constructivists would expect as a precondition for governance.

For the most part, this case study confirmed observations made in previous studies of international norm diffusion. First, advocacy groups operating in transnational networks, significantly aided by recent advances in internet and communications technologies, are instrumental to diffusing norms across institutional contexts. In this aspect, the emergence of the Equator Principles has strong parallels to the origins of environmental reforms at both the World Bank and the IFC. Secondly, in terms of modes of interaction, it confirmed the assumptions made by Finnemore and Sikkink (1998) about the strategic nature of norm entrepreneurship, particularly how transnational advocacy groups seek to maximize their impact by deliberately selecting vulnerable target actors and framing causal stories in ways that could capture the public's attention. And third, target actors, in this case commercial banks, behaved predictably, first repressing and denying accusations, and later defending

their behavior in the public domain, increasingly seeking to demonstrate that they complied with the emerging norms.

Yet, compared to how norms emerge and diffuse among states, the research found two important differences when TNCs are target actors. First, while human rights activists could build their case on the need for states to honor the U.N Charter and comply with a variety of international human rights laws, no such international legal structure exists to regulate TNCs. In the case of project finance, while multilateral development banks have indeed institutionalized norms that have come to define 'international best practices', these policies emerged and evolved in the context of fulfilling their public mandates as international organizations. In turn, these policies were in part created to differentiate public lenders from private investors, and ensure that the former went beyond the latter in terms of financing projects with clear, direct development benefits. Therefore, as part of advocating these norms in the private sector, transnational advocacy groups had to persuade commercial banks that these concerns were indeed relevant to their commercially-driven lending strategies. In doing so, the advocacy groups drew on their moral authority as perceived representatives of the poor and the environment to challenge the corporate power of commercial banks, reflected in the autonomy they enjoyed as foreign investors in countries with weak and poorly enforced regulations.

Secondly, while transnational advocacy groups significantly drew on the political leverage of allied governments in diffusing human rights norms, they sought to mobilize market actors in the case of TNCs. Recognizing the transnational characteristics of these banking conglomerates, advocacy groups made statements of disapproval against their project finance business in developing countries by staging protests against their consumer banking branches in Western capitols. As a result, they sought to mobilize regular bank customers against their banks, and participate in demonstrations against their project financing in developing countries. In addition, they often contacted institutional investors and shareholders, or in some cases purchased shares themselves, in order to influence (or disrupt) annual shareholder meetings and impact the stock market valuation of the banks they were targeting. More broadly, they took advantage of how sensitive commercial banks are to their reputation in the marketplace by seeking to induce a negative market reaction against the development impact of the project financing in developing countries.

And third, with regards to the stages of norm evolution, material events and conditions played a central role in determining the success of environmental advocacy groups. Initially, producing credible information about environmental and social harms generated by projects was a prerequisite for the success of norm entrepreneurs. Subsequently, they had to be able to demonstrate an operational connection between the (non)-decisions of commercial banks and the particular environmental or social harm. And even if successful, inducing changes to corporate practice was predicated on commercial banks being sufficiently concerned about damages to their corporate reputations. In combination, the analysis suggests that the ability of norm entrepreneurs to successfully persuade target actors does not simply

depend on the communication and argumentation skills, but also the extent to which their empirical evidence of wrongdoing provide support for their moral claims and make their discursive strategies persuasive.

The next six sections will revisit the areas of comparison chosen to evaluate the explanatory power of the three competing theoretical perspectives on governance formation – realism, neo-liberal institutionalism and constructivism – and consider the extent to which this case affirmed or discredited their respective hypothesis. By reviewing what the case study tells us about the reasons norms emerge in the international system, the timing of private governance formation, the main initiators, their sources of influence, the governance structure, and why norms are adopted, this concluding analysis attempts to make concrete theoretical contributions to some of the most common research questions discussed in the literature on private governance formation in world politics.

## **8.2 Why Norms Emerge: The Power and Legitimacy of Multilateral Institutions**

The most recent decade has seen the birth of a number of governance initiatives between international organizations and TNCs, often taking the form public-private partnerships. As an element of this trend, multilateral development banks that operate through the private sector have become leading proponents of voluntary business regulation and private sector growth and investment as the most appropriate and effective solution to a wide variety of public policy objectives. As a result, there has been a gradual convergence between development policies in the multilateral system and the norms and practices of transnational business, evident in multilateral support for the privatization of many public sector services, the promotion of carbon finance as a climate mitigation instrument, and the advocacy of corporate social responsibility as the policy paradigm within which the environmental and social costs of business should be dealt with.

Within multilateral development banks, and in particular those that serve the private sector, the dominance of neo-liberal norms creates a strong cognitive bias against norms and principles that do not conform to the commercial imperatives and the logic of markets.<sup>514</sup> By contributing to the institutionalization of norms in the multilateral system, the IFC not only encourages the harmonization of practices across national jurisdictions, but also act as a norm entrepreneur in its own right, favoring technocratic solutions to environmental and social problems that give the private sector a central role in implementation. The World Bank has formally recognized and embraced this discursive role by seeking to project itself as a ‘knowledge bank’, whereas the IFC is increasingly promoting itself as a depository of knowledge and technical expertise in environmental and social risk management, producing research

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<sup>514</sup> For example, the World Bank has largely ignored the policy recommendation made by the World Commission on Dams (WCD) and the Extractive Industries Review (EIR), two recent multi-stakeholder processes that assessed the development impact and effectiveness of the World Bank’s infrastructure lending. (see Dingwerth 2005)

reports, surveys and guidelines, in addition to providing training for financial institutions.<sup>515</sup> As a result, the IFC has become a significant discursive force in financial markets in developing countries, articulating ideas and norms that define how and why financial institutions should further sustainable development in their investment practices.<sup>516</sup>

Notwithstanding its mission to define and diffuse 'international best practices', the IFC does not have any formal powers over private companies, apart from the leverage it enjoys over corporate borrowers. Therefore, its effectiveness at inducing behavioral changes rests primarily on its organizational legitimacy, and the legitimacy of the rules it advocates.<sup>517</sup> Over time, the environmental and social standards and procedures of the World Bank and the IFC have acquired a status as a 'discursive frame of reference' against which the legitimacy of both multilateral and commercial project financing is assessed and judged.<sup>518</sup> Moreover, these standards and procedures do not only delineate between responsible and irresponsible lending. By providing the foundation for the Equator Principles, they in effect give commercial lenders a number of mandates and responsibilities previously restricted to public agencies, thereby contributing to constituting the issue area of environmental governance in international banking. In other words, these standards and procedures did only provide a powerful benchmark for commercial banks involved in the drafting process, they also constituted the link between finance and sustainable development that enabled a public discourse on responsible project financing to emerge.

The standards and procedures upon which the Equator Principles are based have attained this legitimacy in three principle ways. First, from a Weberian perspective, the World Bank and the IFC have formulated rules that serve to promote sustainable development that can be explained and justified using rational-legal reasoning.<sup>519</sup> As outlined in chapter 6, the process of environmental review was designed to ensure that environmental (and later social) considerations could be seamlessly integrated into project preparation processes without undermining the existing operational objectives. More broadly, the ideas and norms furthered by technocratic decision-making tend to carry a legitimacy of their own by virtue of being grounded in scientific methodologies and rationalizations. As such, the research and expertise accumulated within the World Bank and the IFC, and their adherence to rational decision-making processes enhances the legitimacy of the rules they promote.

Secondly, the standards and procedures have not been created in a closed and exclusive decision-making process. Instead, drafts had been widely circulated to a range of actors as part of formal consultations, thus giving each a sense of ownership. As a result, the standards and procedures enjoy 'input legitimacy' because they

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<sup>515</sup> See World Bank (1999) and Stone and Wright (2006), pp.9-16.

<sup>516</sup> See Wright (2006), pp.70-76. For similar arguments about the World Bank and the IMF, see Woods (2006).

<sup>517</sup> Dingwerth (2005).

<sup>518</sup> This mirrors the way in which the World Commission on Dams changed the public discourse on hydropower development. (see Dingwerth 2005, p.77)

<sup>519</sup> Steffek (2003).

appear transparent, inclusive and accountable in the eyes of many external observers.

<sup>520</sup> This legitimacy did not derive primarily from the normative content of the policies, but rather from the governments that had endorsed them. In addition, the fact the environmental advocacy groups referred to them as benchmarks for responsible lending reflects the legitimacy these norms enjoyed in development finance. As such, commercial banks could not produce standards on their own that would attain the same level of legitimacy.

And thirdly, apart from ‘input legitimacy,’ legitimacy also depends on the extent to which rules are effective in achieving pre-stated objectives, so-called ‘output legitimacy’. For commercial banks, the IFC’s policy framework was legitimate in part because it was ‘tried and tested’, as it had a positive track record in reducing the non-financial risks of controversial projects by reassuring a wide range of actors that broader environmental, social and political risks had been identified and effectively managed. In this context, commercial banks valued the operational characteristics of the standards and procedures, and how they were meant to be applied to the most difficult projects in developing countries. Overall, commercial banks expected that adopting the IFC’s policy framework would relieve them of some of the public pressure and ensure that the environment and local communities were not harmed by their project finance investments.

Having been entrusted with creating and diffusing rules in the international system, international organizations such as the IFC have a significant discursive influence on world politics. The legitimacy they enjoy as international organizations often makes them arbiters of norm contests, implicitly judging the appropriateness of normative claims made by external observers, and creating rules that attain an ‘official’ and ‘legitimate’ status among a wide range of external observers for the reasons outlined above. As a result, in the words of Claude (1966), they provide ‘collective legitimation’, by explicitly or implicitly, ‘dispensing politically significant approval or disapproval of the claims, policies and actions of states, including, but going far beyond, their status as independent members of the international system.’<sup>521</sup> In turn, private actors that align their behavior with rules created by international organizations enjoy a level of immediate positive recognition, as they become associated with norms that define appropriateness for a wider range of actors within given policy areas

Since the emergence of the Equator Principles, the IFC has more forcefully embraced its role as a producer of knowledge and information on sustainable business. It is increasingly publishing ‘good practice’ handbooks and guidelines on how private investors and companies should conduct themselves when operating in developing

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<sup>520</sup> Börzel and Risse (2004). For example, as Dingwerth (2005) notes in relation to the World Commission on Dams (WCD), whereas inter-governmental rule-making derives its legitimacy from being legally binding on individuals, states, or other collective actors as such, the WCD’s guidelines (and similar public-private rules) rely on an aura of legitimacy to have an effect on actual decisionmaking. (p.77).

<sup>521</sup> Claude (1966), p.367.



countries.<sup>522</sup> In doing so, it is contributing to defining standards of responsible corporate behavior, thereby creating and popularizing particular distinctions between ‘good’ and ‘bad’ forms of conduct and providing justifications for private companies to engage in certain activities. As part of its growing agenda to define and diffuse ‘best practice’ standards and procedures in the private sector, the IFC frequently puts forward the Equator Principles as its greatest achievement.<sup>523</sup> In promoting responsible corporate conduct in developing countries, it almost exclusively focuses on the commercial benefits that private companies may derive from it, with little attention given to the role of government in designing rules or enforcing existing ones. According to the IFC, a central premise underlying this voluntary regulation agenda is that, as laws and regulation in the conventional sense do not exist at the global level, ‘the reputational process of developing voluntary standards for corporate responsibility will continue to play an important role.’<sup>524</sup> This is particularly the case for environmental considerations, as these are not governed by a recognized collection of international legal requirements as in the ILO Conventions.<sup>525</sup> In turn, the promotion of voluntary forms of governance as supplements to existing laws and regulations ascribes particular institutional roles to actors that affect corporate decision-making, and in general terms, legitimizes partnerships and new forms of governance between civil society, government and business that focus on areas of convergence and collaboration, rather than ideological differences.

The influence of the World Bank and the IFC, and the emergence and institutionalization of these norms in the multilateral system notwithstanding, it was not inevitable that these norms would diffuse to the private sector and become commonly accepted criteria for evaluating whether commercial banks are lending responsibly. As part of explaining the timing of the Equator Principles, the next section summarizes the main findings about the significance of public advocacy campaigns against project finance banks.

### **8.3 Timing: Norm Entrepreneurs Target the Commercial Banking Sector**

Chapter 6 demonstrated that the most critical factor in determining the timing of the Equator Principles was the rise of a corporate accountability movement that systematically scrutinized and publicly reported on the project finance loans of market leaders in commercial project financing. While some commercial banks had

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<sup>522</sup> For some recent examples, see ‘Creating Business Opportunity through Improved Animal Welfare’ (April 2006), ‘ILO Convention 169 and the Private Sector: Questions and Answers for IFC Clients’ (March 2007), and ‘Stakeholder Engagement: A Good Practice Handbook for Companies Doing Business in Emerging Markets’ (May 2007). Date of Access: July 2, 2007.

