



Institutions for People

Managing Environmental and Social Risks

A Roadmap for National Development
Banks in Latin America and
the Caribbean

Authors: Gijs Nolet, Willem Vosmer, Matthijs de Bruijn,
and Isabelle Braly-Cartillier

Editors: José Juan Gomes Lorenzo and Maria Netto

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Acronyms

AFD	Agencia Financiera de Desarrollo de Paraguay	FI	Financial institution
ALIDE	Asociación Latinoamericana de Instituciones Financieras para el Desarrollo	FINDETER	Financiera de Desarrollo Territorial de Colombia
BANCOLDEX	Banco de Comercio Exterior de Colombia	FIRA	Fideicomisos Instituidos en Relación con la Agricultura de México
BM&F BOVESPA	Bolsa de Valores, Mercadorias & Futuros de São Paulo	FTE	Full-time equivalent
BNDES	Banco Nacional de Desenvolvimento Econômico e Social do Brasil	GEF	Global Environment Facility
CDP	Carbon Disclosure Project	GHG	Greenhouse gas
CEF	Caixa Econômica Federal do Brasil	GRI	Global Reporting Initiative
CEO	Chief executive officer	IDB	Inter-American Development Bank
CSR	Corporate social responsibility	IFC	International Finance Corporation
E&S	Environmental and social	IFI	International financial institution
ESHS	Environmental, social, health, and safety	LAC	Latin America and the Caribbean
EBRD	European Bank for Reconstruction and Development	NCD	Natural Capital Declaration
EPs	Equator Principles	NDB	National development bank
ESG	Environmental, social, and governance	PRI	Principles for Responsible Investment
ESMS	Environmental and social risks management system	SME	Small- and medium-sized enterprise
		UN DESA	United Nations Department of Economic and Social Affairs
		UN PRI	United Nations' Principles for Responsible Investment
		UNEP FI	United Nations Environment Programme Finance Initiative

Executive Summary

This Monograph is part of a technical cooperation program, developed by the Capital Markets and Financial Institutions Division (CMF) of the Institutions for Development Sector (IFD) of the Inter-American Development Bank (IDB). It aims to showcase the importance of managing environmental and social risks and opportunities for sustainable development banking in Latin America and the Caribbean (LAC). The objectives of the publication are to (i) illustrate the growing importance of global sustainable financing; (ii) present how environmental and social risks and opportunities are being integrated by national development banks (NDBs) in LAC; and (iii) outline the costs and benefits of preparing and implementing environmental and social risks management systems (ESMS). The Monograph is based on a literature review, a survey undertaken by 17 NDBs in 9 LAC countries, and interviews with a group of 10 selected stakeholders. The survey was tailor-made for this research and contained a set of questions relating to environmental and social risks management systems (ESMS), including the relevant challenges and opportunities and the role of NDBs and governments in national and international sustainability initiatives. The survey results are presented throughout this publication. The interviews were conducted to validate the survey's results and to discuss the practices that were identified. Some of the findings of these interviews are highlighted in text boxes within the document. In addition, some of the lessons learned emanate from the professional experience of the authors, who have worked for several

years with financial institutions (FIs) around the world regarding ESMS.

The financial sector has a crucial role to play in promoting sustainability and it is increasingly fostering this role. Several initiatives have been launched during the past decade to assist the financial sector in this role, as well as to level the playing field. The initiatives provide for standards, codes of conduct, and roundtables at the global, regional, or local level. This publication will list a number of these initiatives as useful tools for FIs, either to share information and best practices or to develop or expand their systems and processes. Lately, local regulators have been taking it upon themselves to introduce good E&S practices, for example, through voluntary agreements or “Green Protocols”, as demonstrated by Colombia and Brazil.

Results are now evident that sustainable finance has built up significant scale in the global arena and is constantly increasing. The number of asset management companies, which now incorporate environmental, social, and governance factors into their investment selection, has grown from approximately 100 in 2006 to over 1,000 in 2013—representing almost US\$35 trillion in assets (United Nations' Principles for Responsible Investment, or UN PRI). A comparable trend has developed in terms of international project finance. Over the past decade, 78 major banks have adopted the Equator Principles to determine, assess, and manage environmental and social (E&S) risks in project finance. These 78 banks

represent 70 percent of international project finance in emerging markets. In addition, the financial sector has successfully established instruments for sustainable development, such as microfinance, carbon finance, impact investments, and green investments.

Within the financial sector, NDBs have a unique role in promoting sustainability. Due to their public mandate and the role they play in the local credit markets, NDBs are not only well positioned to support sustainable and low-carbon investments, but they can also leverage private capital for these public goods. They can play an important role by engaging with the private sector, understanding local concerns, and using a variety of financial and nonfinancial tools. Many NDBs in the LAC region are, in fact, already promoting sustainability and have acted as pioneers in their respective country. A study by the UNEP Finance Initiative (UNEP FI, 2011) reveals that they have been involved in sustainable policies for a longer period than their peers in the commercial banking sector. Of the 17 NDBs that participated in the survey that was undertaken for this publication, only 41 percent had an established ESMS, although 88 percent had integrated E&S risks into their due diligence process. Current examples from Tier 2 NDBs, in particular, have shown that their position in the local financial sector provides them with the leverage needed to promote good ESMS practices within the sector, particularly when the approach is combined with adequate capacity building for their FI clients. Both the desk review and the survey have showcased reasons why FIs—and, in particular, NDBs—should implement ESMS, and promote the following incentives for doing so:

1. Managing E&S risk is increasingly important for the quality of lending portfolios

With an increasing number of countries having put into place environmental and social legislation frameworks, and while civil society continues to demand sustainable development, FIs are being pressured to

adequately assess and manage E&S risks to avoid liability and maintain their reputation. What emerged from the survey was that risks and compliance issues were the key drivers for NDBs to consider implementing an ESMS (see Section 1.1.1). By appropriately managing its E&S risks, a bank can substantially improve the overall quality of its lending portfolio.

2. Managing E&S risks can promote new business opportunities

While risk was the first *reason* mentioned in the survey, business opportunity was an important *outcome* (see Section 1.1.2). Addressing sustainability in lending operations has proved to be a very powerful source of innovation and has generated new business for the majority of NDBs that were surveyed, examples of which will be presented in this document.

