Client**Alert**

Global Mining and Metals Industry Group

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EP III: an open pit for finance?

The impact of the Equator Principles on the industry's environmental and social performance

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The Equator Principles (EP) is a risk management framework, adopted by financial institutions, for determining, assessing and managing environmental and social risk. EP applies globally to all industry sectors and covers project finance and various forms of lending. Currently, 79 financial institutions in 35 countries have adopted EP, covering more than 70% of international project finance debt in emerging markets. Financial institutions that follow EPs will not provide project finance or project-related loans where the client will not, or is unable to, comply with EP. The lenders' mantra was: "We will not provide loans to projects where the borrower will not or is unable to comply with our respective social and environmental policies and procedures that implement the Equator Principles." Recognising the unavoidable impact on the environment and communities from extractive industries is both complex and challenging. The latest round of revisions to EP – the third set, hence the abbreviation 'EP III' – have attempted to dig deeper into the relationship between financing and lender responsibility for the consequences. On the surface, the EP III appears to impose more onerous requirements on borrowers. Yet, they are designed to reconcile the role of lenders with the global consequences of their lending. But are lenders ready to be charged with the responsibility of being custodians of our global commons when the mechanism of financing mining projects, and the banking industry itself, are being re-invented?

Background

When EPs were first developed in 2003, the founding Equator Principles Financial Institutions (EPFI) aimed to create a voluntary framework for determining, assessing and managing the environmental and social (E&S) risks of major projects they were asked to finance. However, given the general lack of enforcement and the fact that their application is limited to project finance transactions, the effectiveness of EP has been called into question. The EPFI are seen as carving their environmental and social footprints onto landscapes around the world with little or no accountability. Lenders to mining projects have faced criticism that, blinded by returns, they have found ways of financing that have effectively circumvented the EP discipline of international best practices, such as the International Finance Corporation Performance Standards. Even when the EPs have been applied to mining project finance, they have not provided an effective enforcement tool for lenders. To some extent, a cursory application EP – either through blanket compliance covenants or the retainer of an independent environmental and social consultant (IESC) – has given some lenders a false sense of satisfaction that they have discharged their EP obligations and that the project is EP-compliant. Furthermore, the EP prescribe that lenders work with borrowers to help

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them comply by offering grace periods and only resorting to substantive enforcement mechanisms when these other means of correction have been exhausted. This has in fact undermined any leverage that EPFI lenders could have exerted on borrowers, making it clear that E&S compliance would not be the "deal breaker". With inconsistent application and no guidance, some of the EPFI lenders, even after years of being signatories to the EP, do not fully understand what EP compliance entails. In the mining industry, which has complex E&S impacts throughout project life-cycles, the effect is amplified. Will EP III change this?

Mechanisms of mining finance

Over the past 10 years since EP came into effect, the mining industry has experienced various changes, including the continued ups and downs of commodity prices and the arrival of superpowers from Latin America and Asia, including the BRIC nations (Brazil, Russia, India and China), bent on building a new global order both within and beyond their borders. The direction of the flow of funds has also changed. Old players are meeting new money and old money is not going as far. Until recently, traditional financing, whether through equity markets, project finance or syndicated lending, were the most common forms of mining finance. Non-traditional investors – such as state-owned enterprises, sovereign wealth funds, private capital, equipment leasing and infrastructure providers – played less of a role. Since the peak of the mining boom in particular, non-traditional investors have become the mainstay of mining finance, with traditional financing sources trailing behind. But the pendulum continues to swing.

Environmental legacy

A constant through the swings of the mining industry's fortunes is the inevitable E&S impacts of mining projects, from plant operations and processing to developing infrastructure, and the legacy of liability from former, abandoned and disused mines. The social impacts of mining projects are far-reaching and as diverse as the communities they interlope. The social licence to operate (SLO) is considered to be one of the essential factors in assessing mining project risks today.

Scope of EP III

EP III are designed to impose a discipline on project developers and to empower lenders to use their leverage or influence over the exploration, construction and operational phases of a mining project. Although the EP III continue to apply globally and to all industry sectors, their scope has notably expanded since the two previous versions. In 2003, it was limited to project finance where total project capital costs were US$50 million. In 2006, the threshold was lowered to US$10 million and expansion and project finance advisory services were incorporated. The EP III now covers project financing where the total capital cost is US$10 million or more, and this specifically includes:

- Reserve-based financing;
- Project finance advisory services;
- Bridge loans, where the life of the loan is less than two years and the project is intended to be refinanced by project finance or a project-related corporate loan; and
- Project-related corporate loans with a value of at least US$50 million.

Although the addition of corporate loans is a step towards capturing "indirect" project lending, the EP III only apply where all four of the outlined criteria are met:

- The majority of the loan is for a single project where the borrower is the operator or a major shareholder (direct operational control), or where a subsidiary of the borrower operates the project (indirect operational control);
- The minimum total aggregate loan amount is US$100 million;
- The EPFI's individual commitment is at least US$50 million; and
- The tenure of the loan is at least two years.

Lenders as advisers

In the EP III, lenders are now required to "guide and support the client through the steps leading to the application of the Equator Principles". This means that the EPFI, whether acting as financial advisors or lenders, must be fully conversant in the language of the EP III and the intricacies of E&S risk and impact assessment processes. The knock-on effect of this is that the EPFI is required to invest in, and make available, the necessary resources. With the increased accountability of the lenders' independent environmental and social consultant (IESC) in the EP III, responsibility for the scope and content of review by the IESC is now very much a team effort. Lenders cannot simply secure the appointment of an IESC and then use the IESC report to discharge their commitments for EP compliance. With timing considerations and other factors driving investment decisions, it begs the question whether this will change the way E&S impacts are prioritized by lenders in mining projects.

EP III and mining finance

All things considered, the questions remain as to the value of the EP III as the baseline for sustainable financing in the mining industry today. It does not matter that human rights are emphasized in the EP III, or that the carbon footprint of a project must now be assessed for reduction alternatives. With project finance no longer being the predominant method of mining finance and given that most non-traditional finance is not conducted by EPFI at all, but by those often outside EP law, such as sovereign wealth funds and financial investors, the EP III simply does not have enough reach. As the face of mining finance changes, if they are "below-threshold" lenders, EPFI cannot impose their will on other traditional or non-traditional lenders. Where project finance provides only a small percentage of the sector's capital, the potential for imbalance in the industry arises where those wanting or able to secure traditional bank finance are held to the significantly higher standards of the EP III, while non-traditional finance is not covered at all. The result is that EP III is likely to be of limited positive impact on the environmental and social performance of the mining industry overall. Instead, we see improvements in the environ mental and social performance of the industry being driven primarily by a combination of local law requirements and the recognized need for mining projects to have a 'social licence to operate'. Taken together, these are key ingredient for success.

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