[http://www.ifc.org/ifcext/enviro.nsf/Content/Publications\\_GoodPractice](http://www.ifc.org/ifcext/enviro.nsf/Content/Publications_GoodPractice)

<sup>523</sup> For example, following its launch in June 2003, the IFC expressed ‘pride’ in its role, and proclaimed that their emergence exemplifies the potential for [its] leadership on issues of sustainability, by helping businesses recognize the ways their interests align with those of people in developing countries and with the well-being of the global environment.’ (IFC 2003, p.3)

<sup>524</sup> Klein and Harford (2004), p.4.

<sup>525</sup> Ward (2004).

fairly well-developed environmental credit risk procedures prior to the Equator Principles, the timing of the framework can be directly traced back to a collective desire among leading commercial banks to stage an effective response to the growing criticism of their project finance activities. In this regard, it is no coincidence that the commercial banks that took the greatest interest in negotiating an industry standard for managing environmental and social risks and sought to convince others were those that were heavily involved in large-scale infrastructure projects in developing countries, and were therefore most susceptible to being targets of environmental advocacy campaigns.

Given their role in diffusing environmental and social norms between two institutional contexts (public and private project financing), environmental advocacy groups can be usefully referred to as norm entrepreneurs in this context. In the 1990s, the emergence of information and communications technologies that allowed instant and rapid diffusion of information across national boundaries and organizational contexts empowered social movements against various corporate sectors in a number of ways. First, it allowed geographically disparate groups to form networks, share information and build political alliances, which produced a convergence around particular norms and ideas, and increased the mobilization of resources. Secondly, it has increased the availability of independent information (and disinformation) about corporate practices, as the internet has allowed media outlets and 'watchdog' groups to effortlessly disseminate viewpoints and assessments. And third, alongside the transnational mobilization of civil society and the greater access to information, public awareness of the development impact of corporate practices has increased considerably.

More broadly, the empirical analysis provides support for the argument that 'naming and shaming', which imposes a reputational cost on laggards relative to a publicly recognized standard, has become central to the enforcement of environmental norms in the private sector.<sup>526</sup> By gathering, organizing and diffusing information about development projects, transnational advocacy groups were absolutely central to the growing reputational risk associated with large-scale projects in developing countries, and its effect on the environmental and social risk management policies among commercial banks.<sup>527</sup> Prior to these campaigns, commercial bank financing in developing countries still generated adverse environmental and social impacts, but information about these was not widely circulated until transnational advocacy groups brought attention to it.

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<sup>526</sup> Haufler (1999). See Newell (2001), pp.97-100, for a discussion of how NGOs generate counterinformation as part of monitoring the activities of TNCs.

<sup>527</sup> As one senior sustainability officer at a German bank noted; 'the NGOs made the final push to bring issues to the forefront. The campaigns elevated the issue to a higher plain once banks realized that their reputation and brand were endangered. That caught the attention of senior management executives.' (EPFI-07) As an example, in explaining gradual cascade in the U.S banking sector, UNEP (2006) attributed the environmental policy development at Citigroup, Bank of America and JP Morgan Chase to RAN's long-standing Global Finance Campaign. (UNEP 2006, p.17)

In promoting the 'greening' of commercial project financing, transnational advocacy groups engaged in three types of mutually-supportive advocacy activities. First, at an initial stage, they have been very prolific in generating research on the environmental and social costs of commercial project financing in developing countries, and blending this in with specific policy recommendations. Oftentimes, the World Bank standards and procedures were held up as a benchmark for responsible project financing. In most cases, reports have singled out specific projects or industries and brought to light examples of environmental and social injustices in remote areas that have not generated any media attention in the home countries of the respective commercial banks.<sup>528</sup> As an example, in 2000, Milieudefensie and Greenpeace in the Netherlands, with input from an Indonesian network of local NGOs working against palm oil plantations, released a report, *Funding Forest Destruction*, which catalogued the impacts of the government program on Indonesia's forests and the people that depended on them.<sup>529</sup> The same year, the CIFOR and WWF released a report – *Profits and Paper* – that documented how up to £7.5 billion in foreign investment into the Indonesian pulp and paper industry was significantly contributing to deforestation.

There is a strong recognition among leading commercial banks that published research by Banktrack members was important in raising awareness about the negative impacts that project financing could have on local communities and the environment. In cases where commercial banks were unaware of these impacts, such reports have been used by commercial banks as additional sources of information. For example, project finance executives at ABN Amro have openly admitted that Milieudefensie's campaign against mining operations in Papua New Guinea was a real 'wake-up call' for its risk management committee. In other cases, such research reports have directly conflicted with information released by the commercial banks or their borrowers, thereby forcing them to provide additional documentation to back up their assessments. Yet, in both cases, whether NGO-generated research unearthed new information or challenged corporate reporting, it discursively influenced public understandings of the impact of transnational business on the environment and local communities in developing countries.

Secondly, advocacy groups integrated this research into specific advocacy campaigns directed at commercial banks and their stakeholders, which became central to broadening public expectations about the roles and responsibilities of commercial banks in promoting sustainable development.<sup>530</sup> Many of the advocacy groups that would later form Banktrack, including FOE (numerous chapters), WWF, and Campagna per la Riforma della Banca Mondiale (CRBM), had experience staging

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<sup>528</sup> In a survey of commercial banks, events such as 'polluting incidences' that generate significant media coverage were associated with a considerable risk to corporate reputation. (ISIS 2002, p.10)

<sup>529</sup> Milieudefensie (2000). The report recommended that Dutch banks refrain from financing plantations unless guarantees were given that the borrower would not clear more land to make way for new plantations, or violate the rights of local people and Indonesian law.

<sup>530</sup> For the role of NGOs in the 'greening' of the World Bank, see Bramble and Porter (1992), pp.325-336), Keck and Sikkink (1998), O'Brien et.al (2000), pp.115-134, Park (2006), Rich (1993), and Wade (1997).

campaigns against multilateral lenders, and drew lessons from those successes when confronting the commercial banking industry. Therefore, it was not surprising that the campaigns emulated those previously launched against the World Bank and the IFC. As described in greater detail in chapter 6, it began in the mid-1990s when advocacy groups realized that despite having been successful in persuading multilateral lenders to shun the Three Gorges Dam project because of the likely ecological damages it would cause, the development was still being bankrolled by foreign lenders. Specifically, a number of commercial banks and investment houses were indirectly financing the project as purchasers of Chinese bonds, prompting advocacy groups to criticize them publicly. In this and other projects, the initial step was to thoroughly document environmental and social harms associated with a project, and persuasively try and tie these to the negligence or wrong-doing of commercial banks.

Yet, in order to generate adverse media publicity, it was also necessary for transnational advocacy groups to demonstrate that commercial banks could have intervened to prevent the damages, or alternatively, should have avoided financing the project in the first place. Commonly, advocacy groups would present evidence of environmental and social harm and attribute blame to commercial banks, which in response countered such claims with statements of innocence. To build pressure, advocacy groups would creatively mobilize market actors, including consumers and shareholders, that for either financial or ethical reasons objected to the actions of financial institutions. In some cases, campaigns directly targeted senior bank executives, by for example disrupting public appearances or even picketing their homes, whereas more commonly, they staged small demonstrations outside of corporate offices, handing out flyers to passers-by to great effect. As one senior bank official noted, ‘there is nothing that concentrates your mind more than having people outside of your building, sending in complaint letters, and threats going into your CEO’s office’<sup>531</sup>

And third, advocacy groups also influenced the development of environmental and social risk management policies by directly engaging with commercial banks in bilateral discussions. Oftentimes, advocacy groups were invited to speak with bank executives following sustained campaigns in which adverse media coverage of the involvement of banks in particular ‘problem projects’ was getting continuously worse. For example, on the back of the public campaign against ABN Amro over its financing of a copper and gold mine in Papua New Guinea, Milieudefensie was eventually invited by the bank to discuss a resolution of the matter. Similarly, after its sustained advocacy campaign against Citigroup, RAN was invited to meet its senior management to discuss ways in which the bank could operate more responsibly. In both cases, heated confrontations in the press over the responsibilities of financial institutions for the adverse environmental and social impacts of project financing were replaced with direct dialogue because the respective commercial banks wanted to end a wave of adverse media coverage.

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<sup>531</sup> EPFI-06.

In turn, once channels of dialogue had opened up, the dynamic between them gradually evolved into a process of argumentation, in which each side sought to convince the other, and the general public, about the validity and legitimacy of conflicting truth claims. To come across as more persuasive, advocacy groups cushioned their moral claims within well-recognized international norms, such as the precautionary principles, human rights, and transparency, whereas commercial banks stressed the limited responsibility, leverage and opportunity they had for addressing these concerns, given the financial and legal structure of project financing. They also initially claimed that their mandates as fiduciaries barred them from imposing particular environmental and social conditions on loans and disclosing information on the specifics of financial transactions.

Yet, despite the proliferation of advocacy campaigns against commercial banks, it was not inevitable that the growing reputational risk of project financing would translate into a common industry standard eventually backed by a majority of commercial banks active in the global project finance market. For that to happen, both the IFC's role in convening industry leaders and legitimating the framework, and the willingness of commercial banks to engage in cooperation, was instrumental. The next section will identify the main initiators of the Equator Principles by reviewing the significance of the IFC's role in the Equator Principles in the context of the evolving institutional relationship between international organizations and transnational business.

#### **8.4 The Main Initiators: Commercial Banks and the IFC**

The growing scrutiny of commercial banks on the one hand, and the emergence of the IFC as a significant actor in global environmental governance on the other, provided a foundation for the initial interactions that led to the Equator Principles. While advocacy groups produced the institutional context in which commercial banks increasingly felt under pressure to mitigate the adverse development impacts of their projects, it was not a given that this pressure would lead to a common industry standard. Notably, as much as advocacy groups wanted commercial banks to formally adopt the IFC's operational policies, they did not have the power or capability to either force them to do so individually or create a collective framework of this nature. Instead, the initiative to produce a collective industry response to the growing public scrutiny of project investments originated from within the industry, driven by leading commercial banks and the IFC, an increasingly influential multilateral lender to private sector projects in developing countries.

##### *Commercial Banks as Global Standard-Setters*

Since the early 1990s, market reforms in developing countries have resulted in the widespread privatization of traditional public sector industries, harmonization of tax regimes, and lower restrictions on foreign capital. These favorable investment

conditions prompted TNCs based in OECD countries to expand internationally to the fastest growing developing countries, contributing to a tremendous growth in long-term private capital flows to infrastructure projects, including power plants, roads, ports and telecommunication.<sup>532</sup> In turn, commercial banks eagerly followed their corporate clients abroad, bankrolling large-scale investment projects at a rapid pace, surpassing multilateral financing in volume in many countries.<sup>533</sup> Given the growing competition between investors in developing countries, project finance lenders have been forced to sharpen their competitiveness by improving the terms of financing, expanding advisory work and streamlining loan consideration and approval processes.

Hence, improving credit risk processes was very much on the minds of banking executives at the time they were invited by the IFC and ABN Amro to participate in a workshop on environmental and social risk management practices in project finance. Many commercial banks suffered heavy financial losses in their developing country portfolios in the late 1990s, as a result of economic crisis in Asia and Russia. Therefore, during this period, commercial banks paid more attention to developing effective and prudent risk management practices, particularly for large-scale investments in developing countries. In terms of environmental risk management, commercial banks were at this stage predominately focused on mitigating credit risk, or the possibility that adverse environmental impacts could undermine the ability of the borrower to repay the loan, and security risk, or the possibility that environmental contamination would devalue assets used as collateral. Thus, the practice among some leading commercial banks of referring to the *Safeguard Policies* in an ad-hoc fashion when financing complex projects was in part an aspect of prudent risk management but also reflected a recognition that a failure to do so could generate a reputational risk.

Yet, whereas project-specific risks could be mitigated by commercial banks in an individual fashion, reputational risks were of a different nature, requiring a broad industry response to be effectively managed. As an element of this greater visibility, commercial project lenders became increasingly subjected to the same levels of public scrutiny as multilateral development banks, since they were increasingly associated with controversial projects that entailed the disruption of ecosystems and local communities. These developments made commercial banks more receptive to arguments that neglecting to manage environmental and social risks could adversely affect business by resulting in costly delays and a damaged reputation in the marketplace.