3. ESMS can support a more streamlined and efficient process to comply with national regulations

Given their public mandate, NDBs are tightly bound to comply with government regulation, which can be burdensome. Some NDBs may consider that the development of an in-house ESMS will increase this burden and add little value. The experience of developing and implementing an ESMS by some NDBs in the LAC region, however, has shown that it can be very effective in adhering to national regulations, as well as increasing the efficiency of the credit approval process. It may also assist in the regulatory reporting process, improve transparency, identify portfolio risk and, in some cases, shorten the approval period.

4. ESMS practices are increasingly important for accessing international financing

Today, most international financial institutions (IFIs), as well as bilateral or multilateral development agencies (e.g., the IDB), follow appropriate E&S guidelines.

Local FIs that have access to financial resources from IFIs are often required to apply the E&S standards of the IFI to their own operations. Some IFIs, including the International Finance Corporation (IFC) and the IDB, promote good ESMS practices on a global basis. In addition to multilateral and bilateral development agencies, a number of international environmental funds have been applying ESMS criteria for financing eligibility. With regard to climate change, for instance, funding mechanisms include the Global Environment Facility (GEF), Adaptation Fund, Green Climate Fund, and Carbon Fund (established by the Forest Carbon Partnership Facility), among others. These funding mechanisms originally channeled most of their resources through IFIs and UN agencies; however, more recently, they have begun to work with local entities (including NDBs). These organizations consider good E&S risk management practices to be key elements of eligibility criteria for local entities to act as executing agencies.

This publication will provide some key success factors and practical recommendations for NDBs to design and implement an ESMS framework, including:

- i. Ensuring endorsement and continuous support from senior management to bring about staff buy-in.
- ii. Integrating the ESMS in the bank's operational procedures and documentation, rather than building a stand-alone system.
- iii. Planning the implementation rollout with other operational procedures changes.
- iv. Making sure not to overburden staff and clients, but keeping the system and procedures practical and concrete.
- v. Opting for gradual rather than radical implementation, and continuously evaluating, adjusting, and improving the ESMS; the best way to go about this is to just start!

Introduction

As public agencies, national development banks (NDBs) have a key role in channeling funds to environmentally and socially sound programs and in incentivizing the private sector to follow good practices in E&S responsibility for sustainable economic development. National development banks are strategically placed to address the obstacles and market failures that private sector stakeholders face when they seek to improve their E&S performance and invest in E&S innovation.

The IDB is expanding its program of technical support to financial intermediaries, financial institutions (FIs) (including Tier 1 and Tier 2 banks, commercial banks, and NDBs), stock exchanges, and other key financial players, as well as their clients. Technical support will promote innovative financing instruments and programs to enhance E&S performance objectives in Latin America and the Caribbean (LAC), especially in the areas of climate change and sustainability.

As part of that initiative, the IDB has commissioned this publication to demonstrate the benefits of managing E&S risks and the potential opportunities for sustainable development banking in LAC, including examples and case studies of the experiences and good practices of NDBs in the region.

The objectives of this publication are to illustrate the growing importance of global sustainable financing; present the ways in which E&S risks and opportunities are being integrated into financial institutions

around the world and, in particular, by NDBs in LAC; and outline the costs and benefits of preparing and implementing environmental and social risk management systems (ESMS).

This Monograph is based on (i) a literature review; (ii) a survey of 17 NDBs in 9 different countries in LAC; and (iii) interviews of a group of 10 selected stakeholders, including representatives of NDBs, commercial banks, and international financial institutions (IFIs) (see Annex 1 for a list of participants).

A large sample of the development financial institutions in the region were contacted (70 when, for example, ALIDE—the regional association for development banks—has 64 members), and the survey received a 24 percent response rate with 17 NDBs participating. Those 17 NDBs represent a significant portion of the assets of all NDBs in the region (USD 1.2 trillion or 87 percent).¹ The final sample is also geographically representative with 9 out of 19 countries present in the original sample and with both national/subnational and regional institutions. Finally, the diversification ratio is also positive, with some institutions having a sector focus, such as small- and medium-sized enterprises (SMEs) or agriculture, and others with a much wider scope.

¹ Source: Data from the IDB; 2011 Assets for 102 NDBs in LAC. No data was available for three of the participants (AFD, Centro de Energías Renovables, and FIRA).

The results may include a certain bias, as banks involved in E&S risk management may have been more likely to answer the survey. Of the 17 participants, only 2 responded that they had no environmental and social risk management system (ESMS) at all; it is important to note, however, that a positive bias towards the topic is inherent to most surveys.

The survey that was undertaken contained a set of questions relating to ESMS, including the relevant challenges and opportunities, and the role of NDBs and governments in national and international

sustainability initiatives. The survey results are presented throughout the publication.

As a follow-up to the survey, 10 interviews with representatives from different types of financial institutions (FIs) were conducted to validate the results and to discuss the good practices that were identified. Some of the findings of these interviews are highlighted in text boxes within the document.

In addition, a number of the lessons learned come from the professional experience of the authors, who have worked for several years with FIs around the world in relation to ESMS.

Sustainability and Banking Institutions

E&S sustainability is particularly important to the LAC region, as it boasts unique environmental, as well as social, features. LAC countries are among the richest in the world in terms of natural capital. Latin America has more than 40 percent of the earth's biodiversity within a sixth of the world's most biologically diverse countries (Brazil, Colombia, Ecuador, Mexico, Peru, and Venezuela) (UNDP, 2010). Such biodiversity and its related ecosystems can generate environmental services, leading to direct inputs into the development of key sectors in LAC economies, which include agriculture, fisheries, forestry, tourism, as well as protected areas and hydrological services. In addition, the region is rich in culture, especially relating to its indigenous populace, estimated at approximately 40 to 50 million people and representing 8–10 percent of the region's overall population.²

1.1 Sustainability in Finance

The terms *sustainability* and *sustainable finance* are often used as broad, undefined concepts that can mean various things to different people. For the purpose of this publication, *sustainability* is defined as a concept that includes both risk and opportunity. It consists of three pillars: economic, social, and

environmental development. These are interlinked and must be considered as one in order to “meet the needs of the present without compromising the ability of future generations to meet their own needs” (UN, 1987). The financial sector uses this same definition, but has broadened the framework by linking it to financial sustainability, where financial profitability should not come as an environmental or social cost to society.