What induced cooperation between them to create industry standards for commercial project finance banks was the realization that they confronted similar reputational threats in their project finance business. As a result of this convergence in interests, a

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<sup>532</sup> Esty (2004).

<sup>533</sup> According to the World Bank (2004), commercial bank financing for infrastructure in developing countries increased nine-fold between 1990 and 1997, and the annual volume of project finance deals exploded from less than £2.5 billion to over £25 billion.

concentrated industry, and a high degree of cooperation on financial transactions, commercial banks were able to collectively negotiate standards for environmental and social risk management that would not undermine their competitiveness. As documented in chapter seven, through a series of workshops commercial banks presented their experiences with project finance transactions in developing countries and share ideas on how to mitigate risk. A core group of commercial banks volunteered to form a working group that together with the IFC would devote time and resources to formulate a set of standards that could be appealing to a critical mass of commercial banks. Subsequently, these commercial banks consulted their clients and some of the environmental advocacy groups that had been their most frequent critics, in an effort to design a framework that was both acceptable from a commercial point of view, and legitimate from the perspective of the public. All in all, the framework was driven by the interests of the commercial banks, as they recognized that gaining the support of a critical mass of commercial banks in the marketplace was always what separated success from failure.

### *The IFC as an Advocate for Voluntary Business Regulation*

Right about the same time as commercial banks were increasingly targeted by advocacy groups, the IFC was positioning itself as a depository of knowledge and expertise on environmental and social risk management in developing countries. Throughout the 1990s, it gradually expanded its policy framework and added environmental and social specialists to its staff, in part as a response to campaigns by the same environmental advocacy groups. In 2000, the IFC launched the 'Sustainability Initiative', a strategic framework with a number of new metrics that embedded its environmental and social mission within its overarching aim of promoting private sector growth and investment. The initiative reflected the client-driven agenda that was increasingly influencing policies and strategies within the World Bank Group more broadly.<sup>534</sup> By applying the framework, the IFC also intended to demonstrate that multilateral financing to the private sector was still necessary, despite the tremendous growth in private capital flows to developing countries in the 1990s.

As part of this effort, the IFC's new institutional role was to supplement its due diligence framework with a focus on identifying, enhancing and realizing the 'business case' for its clients to voluntarily adopt environmental and social practices.<sup>535</sup> By taking on an advisory role relative to borrowers, rather than a role as a regulator, it placed less emphasis on broadening and enforcing rules and requirements, and more on appealing 'to firms' self-interest as a means of enhancing

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<sup>534</sup> In terms of the environmental agenda, this most forcefully manifested itself in June 2006, when the World Bank announced it would disband the Environmentally and Socially Sustainable Development (ESSD) network and merge it with the Bank's infrastructure department, and create a new Sustainable Development Department. It was meant to streamline management and enhance coordination between operational and support staff, ultimately increasing its efficiency in meeting the demands of borrowers during the preparation of projects.

<sup>535</sup> IFC (2002).

the sustainability of economic activity.’<sup>536</sup> Relative to other financial institutions, it sought to assert itself as ‘a partner of choice’ by offering environmental and social risk management training, producing research on managing development impacts of projects, and promoting voluntary business regulation as the institutional mechanism of choice for increasing corporate environmental performance and accountability.

This strategic initiative, combined with personal relationships between IFC staff and project finance executives of other banks, made the IFC well placed to assist commercial banks in designing the Equator Principles. Its role in convening the first workshop alongside ABN Amro in 2002 was essential, as the latter did not have the legitimacy to do so on its own. Since the workshop would require competitors to share sensitive information about their internal credit risk procedures, the participation of the IFC was critical to giving the project finance executives of commercial banks enough comfort that the exercise was worthwhile, and that the information would not be misused. During the working group’s deliberations and in subsequent workshops, the IFC participated by providing technical advice on formulating standards, and informing banks how they would be implemented in projects. All in all, the involvement of an ‘honest broker’ that enjoyed legitimacy and trust within the industry was critical in order for commercial banks to cooperate on matters that had long been determined by market competition.

In initiating the deliberations that led to the launch of the Equator Principles, commercial banks and the IFC drew on various sources of influence and power, unavailable to other actors. The next section briefly discusses them.

### **8.5 Sources of Influence: Corporate Power, Technical Expertise and Legitimacy**

Both commercial banks and the IFC have been beneficiaries of the gradual liberalization of global capital markets and the growth in investment opportunities in developing countries. IFC’s total committed portfolio increased six-fold between the mid-1980s to 2000, from less than \$1 billion in annual commitments to over \$6 billion. During this time, its engagement with the financial sector deepened, reflected in a growing portfolio of debt and equity investments to financial institutions, as well as risk management training to financial executives in developing countries. Alongside a growing perception in the development community that economic development could only be achieved through private sector growth, the IFC raised its stature within the World Bank Group because of its distinctly commercial orientation. Moreover, during the 1990s, a number of commercial banks gradually increased their project portfolios and market share, becoming important sources of capital for developing countries wishing to build ports, oil and gas pipelines, hydropower dams, palm oil plantations, and transport infrastructure. Their growing influence on the flow of long-term private capital to developing country projects, and the terms upon which financing was provided, is part of the explanation for how and why they were able to

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<sup>536</sup> IFC (2003), p.20.



devise an industry standard for managing environmental and social risks with limited public interference.

### *Commercial Banks: Market Power and Technical Expertise*

Although the timing of the Equator Principles can be traced back to the rise of environmental advocacy campaigns in the late 1990s, the commercial banks that hold a dominate position in the project finance market have from the beginning been the most prominent advocates of the framework, and have played a leading role in persuading competitor banks to endorse it. As one bank official noted;

‘The IFC was interested in getting this initiative up and running. After all, the Equator Principles are based on the IFC’s standards. But after things started to move, it was primarily driven by the banks. Of course they talked with the IFC, but the whole thing was bank-driven. In the end, it is the banks that have to implement it, and it is their reputation that is at stake. IFC was there to provide input, but banks were chairing sessions and creating the framework.’  
- EPFI-12.

The Equator Principles did not emerge from within a government or international organization, and was not directly prompted by regulation. In fact, an important backdrop to its emergence was that developing countries did not have regulations that forced project developers or banks to follow ‘international best practice’ standards in the construction and operation of projects. As a result, commercial banks enjoyed significant discretion in tailoring the framework to their commercial imperatives with limited public interference, on the basis of their powerful position in the marketplace. Given that inducing a critical mass of commercial banks to adopt the standards was the most important objective, the leverage of individual banks in the negotiations was somewhat commensurate with their market share. Indeed, the four commercial banks that comprised the working group were among the largest commercial project finance lenders in developing countries.<sup>537</sup>

In each of these banks, there were banking executives that showed a particular interest in addressing environmental and social risk management in project financing, and given that a direct relationship had emerged between the adverse environmental and social impacts of selected projects and the corporate reputation of commercial banks, senior management executives happily gave space for them to explore the development of common standards for the industry.<sup>538</sup> Interviews revealed that many of these individuals had personal ideational commitments to environmental and social issues, and wanted their respective organizations to reflect that. But in promoting these standards and procedures internally and externally, they relied heavily on developing commercial justifications for doing so. According to one bank official, while the mandates of the project finance executives in the policy discussions were

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<sup>537</sup> In 2001, ABN Amro, Barclays, Citigroup and WestLB arranged more than £7.5 billion in project financing, or 17.5 percent of the market occupied by the 20 largest arrangers (‘Four Bank Adopt IFC Agreement’, by Demetri Sevastopulos, *Financial Times*, April 9, 2003)

<sup>538</sup> EPFI-07.

not open-ended, senior management at the respective banks wanted ‘a framework that could guarantee that risks associated with individual projects would be addressed across the board.’<sup>539</sup>

Throughout the drafting process, commercial banks as a group unilaterally made decisions with regard to the scope and content of the framework, with little interference from the IFC or transnational advocacy groups.<sup>540</sup> In fact, the working group, in consultation with other commercial banks, was deciding upon which elements of the IFC framework was applicable to commercial project lending, and which were not. While it was acknowledged that the framework had to be perceived as legitimate by the public in order to be effective in rebuilding their damaged reputations, the overarching goal was to find a common standard that would generate as much interest as possible within the commercial banking industry. To this end, the initial proposal from the working group was adjusted many times during the consultation phase, in response to objections from commercial banks whose participation was deemed to be of critical importance. For example, whereas the draft presented by the working group in February 2003 covered all financing for limited or non-recourse transactions, the final version limited the scope of the framework to ‘direct lending’, thereby excluding equity and bond financing. Furthermore, the \$50 million lower threshold (reduced to \$10 million in EP2) was added because of concerns raised by some banks that the administrative costs associated with applying the framework to small projects would be excessive. And finally, interviews revealed that the concern for anti-trust accusations among commercial banks from the United States was one of the primary reasons that the commercial banks did not establish a secretariat with its own mandate and resources.

Apart from the market share of commercial banks in the project finance market, the operational experience and technical expertise of the project finance executives themselves was an important source of influence. The operational focus of the negotiations ensured that technical and commercial feasibility was the most important factor in determining the value of any proposition about a particular standard. Of the four individuals that participated in the working group, three had been recognized as among the foremost experts in the project finance industry on environmental and social risk management. While the banks they represented enjoyed significant market shares, the personal experience and expertise of these executives was also an important consideration for being selected.

By way of the Equator Principles, these banking executives placed themselves in a position of power to make crucial decisions about whether and how to apply standards and procedures that were originally created to safeguard public interests. As a result of the growing acceptance of voluntary business regulation of this kind, commercial banks became increasingly viewed by many as legitimate decision-

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<sup>539</sup> EPFI-07.

<sup>540</sup> For example, a joint NGO declaration on after the launch of the Equator Principles clearly reflected how transnational advocacy groups were overall disappointed in how little their demands had been heard, particularly with regards to transparency and accountability. (Focus on Finance 2003)

makers on matters that have historically been seen as antithetical to their commercial objectives, and been the responsibilities of public sector organizations. The implication has been that the commercial imperatives that underlie risk management are increasingly seen as complementary to the need to protect the environment and project-affected communities from harm. In fact, commercial justifications, embedded in the language of ‘sustainability’ and the ‘triple bottom line’, are gradually taking over the public discourse, replacing earlier mentions of regulatory standards and extending right and entitlements to local communities.

### *The IFC: Market Power, Convening Power, and Technical Expertise*

The IFC’s power in shaping the Equator Principles drew on three primary sources of influence that in many ways makes it unique among international organizations. Central to its influence on setting standards for responsible lending was the power it had in the global project finance market, as a lender, a source of technical expertise, and its convening power as a legitimate ‘third-party’ broker.

First, the similarities between its financing operations, policies and procedures and professional culture and those of commercial banks provided a basis for forging close relationships with them. The IFC’s mandate and organizational structure centre on identifying, evaluating, negotiating and closing financially viable investment projects. Its financing operations are organized in nine industry departments, each charged with identifying and completing investment projects in particular industries, such as agribusiness, infrastructure and global financial markets. Tasks associated with identifying and mitigating the environmental and social impacts of project proposals are primarily handled by environmental specialists embedded in investment or country teams, or working in a separate support department. As a result of this transactional orientation, the IFC’s operational staff primarily consists of business professionals with advanced degrees in corporate finance or business management that would otherwise seek employment in the commercial banking industry

Secondly, apart from an organizational structure that focuses on project transactions, the IFC remains firmly wedded to its original purpose of mobilizing financial resources in support of financially viable private sector projects in developing countries. In fact, during the 1990s, the environmental reforms at the IFC were driven by external pressures to better account for the development impacts of its project investments. The IFC’s emphasis of commercial viability effectively meant that IFC financing and commercial bank lending was broadly driven by the same organizing principle, which in turn guaranteed that the IFC’s technical advice to commercial banks would not directly conflict with their profit motive. On both an ideological and practical level, this confluence of interests provided a basis for an exchange of ideas and knowledge, in which the IFC’s technical advice was perceived as directly relevant, and neutral, to the current predicament of commercial banks, namely mitigating the non-financial risks of commercial investments.

Third, given its focus on identifying financially viable transactions, the IFC engages with the environmental and social dimension of private sector development on a project-by-project basis, and with business profitability in mind. While a significant purpose of its environmental and social policy framework is to increase the development impact and accountability of its financing operations, the IFC frequently argues for the existence of a ‘business case’ for managing environmental and social issues in project investments.<sup>541</sup> By having adopted this distinctly corporate perspective on environmental and social issues, the IFC had not only aligned its environmental and social mission with the concept of corporate social responsibility, but also reinforced the notion that private sector growth and investment was a prerequisite for reversing environmental degradation and reducing poverty.

And finally, the IFC had during the last decade amassed considerable expertise in environmental and social risk management by increasing the number of in-house environmental specialists from under 10 to over 100.<sup>542</sup> In doing so, it frequently promoted its specialized expertise in environmental and social risk management, and positioned itself as ‘a partner of choice’ for private borrowers in developing countries.<sup>543</sup> And in the context of its financial sector investments, it had provided environmental risk management training to financial institutions, produced guidance material diffusing its own operational experiences and made the case for considering environmental and social issues in investments.<sup>544</sup> Many commercial banks benefited from this knowledge during the consultation process, and solicited IFC’s advice on a bilateral basis after they adopted the framework.

In combination, its organizational structure, commercial orientation and technical expertise gave it considerable legitimacy in the global project finance market, and by extension, influence in the negotiations that preceded the launch of the Equator Principles. It guaranteed that most commercial banks did not consider IFC’s interests in the negotiation process to conflict with their own, which allowed the IFC to operate as an ‘honest broker’ in the negotiations while clearly having an interest in establishing its environmental and social policy framework as the industry standard.

Given that commercial banks and the IFC were the main initiators of the Equator Principles, and focused on devising a standard that was acceptable to the largest number of commercial banks, it is no surprise that the governance structure was uniquely transnational and market-based, as part of ensuring the harmonization of policy commitments across countries and industries. The next section will briefly

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<sup>541</sup> IFC (2002a), Wright (2006), pp.71-76. Such cognitive frameworks are also prevalent at the World Bank. According to O’Brien et.al (2000), the World Bank’s gender agenda has focused on identifying and promoting a ‘business case’ for gender equity, based on an ‘economic rationale for investing in gender.’ (pp.47-49)

<sup>542</sup> IFC (2002) and Park (2006).

<sup>543</sup> IFC (2003), p.2, and Wright (2006).

<sup>544</sup> After the launch of the Equator Principles, the IFC exploited its enhanced leverage and expertise to form a partnership with the U.N Global Compact and the UNEP FI to further the integration of environmental and social issues in financial markets.

review how and why the governance structure of the Equator Principles took this form.

## 8.6 Governance Structure: Transnational, Market-Based Regulation

Notwithstanding the conformance with existing international institutions, the governance structure of the Equator Principles reflects the interests of commercial banks and manifests their growing power in global governance. Given their discretion in devising the framework, and the importance of mobilizing a critical mass of commercial banks to adopt it, negotiating parties were primarily interested in designing standards that could be applied globally across projects in all industry sectors, and be integrated into the commercial banks with often very different organizational structures and credit risk procedures. The resulting governance structure was therefore uniquely tailored to the strategic interests of the commercial banks involved in the negotiations.

First, while the content of the Equator Principles is strongly associated with norms promoted by powerful states and implemented by international organizations, its institutional design is uniquely tailored to the strategic interests of commercial banks. It is voluntary for commercial banks to adopt the framework, and once adopted, there is no independent enforcement mechanism that monitors compliance or sanctions implementation lapses. As is stated, compliance with host country laws and regulations and relevant World Bank and IFC guidelines will be addressed to the satisfaction of the financier. So whereas World Bank and IFC compliance with operational policies can be enforced by project-affected communities by submitting claims to the World Bank Inspection Panel and the CAO, respectively, no such accountability mechanism exists for the Equator Principles.<sup>545</sup> Instead, as stated, 'each institution adopting the *Equator Principles* individually declares that it has or will put in place internal policies and processes that are consistent with the Equator Principles', and as is clarified, 'this can be done at any time.'<sup>546</sup> Moreover, since the launch of the Equator Principles, transnational advocacy groups have almost in vain called for greater accountability and transparency that allows for independent auditing of compliance.<sup>547</sup> While a reporting provision was inserted into the revised framework in July 2006, it does not require commercial lenders to disclose project-level information beyond an environmental assessment report for the largest projects.<sup>548</sup>

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<sup>545</sup> Not only is an accountability mechanism missing, but the document explicitly states that 'the adopting EPFIs view these Principles as a financial industry benchmark for developing individual, internal social and environmental policies, procedures and practices. As with all internal policies, these Principles do not create any rights in, or liability to, any person, public or private. Institutions are adopting and implementing these Principles voluntarily and independently, without reliance on or recourse to IFC or the World Bank.' (Equator Principles (2006), p.5)

<sup>546</sup> See [www.equator-principles.com](http://www.equator-principles.com). See also Appendix 1.

<sup>547</sup> See Banktrack (2006) and Missbach (2004)

<sup>548</sup> See 'Guidance to EPFIs on Equator Principles Implementation Reporting', Date of Access: July 2, 2007. [www.equator-principles.com/documents/EPReporting\\_2007-06-12.pdf](http://www.equator-principles.com/documents/EPReporting_2007-06-12.pdf)

Second, in addition to its voluntary nature and discretionary language, the Equator Principles outright lack many elements of the IFC's policy framework which commercial banks deemed to be inappropriate or inapplicable to commercial project lending. Most notably, the IFC's Exclusion List, which identifies certain economic activities that are not eligible for financing, does not figure in the Equator Principles.<sup>549</sup> Nor does it include the IFC's disclosure policy, which is an important element of its engagement with civil society, yet deemed incompatible with the need for commercial banks to maintain client confidentiality. These policies are central to the IFC's accountability framework, and its relationships with stakeholders.

Third, as a result of the preferences of commercial banks, the framework was not initially embedded in any kind of formal structure. It has no formal organization or secretariat, and communication with stakeholders is done through a website hosted by one of the Equator banks on a rotating basis. Communication between adopting banks is not systematic, but takes place informally in ad-hoc workshops organized by one of them. Environmental advocacy groups have lamented the fact that communicating with adopting banks requires them to send individual e-mails to an increasing number of banks, given that there is no system for managing communication with external observers. To address this, a formal structure with working groups was introduced in 2007, but it lacks mechanisms for self-policing, let alone independent auditing of compliance.

And fourth, and more broadly, just as the integration of the World Bank's standards and procedures into the IFC's financing operations meant they would be promoted in the multilateral system as an aspect of responsible private sector financing, so did their adoption by commercial banks mean that they were increasingly justified as a central element of prudent risk management. The professional training and responsibilities of the banking executives that determined the direction and pace of negotiations ensured that commercial and operational imperatives took center stage. Whereas TNCs participating in consultations on voluntary guidelines are often represented by executives from public relations or corporate sustainable development units, policy discussions associated with the Equator Principles were dominated by risk management professionals from project finance units that worked directly with transactions on a daily basis.<sup>550</sup> From their perspective, applying environmental and social standards to projects was not principally understood as a moral or ethical imperative, but represented a way to address an emerging and compelling risk that was increasingly affecting their project finance business in developing countries.

Overall, the content and institutional design of the Equator Principles ensure that the framework conformed with the theory and practice of project risk management, as outlined in chapter four. This placed the consideration of environmental and social

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<sup>549</sup> For example, as a result of applying the exclusion list, the IFC is barred from financing projects that include the production of weapons, tobacco, pesticides or radioactive materials. See IFC (1998), p.19.

<sup>550</sup> IFC-04.

issues solidly within a commercial imperative to enhance the financial viability of a project, and a legal requirement not to influence the project beyond what is permitted in fiduciary relationships. In general terms, such risk management involves making judgements about the significance of project-related inputs and impacts, including the identification of risks to the project, and choosing which risks to ignore, mitigate or prevent, including by what means, and formulating operational plans and establishing procedures to monitor them. Therefore, the commercial justification for these standards and procedures is that they enable a financial institution to finance lucrative projects that are associated with high levels of environmental, social and reputational risks. In short, they are designed to enable an expansion of business, not force a constriction.

For environmental advocacy groups, this is a grand paradox of the Equator Principles. As the voluntary framework allows commercial banks to manage risks better, it enables them to increase the volume of bankable projects by financing those that would previously be deemed too risky. As a means to efficiently manage and allocate risk, project financing relies upon the capacity of lenders to identify, assess and mitigate all project-related issues that could impinge on the future revenue streams of projects. Those commercial banks that are strategically pursuing projects in environmentally-sensitive industries are therefore significantly exposed to reputational pressures, and institutionalizing a comprehensive risk management process can ensure that they are made aware of potential project 'controversies', and stand prepared to respond to any external criticisms.<sup>551</sup> For these commercial banks, including ABN Amro, Citigroup and WestLB, there is an expectation that many of the largest and most lucrative projects in the future will be in remote areas in states with weak governance, conditions that typically invite significant external scrutiny. In this context, developing risk management practices commensurate to the likely levels of future risk exposure makes business sense.

### **8.7 Why Norms Are Adopted: The Mitigation of Reputational Risk**

Based on the empirical analysis, the thesis does not find support for the constructivist argument that the widespread adoption of a norm among a group of actors is preconditioned by a reconstitution of their identities and interests. The primary research did not find evidence that banks had internalized the norms to the extent that failing to comply with them would be seen as antithetical to their corporate identities. Instead, it argues that a commercial bank's decision to adopt the Equator Principles was largely strategic and primarily based on the level of reputational risk it was exposed to through its project finance business. In the context of investments in

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<sup>551</sup> As an environmental risk officer at one of the four commercial banks in the working group noted, 'the original four banks had been involved with difficult transactions during which they had received questions and queries about how environmental and social issues were managed in projects. Prior to implementing systematic risk processes, it was very difficult for the banks to answer those questions, and by and large, they could not confidently say whether standards had been met, as this was not part of their formal credit policies.' (EPFI-08)

developing countries, a commercial banks' reputational risk can be defined as 'the probability of being a target of a public campaign multiplied by the cost for the bank of such a campaign.'<sup>552</sup> Given that international banking is increasingly based on building client relationships, commercial banks are extremely sensitive to their reputation in the market place, and this fact is reflected in adoption patterns.

It is possible to identify a number of factors that explain why commercial banks face different levels of exposure to reputational risk. Drawing on research presented in chapters 6 and 7, figure 8.1 summarizes findings of the three most significant factors for determining the extent to which a financial institution's project finance investments in developing countries are likely to lead to reputational damages.

First, the level of home country pressure on the financial institution to consider environmental and social issues in investments is important in determining the likelihood that a controversial project in a developing country will translate into a reputational liability. Exposure increases significantly if the financial institution has a large consumer banking network, as banking customers are in position to directly punish its commercial standing by withdrawing funds and moving accounts to a competitor. As a result, the fact that a commercial bank is a deposit-taking financial institution that allow consumers to make their preferences known in the marketplace enhances the leverage of advocacy groups, and makes it much more likely that public revelations of irresponsible financing practices will result in financial costs.<sup>553</sup> Apart from advocacy groups and 'ethical' bank customers, there is now a wide variety of public and private actors that put pressure on financial institutions to adopt more responsible investment practices, including socially responsible investment funds and environmental technology firms, pension funds and a wide range of financial services clients. In addition, formal regulations or government-issued guidelines can call attention to the negative consequences that can be generated by the activities of TNCs in developing countries, and force financial institutions to publicly disclose their corporate practices.

Secondly, the level of host country pressure, or civic pressure against a development project in the country in which the project takes place, significantly determines the extent of negative local and international media coverage that is produced. In many cases, a controversy erupts when a local community organizes a protest or court action against a project operator over negligence or deliberate injustices, generating publicity around the adverse environmental and social impacts generated by a project. While the severity of ecological damages and social injustices is a factor in determining the level of local opposition, the political rights and capacity of local community groups to organize a response and be heard is also crucial. In addition, in cases where local authorities bearing the costs of a project are pitted against a national government that favors an export-oriented growth strategy, the extent to

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<sup>552</sup> EIRIS (2006), p.7

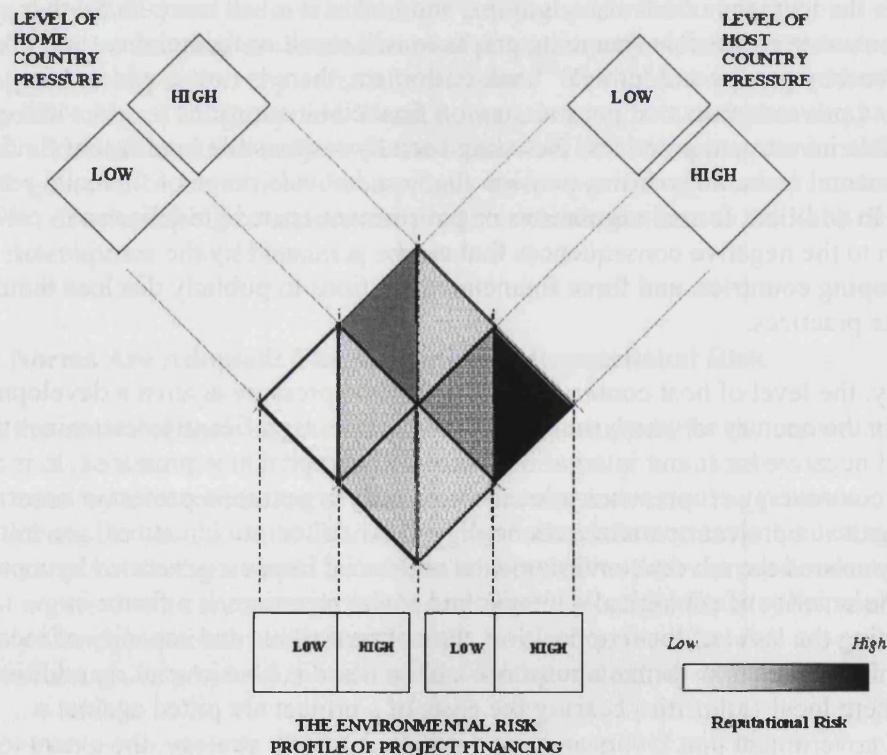
<sup>553</sup> See Newell (2001) for a similar discussion. The importance of the institutional environment in the home country explains why two financial institutions involved in the same controversial development project may not be exposed to the same level of reputational risk.



which their claims of injustices can be pursued in the national legal system or stir public debate is also an important factor.