Sustainability is internationally recognized not only as central to the growth of emerging market economies (IFC, 2007), but also as crucial to the survival of the financial sector. It can be a means to overcome the challenges and criticism the sector has been facing, mainly because of the recent global financial crisis.

While previously (in the early 1990s), investments to increase sustainability were narrowly focused on environmental protection, the concept has evolved over time and now includes much broader environmental, social, and governance (ESG) aspects. These cover, for example:

² See: <http://www.iadb.org/en/topics/gender-indigenous-peoples-and-african-descendants/indigenous-peoples,2605.html>.

- *Environment*: air and water quality, land use and protection of natural habitats, water use and conservation, energy use and conservation, biodiversity protection, waste management, disaster risk management.
- *Social*: human rights, labor and working conditions, occupational health and safety, gender and diversity, resettlement, indigenous peoples, cultural heritage.
- *Governance*: anticorruption, adequate ESMS, business integrity, transparency and accountability.

It is clear that ESG issues need to be considered in terms of their interaction. For example, negative impacts on air and water quality can result in negative social consequences. The impact could jeopardize a community's water supply.

Sustainable FIs are those that have the practices in place that will adequately address those ESG issues in the businesses they finance, such as the following:

- *Environment (E)*: the financial sector has long adopted the principle of “doing no harm” and now is embracing the concept of “doing good” (i.e., going beyond mitigation of environmental impact to actively considering environmental investment).
- *Social (S)*: the financial sector is not only seeking to ensure that business activities respect core labor and health and safety standards, as well as human rights; it is also ensuring that their activities do not pose any harm to marginalized and vulnerable groups. Where possible, the financial sector supports their inclusion in more economically productive activities, as well as promotes gender equality.
- *Governance (G)*: UN Global Compact first integrated this concept into the sustainable development agenda and discussion in 2000, which included sustainable finance and responsible investment. Governance is now an integral part of the agenda, including business ethics and transparency, as well as the need for adequate ESMS.

Sustainable finance has two components: (i) the management of environmental and social risk (minimizing the downside) and (ii) the promotion of new business opportunities (i.e., in support of the financing of business activities that benefit E&S sustainability, maximizing the upside). In other words, sustainable finance is access to financial resources (loans, guarantees, grants, etc.) to enable investment (projects) in such a way as to promote environmental protection, social justice, and economic prosperity.

Within the global arena, sustainable finance has scaled up and continues to grow. As mentioned in the Executive Summary, the number of asset management companies that now incorporate ESG standards into their investments has grown substantially, from approximately 100 in 2006 to over 1,000 in 2013, representing almost \$35 trillion in assets.³

Seventy-eight major banks—by having adopted the Equator Principles⁴—now address E&S risk in their project finance transactions, which cover 70 percent of all international project finance in emerging markets. In addition, the financial sector has successfully established sustainability-based financial instruments, such as microfinance, carbon finance, and impact and green investments. More recently, regulators have been including E&S sustainability standards within their legislation, such as the protocols for green financing in Brazil and Colombia⁵ and the Paraguayan Roundtable for Sustainable Finance.⁶ Another recent initiative, the Natural Capital Declaration,⁷ represents the commitment of 41 major international banks (including 11 from the LAC region) to integrate natural capital standards into their financial products and services.

³ See <http://www.unpri.org/about-pri/about-pri/>; January 2014; data as of April 2013

⁴ See <http://www.equator-principles.com>.

⁵ See <http://www.ghgprotocolbrasil.com.br> and <http://www.felaban.com/praticas/2942047.pdf>.

⁶ See <http://www.fmo.nl/k/n114/news/view/10712/179/launch-of-the-paraguayan-roundtable-for-sustainable-finance.html>.

⁷ See <http://www.naturalcapitaldeclaration.org>.

1.1.1 Sustainability as a Risk

In the past two decades, E&S risk became a serious threat for FIs. As a result, E&S management has steadily gained a place in the risk management best practices of the financial sector. By identifying and managing the E&S risks related to clients and their business activities, FIs can improve their risk profile portfolios (IFC, 2007).

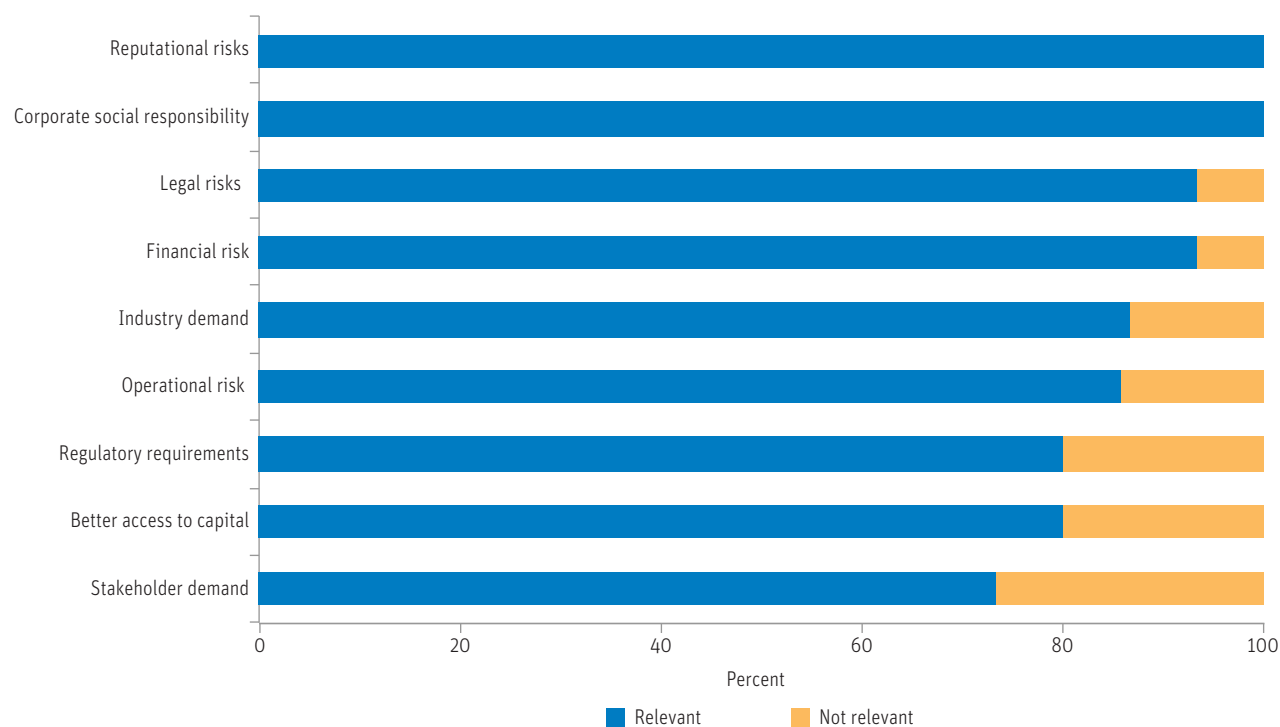
E&S risk primarily relates to potentially direct and indirect negative E&S impacts, generated by the business activity that is being financed by the bank. By financing high-risk projects, such as mining and infrastructure, the negative E&S impacts that will result will not only affect the enterprise, but also the bank that financed the project. The implications may have financial or legal consequences and/or reflect poorly on the FI's reputation. These risks, however, are not only present in high-risk projects. They are also present