More broadly, the level of environmental laws and regulations and the extent to which they are comprehensively enforced contributes to the level of pressure in host countries. For example, requirements associated with the provision of operating permits and licenses can put pressure on financial institutions to undertake more rigorous environmental and social risk studies. Similarly, if a project is found in violation of environmental laws and regulations, or the rights of local communities, this would put project operators and lenders on the defensive in need of recognizing failures and rectifying them. This explains why the most controversy has arisen in connection with large-scale development projects that require widespread government approvals, and undertaken in developed countries with generally mature democratic institutions and well-organized civil society groups, that collectively are able to mobilize political support behind the concerns of project-affected communities.<sup>554</sup>

**Figure 8.1 Project Financing in Developing Countries and Reputational Risk**



<sup>554</sup> Examples include large-scale colonization projects in Brazil and Indonesia, and several hydropower projects in India, which have involved large-scale land conversion, infrastructure development and the resettlement of local communities. Many of these are referenced in earlier chapters.

And third, the vulnerability of a financial institution to a public backlash also depends on its overall role and market position in the project finance market, and the environmental risk profile of the projects it finances. In general terms, mandated arrangers, or those commercial banks nominated by the borrower to take the lead in negotiating contracts and conducting risk management, are commonly more exposed to reputational risk as an aspect of their greater public visibility.<sup>555</sup> In terms of their individual project finance portfolios, both the geographical and sectoral distribution has an impact on the overall level of environmental risk commercial banks are exposed to. For example, since systems of governance and environmental management differ widely between developed and developing countries, an industrial accident is much less likely to happen in developed countries, and if it does happen, will have much greater adverse impact on the environment or local people in developing countries.<sup>556</sup> In terms of sectors, projects in industries associated with significant adverse environmental impacts, such as oil, gas, mining and hydropower, are more likely to generate adverse environmental and social impacts than those in more service-oriented industries, such as health, education and telecommunications. In the latter case, larger projects are also more likely to attract public attention than smaller projects.<sup>557</sup>

The regional representation of financial institutions that have adopted the Equator Principles underscores the extent to which reputational risk is a primary driver in the decision to adopt a code of conduct. Among the ten initial adopters, all were from Western Europe or North America, and many had significant project finance portfolios in high-risk sectors in developing countries. Of the thirty-two financial institutions that had adopted the framework a year after its launch, 53 percent (nineteen banks) were located in Europe, 25 percent (nine banks) in North America, with no representation in South Asia or South-East Asia. The remaining 23 percent is made up of financial institutions headquartered in Brazil (14 percent, five banks), Japan (3 percent, one bank) and Australia (3 percent, one bank), and South Africa (3 percent, one bank). Five years after its launch, the geographical distribution of the signatory banks is less skewed, but still heavily weighted towards commercial banks in the OECD.

This skewed regional distribution towards OECD countries mirrors that of other voluntary codes of conduct targeting TNCs. For example, of the current financial institutions that have signed the UNEP's *Statement by Financial Institutions on the Environment and Sustainable Development*, 72 percent are from Europe, twelve percent from Asia and seven percent from North America, with only marginal representation from Africa (three percent), South America (two percent) and the Middle East (one percent).<sup>558</sup> Regional figures for commitments to the GRI are

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<sup>555</sup> EIRIS (2006), p.9.

<sup>556</sup> EPFI-06.

<sup>557</sup> On this point, see Esty (2004).

<sup>558</sup> See [www.unepfi.org](http://www.unepfi.org).

Europe (48 percent), Asia (22 percent), Oceania (7 percent), Africa (5 percent) and Latin America (4 percent). And finally, corresponding figures for the United Nation's *Global Compact* are Europe (46 percent), Asia (25 percent, North America (eight percent), with the remainder distributed across other regions.<sup>559</sup>

The overall conclusion about the significance of reputational risk associated with project financing in developing countries finds support in numerous business surveys and reports. In a survey of European and North American commercial banks conducted prior to the Equator Principles, reputational risk to be a 'key policy driver' in the development and expansion of environmental credit risk assessment policies.<sup>560</sup> Freshfield Bruckhaus Deringer, the international law firm, conducted a much larger survey in which respondents repeatedly spoke of 'the value and importance of reputation, the need to protect a good reputation and the difficulty in regaining a good reputation, if tarnished.'<sup>561</sup> Similarly, in a more recent IFC survey of financial institutions that have attended its Competitive Business Advantage Workshops, the most cited reason among respondents (66 percent) for considering environmental and social issues in investments was 'increased credibility and gain in reputation.'<sup>562</sup> Similarly, when asked to identify key environmental and social risks, again the most cited reason given by financial institutions (76 percent) was 'reputational risk / negative publicity with customers, shareholders and the general public'.<sup>563</sup> Indeed, as an example of how adopting the Equator Principles benefits corporate reputation, Unibanco's brand recognition as a socially responsible bank reportedly improved seven fold within the first three months of adopting the framework.<sup>564</sup>

What does this empirical case tell us about the explanatory power of the three beforementioned theoretical perspectives on private governance formation? As identified in chapter 3, the thesis adopted a synthesis approach for understanding private governance formation which carefully considered the validity of power, interest, and knowledge-based approaches to understanding why private governance

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<sup>559</sup> These figures refer to all 'participants' of the UN Global Compact, which includes companies (82 percent), NGOs (seven percent), Labor (one percent), and cities, universities, associations and foundations (a combined ten percent), see McKinsey & Co., 'Assessing the Global Compact's Impact', May 11, 2004. Date of Access: November 18, 2005.

[http://www.unglobalcompact.org/content/NewsDocs/Summit/imp\\_ass.pdf](http://www.unglobalcompact.org/content/NewsDocs/Summit/imp_ass.pdf)

<sup>560</sup> ISIS (2002), p.9. In this survey of commercial banks, it features a story of a Senior Director, who also held a board seat in another major industrial company. This company was the subject of a high-profile environmental pollution incident. The industrial company suffered huge adverse publicity and a downturn in public sentiment which all board directors, including Non-Executives witnessed, up front. As a result, the senior director determined that the Bank should not allow itself to fall victim to such reputational damage, even if only indirectly through its client relationships. This event triggered the development of the bank's environmental credit risk assessment policy. (ISIS 2002, p.12).

<sup>561</sup> FBD (2005), p.52. According to the report, banks used 'reputation' in two different senses. First, the need to protect the public image of the institution regarding internal decisions such as what projects to finance and, second, the vulnerability of the reputation of the bank to what the bank's customers or clients do, such as what project sponsors do in areas which are out of the control of the bank.

<sup>562</sup> See IFC (2007), p.5.

<sup>563</sup> See IFC (2007), p.6.

<sup>564</sup> UNEP (2006), p.15.

emerges. Having reviewed the emergence of the Equator Principles in detail, the final section will draw some conclusions about the validity of these perspectives relative to the six dimensions of private governance formation that were considered.

### **8.8 Summary: Revisiting the Three Theoretical Perspectives**

Overall, the empirical analysis provides support for a theoretical approach that resembles what Hurrell (1993) refers to as ‘weak cognitivism’. The study of private environmental governance entails explaining why TNCs include environmental and social considerations, many commonly regarded as public interest concerns, into their business practices in developing countries. It is difficult to explain the growth of corporate environmental practices, and private environmental governance more broadly, without reference to the changing public expectations of corporate performance. The commercial rationale for integrating environmental and social considerations into business practices rests in part on the need to enhance corporate reputation and defend corporate brands against reputational damages. As a result, there is often direct link between the pursuit of commercial objectives in the private sector and the evolution of public expectations and judgements about the legitimacy of different forms of corporate behavior. While the former can be understood within a rational-materialist logic, the latter is subject to the meanings and understandings external observers attach to different corporate practices. As such, understanding how and why norms emerge in the private sector is critical to explain variations in corporate environmental practices.

Chapter 3 identified three competing hypothesis for how and why private governance emerges, and table 8.2 summarizes the main findings. The theoretical perspective that was found to have the most explanatory power for each of the different aspects of private governance formation is shaded in grey. While the analysis found support for elements of all three theoretical perspectives, a neo-liberal institutionalist approach had the most explanatory power among the three. Not surprisingly, its explanatory power proved to be particularly strong relative to the other approaches in explaining those aspects of private governance formation that sought to explain behavior, and less useful in explaining why norms emerge and diffuse. Conversely, neither one of the three theoretical perspectives were found to have most explanatory power across all six dimensions of governance formation.

**Why Norms Emerge:** On the question as to why the Equator Principles became based on a particular set of environmental and social norms that had been institutionalized in the multilateral system, as opposed to norms that had emerged from within the private sector, the thesis finds support for a realist argument that powerful states, directly or indirectly through international organizations, in large part determine why particular norms emerge. In other words, having been institutionalized in the multilateral system seems to be a prerequisite for a norm to be influential, and by extension, for environmental advocacy group promoting it to be successful.

**Table 8.2 Three Perspectives on Private Governance Formation – Main Findings**

	<b>Realism</b>	<b>Neo-Liberal Institutionalism</b>	<b>Constructivism</b>
<b>Why norms emerge</b>	<b>Hegemony</b>	Efficiency	Legitimacy
<b>Timing</b>	Shift in balance of power between states	Change in institutional conditions and interest structure	<b>Rise and fall of international norms</b>
<b>Main initiators</b>	States (and international organizations)	<b>States, international organizations and transnational actors</b>	Norm entrepreneurs (both states and non-state actors)
<b>Sources of influence</b>	Economic resources	<b>Economic resources / technical expertise</b>	Knowledge / legitimate moral claims
<b>Governance structure</b>	(Inter)national, state-based	<b>Transnational, market-based</b>	Global, society-based
<b>Why norms are adopted</b>	Response to coercion	<b>Convergence in interests and response to incentives</b>	Effect of persuasion

Thus, while environmental advocacy groups were instrumental in diffusing norms between the institutional contexts of public- and private project finance, their success in large part depended on the legitimacy that these norms already enjoyed among states in the international system. For example, their success in pressing for environmental reforms at the World Bank in the 1980s depended heavily on mobilizing the support of key members of the U.S Congress, which used the United States' veto power on the Bank's board to establish an Environment Department and institutionalize environmental and social policies, particularly the public disclosure of environmental impact assessments. (*the Pelosi Amendment*, 1990) Therefore, this meant that when commercial banks initially rejected the norms and claimed they were irrelevant to their commercial project financing, they implicitly challenged the legitimacy of the World Bank, and by extension its government shareholders, in setting standards in transnational markets.

However, the alternative theoretical explanations of norm emergence were not entirely without merit. Neo-liberal institutionalists would argue that norms which most effectively solve conflicts and coordination problems between market participants and increase the efficiency of interactions are more likely to emerge and become institutionalized. An important objective for commercial banks leading the negotiations was to produce a framework that would prevent a divergence in environmental and social risk management practices, so as to avoid a race-to-the-

bottom in which competitive pressures would induce some banks to bypass the standards in exchange for more business. As a result, harmonizing practices was in many ways more important than which sets of standards that would be adopted. Choosing the IFC's policy framework as a blueprint for the Equator Principles was based in part on the fact that commercial banks, their clients, and public agencies involved with issuing operating permits and licenses were very familiar with them. As such, linking the Equator Principles with the IFC's policy framework ensured continued harmonization in the practices of public and private lenders, which clearly has its efficiency benefits when they co-finance projects. Yet, the reason that these norms had become influential was precisely because they enjoyed a multilateral endorsement for addressing a variety of public interest concerns.