where there are a large number of low-risk operations (e.g., microfinance in the textile sector) in one fragile region, and the risk may be significant when the cumulative impact is taken into consideration. Some projects that are considered medium risk (e.g., hotel and tourism development) may have negative spillover effects that can damage the surrounding natural environment or affect local communities, generating negative publicity. The risks should be properly identified and assessed prior to managing them. Those that are not systematically assessed may incorrectly be assumed irrelevant. Figure 1 below lists the relevant drivers for E&S risk management, identified by the NDBs that were surveyed.

In sum, E&S risks (see Figure 2 for a list) can have the following direct and indirect consequences:

1. *Credit risk.* This can occur when a client is unable to repay a loan or when negative impacts affect

FIGURE 1. Drivers for E&S Risk Management



Source: NDB Survey.

collateral due to E&S issues. A risk may be present when a client faces certain legal obligations, fees, and/or fines for E&S damage caused by negligence, or when the client is forced to pay compensation to affected third parties. These risks can still be present when complying with national and local E&S regulations.

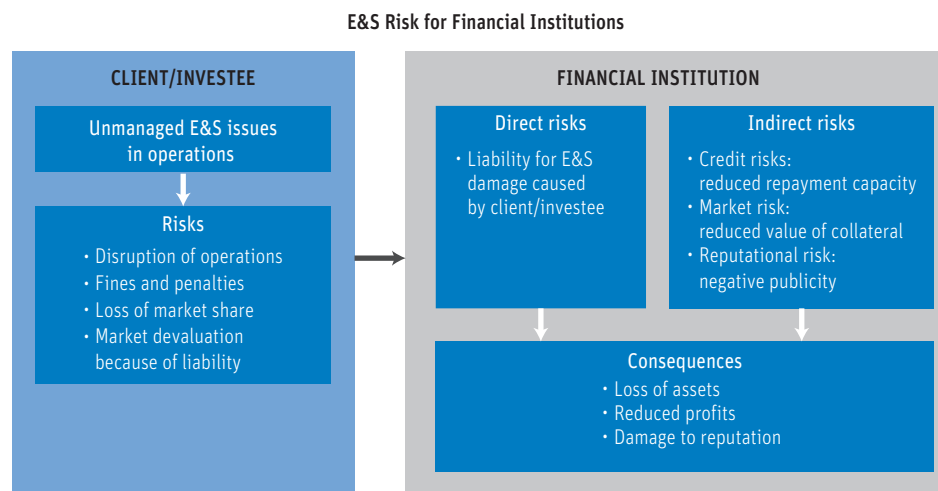
2. *Direct legal consequences.* Financial institutions in the LAC region have been, in some cases, legally responsible for E&S impacts due to their lack of due diligence in providing financing to projects or companies that have brought about E&S damage. In some countries, such as Brazil, an FI is considered to share responsibility for the damage with its client.
3. *Potential reputational risk.* By associating with certain clients or controversial business activities, an FI can lose its integrity. This can occur as a result of adverse actions by a client or an unfavorable business activity, which can be detrimental to the image of the FI in the face of the media, business and financial communities, and its own staff. Such damage can result in market boycotts, lower ratings, decreased market share, and a loss of business opportunities.

“NDBs that were surveyed regard mitigating risks and promoting sustainability as the main drivers for sound E&S management.”

Environmental and social risks are not static; rather, they are progressive over time and are subject to change. These risks may not appear to be relevant or significant during credit appraisal, but they may become so during the execution of the transaction because, for example, of the adoption of new and more stringent regulations or laws of increased levels of enforcement or public scrutiny. Managing E&S risk requires close analysis, consistent management, and monitoring to avoid not only what may seem insignificant impacts, but also what could become a *low probability, high impact* case, such as spills or explosions. While unlikely, should this occur, the E&S impact could be extremely high (e.g., BP’s Deepwater Horizon oil spill in the Gulf of Mexico).

Implementing an ESMS will enable the bank to understand and balance the E&S risks in its portfolio and allocate the necessary resources to manage the risks. Investing in an ESMS will also enable an FI to apply

FIGURE 2. E&S Risk for Financial Institutions



Source: FIRST for Sustainability (see <http://firstforsustainability.org>).

appropriate credit criteria, contractual arrangements, fee structures, and risk allocation mechanisms to reduce or eliminate E&S risk.

1.1.2 Sustainability as an Opportunity

Sustainability is not only about managing risk. Sustainability is viewed by the financial sector as a means to increase business opportunities. By applying E&S criteria in a systematic manner, an FI will be able to identify new products and markets, such as energy efficiency, carbon markets, and green mortgages. When clients engage in improved risk and resource management, they can anticipate regulatory enforcement, realize cost savings through more efficient resource use, and increase market access through better practices, certification, and integrity—all adding to a client’s creditworthiness.

As shown in Figure 3, the NDBs that were surveyed identified the following benefits of addressing sustainability in their own operations:

- Formalizing and disclosing sustainability programs leads to improved relations with stakeholders, such as governments, nongovernment organizations (NGOs) and financial partners.

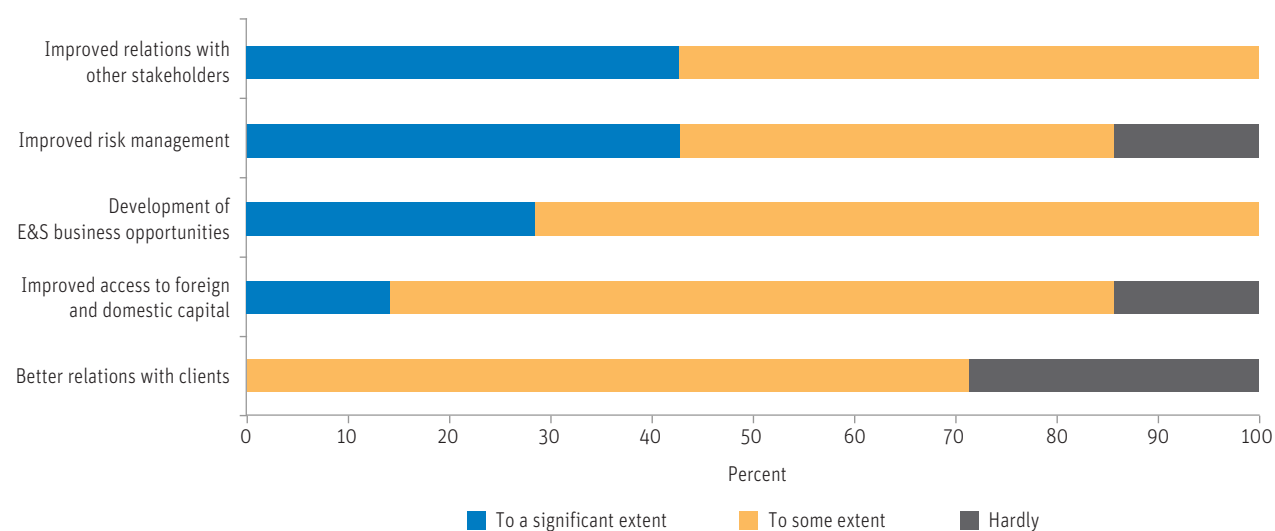
- Focusing on the financing aspect of sustainability presents E&S business opportunities to both clients and financial institutions.
- Systematically including E&S risk in risk management practices leads to improved risk management.
- Applying E&S standards to lending operations leads to improved access to capital, as most international lenders, such as development banks (e.g., the IFC and the IDB) and institutional investors (e.g., pension funds), now require FIs to implement adequate E&S risk management mechanisms.
- Understanding a client’s position with regard to sustainability leads to improved client relationships, as clients often will appreciate a lender that can help them address the E&S challenges they will face.

Most importantly, NDBs expressed that implementing their sustainability programs provided them with a new way of looking at clients, products, portfolios, and employees. It essentially introduced a new way of looking at business.

1.2 Sustainability and NDBs

There is a growing awareness that NDBs have a unique role in promoting sustainability in their countries

FIGURE 3. Benefits for Surveyed Banks of Addressing Sustainability in Lending



Source: NDB Survey.

Box 1. Bancolombia: Sustainability as a New Way of Looking at Business

Bancolombia, S.A., is Colombia's largest commercial bank in terms of assets and shareholder equity and is generally considered a leader in sustainability. According to the IDB's beyondBanking Survey of 2011, Bancolombia is one of five banks in the LAC region that is best positioned with regard to E&S responsibility and corporate governance.

In 2012, Bancolombia entered the Dow Jones Sustainability World Index,^a the global index that evaluates the sustainable management of more than 2,500 companies in 58 economic sectors, worldwide. Out of 193 international banks, only 26 were selected to be included in the global sustainability index, one of which was Bancolombia. *With a score of 81 out of 100, it is one out of four Latin American financial institutions and the first in Colombia that became part of this group.* Bancolombia is also included in The Sustainability Yearbook 2013,^b an annual publication prepared by RobecoSAM, one of the world's most prominent sustainability investment groups.

For Bancolombia, managing E&S risks by closely working with clients and suppliers is associated with new business opportunities. During the regular visits to suppliers, as part of guaranteeing a sustainable supply chain, the bank became familiar with various firms and was able to help promote new business opportunities. For environmental enterprises, Bancolombia offers attractive financing instruments that contribute to more efficient and cleaner activities, such as environmental credit lines (using subsidies provided by the Government of Switzerland) and carbon market credits (supported by the IDB). Through its alliance with technical experts, Bancolombia also has been able to assist customers to identify opportunities in emerging markets.

In addition, Bancolombia has developed a Code of Good Corporate Governance, committing it to good governance, ethical procedures, transparency, and corporate and social responsibility (CSR). According to Bancolombia, it has (i) generated confidence among all parties interested in Bancolombia; (ii) drawn new investors and facilitated the securing of finance resources; (iii) improved communication with interested parties; (iv) promoted a culture of transparency, ethics, responsibility, and management; (v) prevented illicit business and conflicts of interests; and (vi) ensured compliance with relevant regulations.

Source: www.grupobancolombia.com.

^a <http://www.sustainability-indices.com>.

^b http://www.sustainability-indices.com/images/sustainability-yearbook-2013_tcm1071-363199.pdf.

(IDB, 2013a). The fundamental focus of NDBs is on long-term financing to projects that will foster development and generate positive externalities. A unique characteristic of an NDB is that when it considers a financing opportunity, it not only takes into account the financial return, but also the economic, environmental, and social development impacts. Due to their public (sectoral or national) mandate and special status in local credit markets, NDBs are not only well positioned to support sustainable and low-carbon investments, but they are also able to leverage private capital for these public goods. Their strong

engagement with the private sector, understanding of local conditions and sectors, and ability to use a variety of financial and nonfinancial instruments (including long-term financing, syndication, equity, guarantees, technical assistance, etc.) give them the capacity to play a fundamental role in sustainable finance (UN DESA, 2005; IDB, 2012a; IDB, 2012b). One area, in particular, where NDBs are already playing a key role is climate change. A recent study indicated that a select number of NDBs have financed around US\$89 billion in programs that address climate change (IDB, 2012b).