**Timing:** In terms of explaining the timing of the Equator Principles, the thesis finds considerable support for the constructivist hypothesis that governance emerges as a consequence of norms shifts, which are triggered by the actions of norm entrepreneurs. The emergence and diffusion of environmental and social norms in the project finance market cannot be understood without reference to the growing influence of environmental advocacy groups. While their success rested on a strong moral case, which the existence of the World Bank's policy framework provided, the staging of advocacy campaigns was nevertheless a precondition for commercial banks to consider adopting them. Without them, the adverse environmental and social impacts of projects would not have been identified to the media, shareholders, consumers and indeed the banks themselves. These groups successfully argued that commercial banks should be held equally accountable for projects as public lenders, which meant abiding by the standards and procedures of the World Bank. As the empirical chapters demonstrated, the negotiations that led to the launch of the Equator Principles started at a time when the public scrutiny of projects peaked, as industry leaders all faced considerable pressure to mitigate the adverse development impacts of their projects. Therefore, as confirmed by interviews with bank executives, the efforts of these norm entrepreneurs was the single most important factor in determining the timing of the Equator Principles.

With regards to competing explanations, the realist hypothesis was not validated given that the timing of the Equator Principles cannot be directly traced back to the actions of any government. However, it is easy to identify a variety of complementary institutional developments that set the stage for the framework to emerge, and that could provide support for a neo-liberal institutionalist argument that a focus on changing interest structures best explains the timing of the framework. The Rio Summit in 1992 and the establishment of the UNEP FI in its aftermath led to a growing consciousness in the banking sector of both the risk that could materialize from being associated with controversial projects and the commercial opportunities presented by the growing public interest in sustainable development. In addition, numerous national-level policies alerted banks to the prospect that environmental damages associated with projects could result in legal liabilities, and shareholders began to put pressure on banks to strengthen internal control systems. As a result of both national and international developments, new environmental risk management

units and business divisions developing green financial products began to emerge in the banking sector, increasingly as part of an overall strategy to build a positive reputation in an increasingly competitive marketplace.

Yet, these developments do not explain the emergence of cooperation between commercial banks engaged in project financing, and why such initiatives did not arise between investors in other financial markets. In this regard, the emergence of the Equator Principles was a direct consequence of the higher level of public scrutiny against project finance loans in comparison to other forms of financing, and the demands put forth by environmental advocacy groups that commercial banks abide the World Bank's standards and procedures as a proxy for lending responsibly.

**Main Initiators:** Notwithstanding the significance of environmental advocacy groups, they lacked the authority to compel commercial banks to formally adopt the World Bank's standards and procedures. While there would be no collective interest among commercial banks to pursue cooperation without them, the main initiators of the Equator Principles were the handful of commercial banks that were under the most pressure to strengthen their environmental and social risk policies, and the IFC which was instrumental in convening them and providing technical expertise in the negotiations. The cooperation between commercial banks and the IFC built on relationships developed through their respective project finance operations. In particular, through its syndicated loan program, the IFC regularly partnered with commercial banks from the US, UK, the Netherlands and Germany, which resulted in personal relationships and informal ties between banking executives. These facilitated the organization of the first workshop and were critical to attracting the interest of a critical mass of banks.

On the basis of this observation, the thesis finds support for the neo-liberal institutionalist hypothesis that global financial and economic integration has expanded the influence of transnational actors in world politics by increasing the value of their resources and expertise. While commercial banks have taken advantages of the opportunities that liberalization and privatization reforms provided them in developing countries, multilateral development banks are both products and drivers of this development. For example, as a frequent promoter of private sector growth and investment as the most viable development strategy, the IFC has put pressure on developing countries to accommodate foreign investment and facilitate the privatization of industries. To this end, IFC financing is deliberately structured so as to stimulate additional private investment, thereby encouraging foreign investment, and more broadly, the globalization of finance.

A notable observation about the emergence of the Equator Principles is the complete absence of direct state involvement in the negotiations. Governments were not represented at meetings, and on the basis of primary data collected for this research, they were not consulted by either the IFC or the commercial banks in the consultation period that preceded the launch. While the praise that the framework has since received from governments, especially those of capital-exporting countries, suggests

that states may have endorsed the initiative and given it their tacit consent, it is nevertheless striking that a framework that would influence the way large public sector infrastructure projects would be governed was not subject to government consultation.

**Sources of Influence:** Leading commercial banks and the IFC, the main initiators of the Equator Principles, exerted influence primarily by virtue of possessing economic resources and technical expertise in project management, credit risk processes, and financial analysis, and being recognized as a legitimate ‘honest broker’ in convening negotiations and leading discussions, respectively. By extension, the thesis finds support for a neo-liberal institutionalist interpretation that the transnationalization of finance has created new policy spaces in which actors that operate transnationally and possess technical expertise that is seen to be globally applicable hold privileged positions over those whose objectives and interests are oriented towards particular states. Unlike other transnational governance processes based on an inclusive negotiating model that prioritized input legitimacy over expediency (such as the World Commission on Dams or the Extractive Industries Review), the Equator Principles were created by banking executives focused on improving environmental and social risk management processes as a means to reduce the reputational risk of project finance loans. In this context, the power of actors in the drafting process was primarily based on their significance in the market as well as their experience with project finance, and their technical expertise in environmental and social risk management. This point is supported by the fact that commercial banks have continued to dominate the negotiating process in the aftermath of the framework being launched. Since 2003, a network of project finance executives at leading commercial banks have met regularly to discuss revisions to the framework and issues related to implementation, often alongside members of Banktrack, the network of environmental advocacy groups.

**Governance Structure:** The thesis finds support for a neo-liberal institutionalist hypothesis that the governance structure of private governance would be driven by a concern for efficiency and generally conform to the logic of transnational markets by encouraging harmonization and globally applicable standards. Its institutional design reflects how cooperation emerged because of a collective interest among private actors to create or clarify legal liabilities, improve information quality and flows, and increase the efficiency of interactions by reducing transactions costs.<sup>565</sup>

First, in terms clarifying legal liabilities, the *Safeguard Policies* had a long track record in development finance, and broadly conformed to national laws and regulations in many countries.<sup>566</sup> As a result, applying them to project finance

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<sup>565</sup> Keohane (1982), p.338.

<sup>566</sup> Several bank officials that took part in the negotiations noted that although the working group could have formulated a new set of standards for commercially-oriented lenders, the pre-existence of global standards developed by a third party, such as the IFC’s *Safeguard Policies*, meant they were able to produce and agree upon a new industry standard for the global project finance market within seven months. ( EPFI-03; EPFI-06; EPFI-07; EPFI-08)



transactions could absolve commercial banks from bearing moral and ethical, if not legal, responsibilities towards local communities and the environment.

Secondly, in terms of reducing information imperfections, aligning the Equator Principles with the dominant standard that existed in the market would reduce uncertainty among lenders and borrowers, and encourage the removal of environmental and social risk management practices from the realm of competition.

And third, in terms of reducing transaction costs, the IFC's framework was well suited for an increasingly globally integrated industry, in which the project finance portfolios of commercial banks differed widely in their geographic and sectoral concentrations.<sup>567</sup> In addition, as most commercial project lenders had participated in IFC loan syndications, they had referred to its standards in their past practices, as had many of their corporate clients in environmentally-sensitive sectors such as oil, gas and mining.

So while the content of the framework was based on international norms, the governance structure was designed according to the strategic interests of commercial banks negotiating the framework. Overall, the legitimacy of the standards ensured that adopting them would mitigate the reputational risk in project financing, whereas creating a discretionary and informal governance structure allowed commercial banks to retain flexibility in integrating the standards into their own credit risk processes and apply them to their project financing.

**Why Norms Are Adopted:** In terms of understanding why commercial banks adopted the norms (e.g. the Equator Principles), the analysis finds considerable support for a neo-liberal institutionalist argument which explains corporate behavior in the context of the costs and benefits associated with different strategic choices. Returning to the 'spiral model' identified by Risse and Sikkink (1999), the adoption of the Equator Principles was a tactical concession in the case of most banks, and an affirmation of practice for a few others that consider compliance with the World Bank's standards and procedures to be an aspect of prudent risk management when financing particularly large projects in developing countries. Therefore, the thesis does not find support for the constructivist argument that a reconstitution of identities and interests explains new rule-following behavior.

The level of exposure to reputational risk explains which commercial banks showed the greatest interest in establishing an industry standard, and in the aftermath, which banks have been most aggressive in upgrading environmental and social risk management processes, consulting with environmental advocacy groups on issues related to reporting and implementation, and demonstrating compliance with the Equator Principles.

Indeed, the argument that the level of reputational risk determine the level of interest that different commercial banks had in creating the framework is supported by the

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<sup>567</sup> Lazarus (2004); EPFI-08.

observation that leading commercial banks that were faced with significant reputational pressures had difficulties in inducing other less scrutinized banks that did not see a commercial justification for adopting the framework and investing in additional staff and risk management training to implement it. While the emergence and growing legitimacy of the norms in the multilateral system, and later in global finance, cannot be explained without reference to the interests of powerful states and the actions of environmental advocacy groups, the adoption of the norms should be viewed in the context of the corporate strategies and market positions of commercial banks. This provides a basis for understanding why there are considerable disparities in environmental and social risk management practices between commercial banks operating in the same market.

The empirical analysis provides very little support for alternative explanations for why the ten commercial banks that initially adopted the framework did so. The validity of a realist explanation would depend on identifying some form of state coercion as the impetus for commercial banks to adopt the norms. But complying with these norms is not formally required in most developing countries, and the IFC does not have any formal powers over commercial banks. In fact, the pace and direction of negotiations was determined by the interests of commercial banks during the process, and promoters of the framework faced difficulties in convincing skeptical banks of the need to adopt the norms despite the lack of a regulatory obligation to do so. The fact that commercial banks were in a position to deselect aspects of the IFC's policy framework that they found objectionable, and their decision to build a significant level of discretion and flexibility into the framework, supports the notion that negotiations were driven by the banks own interests, and not an external threat of regulation.

Similarly, a constructivist approach which associates norm adoption with a reconstitution of identities and interests overstates the extent to which commercial banks have internalized the norms. Revisiting the Risse and Sikkink (1999) 'spiral model', the adoption of the Equator Principles amounted to a tactical concession for most banks, and should be viewed as an attempt to mitigate the reputational risk of financing. For others that already had fairly well-developed environmental and social risk management processes, adoption was both a tactical concession and a reaffirmation of the legitimacy of these norms. Therefore, a reconstitution of identities and interests was not a precondition for adopting the norms, as doing so was fully compatible with their preexisting commercial interests in the global project finance market.

Instead of manifesting a deeper transformation of corporate identities, the Equator Principles reflected a broader trend among commercial banks to pay greater attention to risk management in their international operations in response to financial losses resulted from some private financing in developing countries in the 1990s.<sup>568</sup> Thus,

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<sup>568</sup> For example, the financial support for APP in many ways epitomized how the absence of external pressure and long-term financial risk management led investors to absolve themselves of environmental and social responsibilities in favor of short-term profitability. According to one bank

the Equator Principles can be seen in the broader context of a continued improvement of credit risk processes as an aspect of enabling international diversification in project finance portfolios. As part of this, the management of reputational risks became an important imperative for those commercial banks that positioned themselves in the market as financiers of large-scale project transactions in developing countries. Whereas the potential financial losses of project risks were commonly confined to a single project, reputational risks associated with a specific project could adversely affect every division of the bank. Therefore, reputational risk management associated with project financing was much more of a corporate-wide concern than other product-specific risk policies. In turn, adopting the Equator Principles was not only a decision that affected project finance units within banks, but concerned the identity of the bank as a whole, and in particular, the reputation of their global corporate brand.<sup>569</sup>

## Conclusion

This thesis has considered the emergence of the Equator Principles in order to advance our understanding of how and why private actors are increasingly creating new forms of transnational institutions to govern corporate environmental and social practices. Given the growing prevalence of such institutions in global environmental governance, the thesis hopes to make a timely and constructive contribution to the study of international relations.

In concluding this thesis, two points should be made in relation to its broader contribution to further research on private governance formation; its implications for understanding norm emergence and diffusion in transnational markets, and its implications for the ongoing debate about the relative power of states and markets in an increasingly integrated global economy.