1.2.1. Environmental and Social Risk Management and NDBs

NDB Survey: What type of E&S risk management has your institution integrated into its processes?

E&S in due diligence:	88%
E&S categorization:	69%
E&S monitoring of clients:	65%
E&S requirements in contracts:	59%
Exclusion List:	59%
E&S Management System:	41%

The survey that was undertaken relating to the integration of E&S risk management among NDBs in the LAC region shows a mixed picture. Nearly all those surveyed have integrated some elements of E&S risk management into their operations, but less than half of them carry it out in a structured and integral form. The survey indicates that 88 percent of NDBs include E&S criteria in their due diligence, 69 percent categorize their transactions based on E&S risks, 65 percent monitor their clients' compliance with E&S criteria, 59 percent exclude the financing of certain activities on the basis of an Exclusion List, and 59 percent have specified E&S requirements to borrowers in contractual arrangements. At the same time, only 41 percent of NDBs indicated that they have a full-fledged ESMS in place. These figures indicate that NDBs regard E&S risk management as an important issue, but that the manner in which it is applied is not the same across the board. This can be explained by differences in their E&S risk profiles (see Section 4.3). Furthermore, some NDBs may rely more stringently on national regulatory frameworks than others (see Section 2.3)

1.2.2 The Difference between Tier 1 and Tier 2 NDBs

NDBs operate as Tier 1 and Tier 2 banks, sometimes combining the two models (UN DESA, 2005). Tier 1 institutions deliver financial services directly to their clients

(e.g., individuals, corporations, or projects), while Tier 2 NDBs channel resources through financial intermediaries, including commercial banks (IDB, 2012b). Tier 2 NDBs take the credit risk of the intermediary, and the intermediary assumes the credit risk of the project (IDB, 2012c). Given their more direct link with the beneficiaries—and thus, more direct exposure to E&S risk—it is not surprising that the survey results show that an ESMS is more common in Tier 1 banks (50 percent) than in Tier 2 banks (14 percent) in the LAC region.

In general, Tier 2 NDBs channel the financial resources to the private or public sector through eligible Tier 1 local FIs. As a consequence, the Tier 2 FIs (and even more so their financiers, such as IFIs) have less direct control over E&S issues than their Tier 1 counterparts to ensure that the final recipients of the financing have sound and adequate E&S measures in place.

Nevertheless, Tier 2 NDBs may have substantial leverage on the use of their credit and guarantee facilities, as well as a crucial impact on their local banking sector, but they need to address E&S issues with specific approaches. The specific characteristics of an ESMS for Tier 2 NDBs are described in Section 4.4.

1.3 The Financial Sector as a Driver for Change

The financial sector, while having entered relatively late into the sustainability discussion, is now emerging as an important driver for new initiatives relating to sustainability standards, codes of conduct, and roundtables at the global, regional, and local levels (IFC, 2007). At the global level, the UNEP FI has been a catalyst for change by bringing together key players in the financial sector and through its publications (see UNEP FI, 2011). In the LAC region, this type of dialogue is becoming increasingly common practice. For instance, the four leading commercial banks in Paraguay have recently established a Paraguayan Roundtable for Sustainable Finance to harmonize and potentially raise ESG standards in the country (June 27, 2013). By bringing together industry peers, the roundtable will be instrumental in implementing best practices.

Box 2. Agencia Financiera de Desarrollo: Promoting Long-Term Financing in Compliance with Short-Term Renewable Environmental Permits

Loan maturities are one of the barriers facing the financing of most programs, including environmental projects. Investment in green markets usually requires medium- to long-term financing whereas, due to their own funding structure, commercial banks promote lending on shorter terms. Agencia Financiera de Desarrollo (AFD) in Paraguay, as a Tier 2 bank, has been successful in changing the culture of the Tier 1 banking system by thinking more long term, paving the way for future investment in greener projects. Another barrier is the disparity between the terms of the environmental license (one to two years) and the duration of the funding, which makes the application of stringent environmental covenants in loan agreements more complicated. AFD's financial intermediaries are legally bound to ensure that all final beneficiaries of its funding have a valid environmental license. The use of environmental covenants in loan agreements beyond the license is not common practice in the market.

Ronald Granados, former President and Board Member of AFD, commented on the AFD's environmental conditions:

"We have been showing banks that the world does not end after 365 days and encourage them to think long term. As to environmental licensing, the law has its minimum requirements, although we are aware of the bureaucratic challenges for end-customers always to be in full compliance. Nevertheless, there are ways in which to continue promoting longer-term financing for environmentally sensitive investments without deteriorating the risk profile of the loan. Having the knowledge of those E&S risks and the tools to analyze them definitely helps attain the right balance for the financing that AFD can promote."

Due, in part, to strong criticism towards the financial sector as being partially to blame for the global financial crisis of 2008–09, the sector finds itself

in need of fundamental reform. In particular, when public resources are used (e.g., in the case of state-owned and multilateral development banks), sustainability measures should be included to "maintain their social license to operate" (Coastal Quest/Blue Earth Consultants, 2012). At the same time, one of the main drivers of initiatives for sustainability is the strong belief that by embracing sustainability and exhibiting leadership, banks will achieve a competitive advantage. Furthermore, there are several global financial mechanisms that provide international financing, such as carbon finance for climate change, and FIs have now realized that in order to take advantage of the opportunities in this area, they will need to strengthen their sustainability agenda (UNEP, 2011).

The survey conducted for this paper specifically targeted NDBs in the LAC region and builds upon several recent surveys regarding the financial sector and sustainability (IDB, 2011; Coastal Quest/Blue Earth Consultants, 2012; UNEP FI, 2012). They indicate that there are significant variances among different regions and types of FIs. At the global level, banks with a developmental mandate generally have more robust structures in place for considering ESG issues and had established them sooner (Coastal Quest/Blue Earth Consultants, 2012).

Not all FIs consider the varying ESG issues equally relevant to their business. Some attach a high priority to governance issues, while others focus more on environmental standards. The priority remains different for each country and it depends on the type and size of the FI. This came to light in the recent IDB regional survey of 55 private and public banks in the LAC region (IDB, 2011), wherein only 62 percent of the banks incorporate E&S standards for their credit and loan business. The IDB survey also shows that anti-corruption is considered more important compared to E&S issues, given that policies to combat money laundering and corruption were in place at a significantly higher number of FIs (above 90 percent).

The surveys also indicate that large commercial FIs, operating at an international level, have taken into account the business case for E&S management and have

embraced E&S risk management as an integral part of their risk management practices. In some cases, however, this may have been initiated by external factors, such as pressure from stakeholders or the conditionality of international funding agencies. Some FIs capitalize on the basis of E&S risk management to explore business opportunities relating to environmental and social matters or sustainable development. These FIs position themselves as green or sustainable institutions, as a result of stakeholder and/or peer pressure. International initiatives, such as the Equator Principles and the UN PRI, prove that interest from the financial sector in environmental and social issues continues to grow.

While an increasing number of FIs have already developed robust E&S policies and procedures, some—mostly smaller public and private FIs—remain skeptical of the benefits of systematically managing E&S issues. This skepticism is based on several prevailing perceptions: E&S risks are not immediately relevant to the market segment in which the FI operates; E&S risks do not impact the FI's financial performance; E&S management is not deemed to be the FI's responsibility but rather that of regulatory and enforcement agencies; and FIs consider that managing E&S issues provides no value addition to their portfolios, but only increases transactional costs. In addition, FIs may not be sufficiently convinced that there are, in fact, any business opportunities, given their belief that green markets fall within a niche in which they cannot compete.

The surveys confirm that in the financial sector, as a whole, FIs (including NDBs) can benefit from additional information and support. This leads to their understanding that sustainability presents not only a framework to manage risks, but also a window for new business opportunities, including in fast-growing areas, such as sustainable energy and cleaner production, which can enhance their access to financing.

1.3.1 Key Sector Initiatives

Over the past decade, several initiatives have been launched to promote sustainability in the financial sector, as well as to level the playing field. The following

NDB Survey: How do you consider the added value of these initiatives?

Good source of information:	73%
Driver for E&S management:	40%
Level playing field among FIs:	40%
Marketing tool:	13%
Seal of approval:	7%

nine initiatives have been the most relevant to the NDBs that were surveyed in the LAC region.

Finanzas Carbono (Carbon Finance): This initiative is a knowledge e-platform, developed by the Capital Markets and Financial Institutions (CMF) Division of the IDB and maintained by the Fundación Torcuato Di Tella of Argentina.⁸ Its main objective is to be a tool for decision making by strengthening the knowledge and skills of key stakeholders in the public and private sectors in LAC relating to climate finance. It serves as a web-based meeting point for those involved with climate finance and carbon markets in the LAC region to exchange information, skills, and services. It enables collaboration with various international experts, several private and public institutions, and international organizations. The website has a dedicated community of practice from financial institutions, providing webinars, e-learning materials, online chats, information on events, and a library of studies and publications about FI experiences in the design and promotion of green financing instruments.⁹

UNEP Finance Initiative: This UNEP FI program is a unique global partnership between the UNEP and the global financial sector. The UNEP FI works closely with over 200 FIs and a range of partner organizations to develop and promote linkages between sustainability

⁸ For more information, see <http://finanzascarbono.org/> or www.itdt.edu.

⁹ For more information, see <http://finanzascarbono.org>.

and financial performance. Through peer-to-peer networks, research, and training, the UNEP FI carries out its mission to identify, promote, and support the adoption of best environmental and social sustainability practices at all levels of financial institutions' operations.¹⁰

Global Reporting Initiative (GRI): A pioneer in its initiative, GRI developed a comprehensive Sustainability Reporting Framework that is widely used around the world to disclose sustainability performance in a way that is comparable and as commonplace as financial reporting. The GRI reporting framework provides sustainability reporting guidelines and sets out the principles and indicators that organizations and companies can use to measure and report on their sustainability performance.¹¹

United Nations (UN) Global Compact: Established in 2000, the UN Global Compact is a strategic policy initiative for businesses that are committed to align their operations and strategies with 10 universally accepted principles in the areas of human rights, labor, environment, and anticorruption. By doing so, businesses—as the primary drivers of globalization—can help ensure that markets, commerce, technology, and finance advance in ways that will benefit economies and societies everywhere. With over 10,000 corporate participants and other stakeholders from over 130 countries, it is the largest and most widely recognized voluntary corporate responsibility initiative in the world.¹²

Natural Capital Declaration (NCD): The declaration is a commitment by chief executive officers (CEOs) from the financial sector and was launched at the Rio+20 Earth Summit in 2012. The NCD was created so that FIs can benefit from greater guidance to embed specific ESG factors in their risk management, due diligence, loan assessment, investment, and insurance activities. The declaration demonstrates a commitment by the financial sector to change business models to reflect the application of natural capital in their financial products and services.¹³

NDBs surveyed: Which initiatives do you adhere to?

Finanzas Carbono:	47%
UNEP Finance Initiative:	40%
Global Reporting Initiative:	27%
UN Global Compact:	27%
Natural Capital Declaration:	20%
Equator Principles:	13%
Carbon Disclosure Project:	13%

Equator Principles (EPs): Established in 2003, the EPs are a widely adopted credit risk management framework for determining, assessing, and managing E&S risk in project finance. Since its update in June 2013, it also includes certain corporate loan transactions. The EPs are applied where total project capital costs exceed US\$10 million. The EPs are primarily intended to provide a minimum standard for due diligence to support responsible risk decision-making. The EPs consist of 10 principles and build on and incorporate the IFC's Performance Standards and associated Environmental, Health and Safety (EHS) General Guidelines. Signatory institutions include global and local banks and other financial institutions, which provide project and corporate finance in emerging markets.¹⁴

Carbon Disclosure Project (CDP): This project is an international NGO, providing companies and cities with a global system to measure, disclose, manage, and share vital environmental information. The objective of the CDP is to motivate companies to disclose their impacts on the environment and natural resources and take action to reduce them. CDP now holds the largest collection, globally, of primary climate change, water,

¹⁰ For more information, see <http://www.unepfi.org>.

¹¹ For more information, see <https://www.globalreporting.org/Pages/default.aspx>.

¹² For more information, see <http://www.unglobalcompact.org>.

¹³ For more information, see <http://www.naturalcapitaldeclaration.org>.