This case study illustrates the importance of considering the institutional features of markets in order to explain why institutionalized cooperation between private actors emerges.

First, an important observation made in this thesis is that the success of norm entrepreneurs targeting private actors is in large part determined by the characteristics of market transactions. Environmental advocacy groups have struggled to establish

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official close to the project, investors were drawn to the political connections of the company and the security it could provide, not foreseeing the collapse of the Suharto regime in 1998; 'When we approved the credit for millions of US dollars, we just signed and never asked in detail about the risks of the business.' (Anonymous, quoted in Pirard, R and Rokhim, R (2006), *Asia Pulp and Paper Indonesia: The business rationale that led to forest degradation and financial collapse*, Center for International Forestry Research (CIFOR), Working Paper No. 33, 2006, p.4.

<sup>569</sup> As Paul Clements-Hunt, the Head of UNEP's Finance Initiative, noted, 'adopting voluntary codes of conduct should be seen as an initial defensive reaction that creates a positive façade for a collective group of corporations in relation to issues raised in the public space.' (Paul Clements-Hunt, personal interview, January 25, 2006)

with absolute certainty what the proceeds of bond purchases or corporate loans will be used for, as evidenced by the failure to stem the flow of bond financing to the Three Gorges Dam project. As a result, they have been less effective in inducing changes in investment practices in these financial markets. In contrast, when financial institutions provide financing directly to projects, environmental advocacy groups are better able to clearly establish funding relationships and allocate blame for negative development impacts. As a result, even though corporate lending and bond financing dwarfs project financing in volume, it is less scrutinized by environmental advocacy groups, simply because the structure of these markets makes it difficult to ‘frame’ a convincing story that implicates financial institutions into particular environmental and social harms. This in large parts explains why a framework like to Equator Principles has not emerged in other financial markets.

Secondly, the case of the Equator Principles reveals how collective action problems among private actors are reduced in concentrated markets with a high degree of interaction between participants. While competitive, the project finance market is quite unique in that market participants frequently collaborate and therefore have a strategic interest in retaining good relationships with each other. The fact that co-financing through syndications, often involving both public and private lender, is the most common mechanism to capitalize large-scale infrastructure projects means that project finance executives had developed strong professional relationships with each other and established a basic level of trust that was essential for forging the kind of cooperation that arose in conjunction with the Equator Principles. Given that private governance is typically much more informally initiated and negotiated, the strength of relationships between key executives in the industry can become an important determinant as to whether cooperation materializes.

And third, although a reputational risk did emerge because of the activities of transnational advocacy groups, and indirectly, because of the preexistence of a multilateral policy framework that clearly de-legitimated project financing that did not comply with environmental and social norms, commercial banks had the power to decide how and when to act. While societal expectations have indeed risen with the emergence of the Equator Principles, potentially increasing the reputational (and by extension commercial) cost of norm violations, commercial banks still retain the flexibility to integrate these normative obligations as they see fit, and are not externally accountable to those affected by their decisions. Therefore, as predicted by the IFC itself, the threat of a damaged reputation remains the primary enforcement mechanism for voluntary business regulation of this kind.<sup>570</sup> While voluntary regulation has been successful in inducing corporate behavioral changes in some circumstances, it is not effective in inducing changes to corporate behavior in cases where markets suffer from imperfect information, or consumers and shareholders do not call for more responsible corporate conduct.

In this context, the emergence of the Equator Principles only represents a success story for transnational advocacy groups promoting greater accountability and

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<sup>570</sup> See Klein and Harford (2004).

transparency in global finance against the backdrop of the growing power of financial institutions in an increasingly global financial marketplace. The voluntary framework is indeed unique in financial markets, and only came about because of a set of very favorable circumstances, notably the market structure of project finance, the rise of public pressure, the preexistence of a feasible industry standard, and the leadership of a small group of commercial banks. Given these observations, it is hard to see how a similarly specific and operational framework for environmental and social risk management could emerge in other areas of finance in the near future, including corporate lending, bonds or private equity, where its impact may be much greater. The best hope is for the Equator Principles to be a normative reference framework to inform policy development in other areas of finance.

What this tells us is that in terms of ‘greening’ those transnational markets that states are unwilling or incapable of regulating, the obstacles and opportunities for voluntary regulation, never mind externally accountable rules, are primarily presented by the structure of the market and the institutional environment of market participants. As an example, the institutionalized norms and rules regarding client confidentiality significantly constrain the opportunities for making project finance transactions more transparent. Similarly, the growing tendency to syndicate and securitize investments in developing countries makes it increasingly difficult for external observers to ‘follow the money’ and associate environmental and social harms with particular investors. In this context, the reputational mechanism will fall short, as its effectiveness depends on the ability of norm entrepreneurs to clearly demonstrate that actors are engaging in illegitimate and inappropriate behavior, and be able to sufficiently sanction those that fail to comply.<sup>571</sup>

Yet, the framework is unlikely to be embedded in structures that enable independent monitoring and ensure public accountability. This leads us to the second point. Given resilience of voluntary regulation to external pressures from advocacy groups, what does the emergence of private governance tell us about the evolving relationship between public and private actors in international relations? An increasingly observable pattern is that international organizations are putting their legitimacy and political weight behind voluntary market-based regulation that largely depends on reputational mechanisms. Public authority is increasingly converging with new forms of private authority to promote non-hierarchical forms of regulation that address governance gaps produced by processes of transnationalization. Realizing that adopting a code of conduct marks the beginning of sustainable business, and not an end in itself, international organizations are trying to facilitate ‘social learning’ in the corporate sector by organizing business networks that encourage the sharing of knowledge and information about responsible corporate conduct. In doing so, they encourage the integration of national and international laws and regulations into voluntary frameworks that consist of largely aspirational principles around which private actors are expected to converge.

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<sup>571</sup> See Newell (2001a), pp.101-105, for a discussion on how environmental NGOs depend on broader support from consumers and shareholders to effectively pressure TNCs.

As such, the emergence of the Equator Principles is less about the decline of state authority in IPE, as perhaps a transformation of its social purpose.<sup>572</sup> In fact, international organizations have a long history of drafting voluntary codes for TNCs that draw on institutionalized norms in the international system. As early as 1977, the U.N established the Centre on TNCs (UNCTC), which coordinated the negotiation of a *Draft Code of Conduct on TNCs* that affirmed their obligation to respect national laws and legislation, and respect a variety of environmental and social norms and principles.<sup>573</sup> To counter the threat posed by this code, the OECD member states began the drafting of the precursor to the *Guidelines for Multinational Enterprises*, which initially stressed the obligation of countries to offer better national treatment to TNCs in accordance with international law.<sup>574</sup> Another example is the ILO's *Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy*, which contained principles related to environmental protection, workers' rights and the denouncement of bribery.

More recently, the *Global Compact*, launched by the U.N Secretary General at the World Economic Forum in Davos, Switzerland, in January 1999, has become the overarching framework for corporate social responsibility, tying in companies across countries and sectors. Its stated objective is to integrate environmental and social concerns into corporate practices, and encourage business to make investments in support of the development goals of the U.N.<sup>575</sup> Furthermore, it acts as social arena for a wide variety of international organizations to interact and form partnerships with private actors.<sup>576</sup> It is comprised of nested networks of private corporations administered by a small, formal secretariat, which are meant to diffuse into markets a set of ten principles based on norms and values embedded in four international agreements; *the Universal Declaration of Human Rights*, *the Fundamental Principles and Rights at Work* of the ILO, *the Rio Declaration on Environment and Development*, and *the U.N Convention Against Corruption*. The more than 2,400 companies that have thus far adopted the framework are expected to become advocates of the principles in their respective markets, and report annually on lessons they have derived from applying them in their business operations.<sup>577</sup>

In the financial sector, a variety of guidelines and voluntary codes of conduct have recently emerged, most of them products of public-private partnerships between international organizations and private financial institutions. Among them, the

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<sup>572</sup> For a discussion, see Falkner (2003), pp.75-78, and Lipschutz and Fogel (2002). As Higgott et.al (2000) suggest, the central question in contemporary IPE is to better understand how relations between non-state actors and states is changing and affected by transnationalism and an evolving global order. (p.6)

<sup>573</sup> Bendell (2004), p.11, and Muchlinski (1997).

<sup>574</sup> According to Muchlinski (1997), the use of international law as the benchmark for national obligations meant the OECD Guidelines were at odds with the Draft UN Code, as the latter emphasized national policy autonomy in devising laws and regulations for foreign enterprises and investors.

<sup>575</sup> Clapp (2005).

<sup>576</sup> Therien and Pouilot (2006), p.60.

<sup>577</sup> Ruggie (2002).

UNEP's Finance Initiative is the most widely adopted voluntary framework, with over 160 signatories. It was born shortly before the Rio Summit in 1992, when UNEP initiated a partnership with a selected group of commercial banks, which led them to formulate and adopt a *Statement by Banks on the Environment and Sustainable Development*. In 1995, the *UNEP Insurance Industry Initiative* (UNEP III) was launched for the insurance industry, and following a merger in 2003, these two policy initiatives formed UNEP FI.<sup>578</sup> In contrast to the *Global Compact* and the *OECD Guidelines*, the statements do not make explicit references to any U.N treaties or conventions, instead listing a series of voluntary commitments to integrate norms and values into investment practices, such as applying the precautionary principle to environmental risk management.

Thus, the collective legitimation of voluntary business regulation by international organizations is not an entirely recent phenomenon, yet is becoming an increasingly important aspect of global environmental governance, and is placing private governance within a broader 'shadow of hierarchy'. But significantly, despite material and discursive ties to international organizations and institutions, private governance of this kind largely remains externally unaccountable, and therefore provides limited policy space for norm entrepreneurs that wish to challenge voluntary institutional forms. Whereas transnational advocacy groups will remain influential in triggering reactive policy development in transnational markets, the structure of markets and the growing need to provide commercial justifications for environmental policy severely limits their leverage. As such, norm contests that pit concerns about environmental protection and social justice up against the institutionalized norms and practices of transnational business will continue to be a dominant feature of global environmental governance. This underscores the point that governance at the transnational level should be conceptualized as a continuous and deeply contested process, and not as a consensual outcome of bargaining processes between different classes of actors.

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<sup>578</sup> Following revisions in 2004, these statements are now formally referred to as the UNEP Statement by Financial Institutions on the Environment and Sustainable Development and the UNEP Statement of Environmental Commitment for the Insurance Industry.

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## ***APPENDIX 1 – THE EQUATOR PRINCIPLES***

4 June 2003

### **THE ‘EQUATOR PRINCIPLES’ AN INDUSTRY APPROACH FOR FINANCIAL INSTITUTIONS IN DETERMINING, ASSESSING AND MANAGING ENVIRONMENTAL & SOCIAL RISK IN PROJECT FINANCING**

#### ***PREAMBLE***

Project financing plays an important role in financing development throughout the world. In providing financing, particularly in emerging markets, project financiers often encounter environmental and social policy issues. We recognize that our role as financiers affords us significant opportunities to promote responsible environmental stewardship and socially responsible development. In adopting these principles, we seek to ensure that the projects we finance are developed in a manner that is socially responsible and reflect sound environmental management practices. We believe that adoption of and adherence to these principles offers significant benefits to ourselves, our customers and other stakeholders. These principles will foster our ability to document and manage our risk exposures to environmental and social matters associated with the projects we finance, thereby allowing us to engage proactively with our stakeholders on environmental and social policy issues. Adherence to these principles will allow us to work with our customers in their management of environmental and social policy issues relating to their investments in the emerging markets. These principles are intended to serve as a common baseline and framework for the implementation of our individual, internal environmental and social procedures and standards for our project financing activities across all industry sectors globally. In adopting these principles, we undertake to review carefully all proposals for which our customers request project financing. We will not provide loans directly to projects where the borrower will not or is unable to comply with our environmental and social policies and processes.

#### ***STATEMENT OF PRINCIPLES***

*We will only provide loans directly to projects in the following circumstances:*

1. We have categorised the risk of a project in accordance with internal guidelines based upon the environmental and social screening criteria of the IFC as described in the attachment to these Principles (Exhibit I).
2. For all Category A and Category B projects, the borrower has completed an Environmental Assessment (EA), the preparation of which is consistent with the outcome of our categorisation process and addresses to our satisfaction key environmental and social issues identified during the categorisation process.
3. In the context of the business of the project, as applicable, the EA report has addressed:
  - a) assessment of the baseline environmental and social conditions
  - b) requirements under host country laws and regulations, applicable international treaties and agreements.
  - c) sustainable development and use of renewable natural resources
  - d) protection of human health, cultural properties, and biodiversity, including endangered species and sensitive ecosystems
  - e) use of dangerous substances
  - f) major hazards
  - g) occupational health and safety
  - h) fire prevention and life safety
  - i) socioeconomic impacts
  - j) land acquisition and land use
  - k) involuntary resettlement

- l) impacts on indigenous peoples and communities
- m) cumulative impacts of existing projects, the proposed project, and anticipated future projects
- n) participation of affected parties in the design, review and implementation of the project
- o) consideration of feasible environmentally and socially preferable alternatives
- p) efficient production, delivery and use of energy
- q) pollution prevention and waste minimization, pollution controls (liquid effluents and air emissions) and solid and chemical waste management

Note: In each case, the EA will have addressed compliance with applicable host country laws, regulations and permits required by the project. Also, reference will have been made to the minimum standards applicable under the World Bank and IFC Pollution Prevention and Abatement Guidelines (Exhibit III) and, for projects located in low and middle income countries as defined by the World Bank Development Indicators Database (<http://www.worldbank.org/data/countryclass/classgroups.htm>), the EA will have further taken into account the then applicable IFC Safeguard Policies (Exhibit II). In each case, the EA will have addressed, to our satisfaction, the project's overall compliance with (or justified deviations from) the respective above-referenced Guidelines and Safeguard Policies.

4. For all Category A projects, and as considered appropriate for Category B projects, the borrower or third party expert has prepared an Environmental Management Plan (EMP) which draws on the conclusions of the EA. The EMP has addressed mitigation, action plans, monitoring, management of risk and schedules.

5. For all Category A projects and, as considered appropriate for Category B projects, we are satisfied that the borrower or third party expert has consulted, in a structured and culturally appropriate way, with project affected groups, including indigenous peoples and local NGOs. The EA, or a summary thereof, has been made available to the public for a reasonable minimum period in local language and in a culturally appropriate manner. The EA and the EMP will take account of such consultations, and for Category A Projects, will be subject to independent expert review.

6. The borrower has covenanted to:

- a) comply with the EMP in the construction and operation of the project
- b) provide regular reports, prepared by in-house staff or third party experts, on compliance with the EMP and,
- c) where applicable, decommission the facilities in accordance with an agreed Decommissioning Plan.

7. As necessary, lenders have appointed an independent environmental expert to provide additional monitoring and reporting services.

8. In circumstances where a borrower is not in compliance with its environmental and social covenants, such that any debt financing would be in default, we will engage the borrower in its efforts to seek solutions to bring it back into compliance with its covenants.

9. These principles apply to projects with a total capital cost of \$50 million or more. The adopting institutions view these principles as a framework for developing individual, internal practices and policies. As with all internal policies, these principles do not create any rights in, or liability to, any person, public or private. Banks are adopting and implementing these principles voluntarily and independently, without reliance on or recourse to IFC or the World Bank.

#### **EXHIBIT I: ENVIRONMENTAL AND SOCIAL SCREENING PROCESS**

Environmental screening of each proposed project shall be undertaken to determine the appropriate extent and type of EA. Proposed projects will be classified into one of three categories, depending on the type, location, sensitivity, and scale of the project and the nature and magnitude of its potential environmental and social impacts.

**Category A:** A proposed project is classified as Category A if it is likely to have

significant adverse environmental impacts that are sensitive, diverse, or unprecedented. A potential impact is considered 'sensitive' if it may be irreversible (e.g., lead to loss of a major natural habitat) or affect vulnerable groups or ethnic minorities, involve involuntary displacement or resettlement, or affect significant cultural heritage sites. These impacts may affect an area broader than the sites or facilities subject to physical works. EA for a Category A project examines the project's potential negative and positive environmental impacts, compares them with those of feasible alternatives (including, the 'without project' situation), and recommends any measures needed to prevent, minimize, mitigate, or compensate for adverse impacts and improve environmental performance. A full environmental assessment is required which is normally an Environmental Impact Assessment (EIA).

**Category B:** A proposed project is classified as Category B if its potential adverse environmental impacts on human populations or environmentally important areas—including wetlands, forests, grasslands, and other natural habitats—are less adverse than those of Category A projects. These impacts are site-specific; few if any of them are irreversible; and in most cases mitigatory measures can be designed more readily than for Category A projects. The scope of EA for a Category B project may vary from project to project, but it is narrower than that of Category A EA. Like Category A EA, it examines the project's potential negative and positive environmental impacts and recommends any measures needed to prevent, minimize, mitigate, or compensate for adverse impacts and improve environmental performance.

**Category C:** A proposed project is classified as Category C if it is likely to have minimal or no adverse environmental impacts. Beyond screening, no further EA action is required for a Category C project.

## **EXHIBIT II: IFC SAFEGUARD POLICIES**

As of 4 June 2003, the following is a list of IFC Safeguard Policies:

*Environmental Assessment*, OP 4.01 (October 1998)  
*Natural Habitats*, OP 4.04 (November 1998)  
*Pest Management*, OP 4.09 (November 1998)  
*Forestry*, OP 4.36 (November 1998)  
*Safety of Dams*, OP 4.37 (September 1996)  
*Indigenous Peoples*, OD 4.20 (September 1991)  
*Involuntary Resettlement*, OP 4.30 (June 1990)  
*Cultural Property*, OPN 11.03 (September 1986)  
*Child and Forced Labor*, Policy Statement (March 1998)  
*International Waterways*, OP 7.50 (November 1998)\*

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\*Note: The principal requirements relate to the role of IFC as a multi-lateral agency and notification requirements between riparian states which are generally outside the remit of private sector operators or funders. It is referenced for the sake of completeness. The substantive elements of good practice with respect to environmental and social aspects therein are fully covered by OP 4.01.

## **EXHIBIT III: WORLD BANK AND IFC SPECIFIC GUIDELINES**

As of 4 June 2003, IFC is using two sets of guidelines for its projects.

1. IFC is using all the environmental guidelines contained in the World Bank Pollution Prevention and Abatement Handbook (PPAH). This Handbook went into official use on July 1, 1998.
2. IFC is also using a series of environmental, health and safety guidelines that were written by IFC staff in 1991-1993 and for which there are no parallel guidelines in the Pollution Prevention and Abatement Handbook. Ultimately new guidelines, incorporating the concepts of cleaner production and environmental management systems, will be written to replace this series of IFC guidelines. When completed these new guidelines will also be included in the Pollution Prevention and Abatement



Handbook. Where no sector specific guideline exists for a particular project then the World Bank General Environmental Guidelines and the IFC General Health and Safety Guideline will be applied, with modifications as necessary to suit the project.\*

The table below lists both the World Bank Guidelines and the IFC Guidelines.

**World Bank Guidelines (PPAH)**

1. Aluminum Manufacturing
2. Base Metal and Iron Ore Mining
3. Breweries
4. Cement Manufacturing
5. Chlor-Alkali Plants
6. Coal Mining and Production
7. Coke Manufacturing
8. Copper Smelting
9. Dairy Industry
10. Dye Manufacturing
11. Electronics Manufacturing
12. Electroplating Industry
13. Foundries
14. Fruit and Vegetable Processing
15. General Environmental Guidelines
16. Glass Manufacturing
17. Industrial Estates
18. Iron and Steel Manufacturing
19. Lead and Zinc Smelting
20. Meat Processing and Rendering
21. Mini Steel Mills
22. Mixed Fertilizer Plants
23. Monitoring
24. Nickel Smelting and Refining
25. Nitrogenous Fertilizer Plants
26. Oil and Gas Development (Onshore)
27. Pesticides Formulation
28. Pesticides Manufacturing
29. Petrochemicals Manufacturing
30. Petroleum Refining
31. Pharmaceutical Manufacturing
32. Phosphate Fertilizer Plants
33. Printing Industry
34. Pulp and Paper Mills
35. Sugar Manufacturing
36. Tanning and Leather Finishing
37. Textiles Industry
38. Thermal Power Guidelines for New Plants
39. Thermal Power Rehabilitation of Existing Plants
40. Vegetable Oil Processing
41. Wood Preserving Industry

**IFC Guidelines**

1. Airports
2. Ceramic Tile Manufacturing
3. Construction Materials Plants
4. Electric Power Transmission and Distribution
5. Fish Processing
6. Food and Beverage Processing

7. Forestry Operations: Logging
8. Gas Terminal Systems
9. General Health and Safety
10. Health Care
11. Geothermal Projects
12. Hazardous Materials Management
13. Hospitals
14. Office Buildings
15. Offshore Oil & Gas
16. Polychlorinated Biphenyls (PCBs)
17. Pesticide Handling and Application
18. Plantations
19. Port and Harbor Facilities
20. Rail Transit Systems
21. Roads and Highways
22. Telecommunications
23. Tourism and Hospitality Development
24. Wildland Manage
25. Wind Energy Conversion Systems
26. Wood Products Industries
27. Waste Management Facilities
28. Wastewater Reuse

\* Exception (the following are World Bank Guidelines not contained in the PPAH and currently in use)

Mining and Milling - Underground

Mining and Milling - Open Pit

## APPENDIX 2 – RESEARCH INTERVIEWS

	LAST NAME	FIRST NAME	TITLE	EMPLOYER	DATE	CODE
1	Burrett	Richard	Managing Director of Sustainable Development	ABN Amro	03/05/06	redacted
2	Mulder	Herman	Former Vice-President for Group Risk Management	ABN Amro	22/11/06	redacted
3	Cochard	Eric	Head, Project Finance and Sustainable Development	Calyon	24/11/06	redacted
4	Smith	Justin	Senior Manager, Governance and Sustainability and Nedbank Enterprise Governance and Compliance	Nedbank	09/05/06	redacted
5	Hancock	Martin	Chief Operating Officer	Westpac	15/05/06	redacted
6	Abu	Baba	Director of Sustainable Banking	RBS	20/11/06	redacted
7	Diebert	Foster	Head of Sustainability Management	West LB	11/05/06	redacted
8	Miller	Shawn	Director, Environmental and Social Risk Management, Global Corporate and Investment Bank. Former NGO Liaison Officer, IFC.	CitiGroup, Ex-IFC	20/12/05 and 09/03/06	redacted
9	Flaherty	Pam	Senior Vice President for Global Community Relations	Citigroup	08/03/06	redacted
10	Sullivan	Francis	Deputy Head, Group Sustainable Development	HSBC	19/07/06	redacted
11	Rico	Stephanie	Spokeswoman	Wells Fargo	26/04/06	redacted
12	Kubusch	Jens	Credit Analyst in Sustainability Management	HVB		redacted
13	Evans	James	Senior Manager, Environmental Risk Management	RBC	08/11/06	redacted
14	Schreve	Leonie	Adviser, Corporate Social Responsibility	ING	04/05/06 and 11/04/07	redacted
15	Williams	Jon	Head of Group Sustainable Development	HSBC	27/04/06	redacted
16	Bray	Chris	Head of Environmental Risk Policy Management	Barclays	13/04/06	redacted
17	Murray	Gavin	Director Institutional and Corporate Sustainability at ANZ. Former Director, Environment and Social Development Department, IFC.	ANZ, Ex-IFC	20/12/05	redacted
18	Kyte	Rachel	Director of the Environment and Social Development Department	IFC	03/06/05	redacted
19	Sheahan	Bernie	Director of the Advisory Services Department	IFC	03/06/05	redacted
20	Lazarus	Suellen	Senior Advisor, ABN AMRO Bank, former Director of Loan Syndications, IFC.	ABN Amro, Ex-IFC	19/05/05	redacted
21	Armstrong	Glen	Co-Founder, Sustainable Finance Ltd., Former Senior Adviser on Sustainable Development, IFC.	Sustainable Finance Ltd., Ex-IFC	11/01/06 and 20/11/06	redacted
22	Chan-Fishel	Michelle	Manager, Green Investments Program	FOE-US	23/01/06	redacted
23	Hogue	Ilyse	Director, Global Finance Campaign	RAN	26/01/06	redacted
24	Frijns	Johan	Coordinator	Banktrack	03/05/06	redacted
25	Pols	Donald	Leader, Climate and Energy Campaign	FOE-NL	11/05/06	redacted
26	Chapple	Alice	Director, Centre for Sustainable Investment	Forum for the Future	20/11/06	redacted
27	Sohn	Jon	Senior Associate on the International Financial Flows and the Environment Project	WRI	02/03/06	redacted
28	Clements-Hunt	Paul	Head, UNEP Finance Initiative	UNEP	25/01/06	redacted
29	Robins	Nick	Head of Socially Responsible Investment (SRI) Funds	Henderson Global Investors	06/07/06 and 20/04/07	redacted