¹⁴ For more information, see <http://www.equator-principles.com>.

and forest risk information and puts these insights at the heart of strategic business, investment, and policy decisions.¹⁵

BM&FBOVESPA Corporate Sustainability Index (ISE):

The Brazilian Stock Exchange Sustainability Index, supported by IFC, was launched in 2005 and is the fourth index of its kind in the world and the first in the LAC region. It provides a comparative analysis of the E&S performance of the companies listed on BM&FBOVESPA, enhancing public understanding of the commitment, policies, and performance of companies and groups with regard to ESG factors.¹⁶

National Green Protocols:

- **Protocolo Verde of Brazil:** Signed in 2009, the Protocolo Verde is an initiative of the Brazilian financial sector and the Environment Ministry through the latter's banking association, Federação Brasileira de Bancos (FEBRABAN). The protocol aims to improve cooperation between financial institutions on sustainable development in Brazil. Commitments made under the Protocol include the promotion of green and social financing products, environmental and social risk management,

internal environmental management, and capacity building. Banks report on compliance with the Protocol on the basis of a set of indicators.¹⁷

- **Protocolo Verde of Colombia:** A similar initiative was launched in Colombia. The very recent signing of this voluntary agreement between the Colombian Government and the financial sector aims to generate environmental benefits to Colombian society. Similar to the Brazilian Protocol, it includes different strategies and guidelines for banks to offer credit lines and/or investments that will contribute to quality of life and sustainable use of renewable natural resources. The strategies also consider the impact and environmental costs in asset management, risk analysis, and project financing.¹⁸

¹⁵ For more information, see <https://www.cdp.net/en-US/Pages/HomePage.aspx>.

¹⁶ For more information, see <http://www.bmfbovespa.com.br/indices/ResumoIndice.aspx?Indice=ISE&Idioma=en-US>.

¹⁷ For more information, see http://www.febraban.org.br/Noticias1.asp?id_texto=626&id_pagina=61&palavra=protocolo%20ambiental.

¹⁸ For more information on this initiative, see [http://unfccc.int/files/cooperation_and_support/financial_mechanism/standing_committee/application/pdf/protocolo_verde_colombia_-_version_final_-_20120604_\(2\)\[1\].pdf](http://unfccc.int/files/cooperation_and_support/financial_mechanism/standing_committee/application/pdf/protocolo_verde_colombia_-_version_final_-_20120604_(2)[1].pdf).

Box 3. The IDB and Its Support to NDBs for the Implementation of an ESMS

An ESMS can only be successful if it is tailored to the FI that implements it. The ESMS must also be supported by the senior management of the institution and receive the adequate resources for capacity building and strengthening. It is on those basic principles that the IDB's CMF Division developed a specific technical assistance program to assist NDBs in the LAC region to design and implement their own ESMSs.

To date, the IDB has helped, or is currently helping, four institutions in the region: La Financiera del Desarrollo Territorial Ltd.(FINDETER) and BANCOLDEX in Colombia and Financiera Rural and FIRA (Fideicomisos Instituidos en Relación con la Agricultura) in Mexico. Other institutions will be included in the coming months.

For most of these FIs, the building of an ESMS has occurred in parallel to, or has resulted in, new product lines dedicated to sustainable products, such as energy efficiency in hotels and hospitals for Bancoldex, sustainable cities for FINDETER, sustainable forestry for Financiera Rural, and sustainable use of water for FIRA.

CMF has also supported regional initiatives to disseminate and share expertise and best practices on the topic, in coordination with the Latin American Association of Development Financial Institutions (Asociación Latinoamericana de Instituciones Financieras para el Desarrollo, or ALIDE) and through the Finanzas Carbono platform.



The Rationale for Sustainability in Banking Operations

2.1 The Benefits of an ESMS

The most common approach to structurally address sustainability issues in banking operations, to date, has been the ESMS. It is believed to be the first step, given that the principal business of banks is to provide access to finance, where credit risk reduction and guarantee protection are the key motivators for profit—the principal objectives of an ESMS.

The introduction of an ESMS is often faced with resistance. Operational staff may feel the implementation of ESMS guidelines is in contradiction with the high performance or volume targets for which they are incentivized. They may argue that E&S requirements could drive potential clients to seek finance elsewhere or that they could unnecessarily delay the approval of disbursements. They may also consider them to be irrelevant, due to a lack of knowledge.

While the implementation of an ESMS will incur financial and human resource costs, the survey and interviews show that, in general, an ESMS is believed by NBDs to have several benefits that will outweigh the costs beyond the risk-reduction. Increased lender liability (as well as good governance) signifies that FIs can no longer demur from their E&S responsibilities,

since the risks translate into financial liabilities, as described in Section 1.1.1.

2.1.1 Good E&S Risk Management Should Improve the Risk Level of the Portfolio

An adequate ESMS will provide a bank with a clear overview of the E&S risks in its portfolio at different levels (individual loans, as well as within sectors and regions), thus enabling it to identify, prioritize, and focus on the most important E&S risks in its overall portfolio. Systematic and sound E&S management of the portfolio should result in an improved risk profile.

2.1.2 E&S Requirements Level the Playing Field

Most clients, especially those exposed to public scrutiny and those who operate in high-risk sectors, are already familiar with E&S assessments. They may, in fact, expect their FI to devote time and the resources to such projects. For example, a subcontracting firm in the textile sector that operates within an international supply chain will, in general, expect its clients to carry out their due diligence. Those firms would like to assume that their FI understands their business and

would expect that their level of compliance with international E&S standards grants them a certain competitive edge, or that their competitors that do not meet the same E&S standards will have difficulties accessing finance.

An increasing number of FIs are adopting international principles and initiatives, including internationally recognized E&S standards and procedures (due also to the requirements of international lenders, shareholders, and business partners). This is leveling the playing field on E&S issues and, increasingly, E&S requirements are being viewed as a way to improve their chances of success.

2.1.3 An Integrated ESMS Should Not Require a Significant Effort

When properly designed and implemented, the burden of an ESMS on an FI's operational staff can be limited, especially when it is integrated into an existing credit review process. For most low and moderate E&S risk transactions, few assessments are required, while more complex E&S requirements are applied only to sizeable and high-risk transactions. A well-integrated ESMS can lead to more streamlined procedures and, ultimately, to overall reductions in transactional costs, compared to E&S reviews undertaken on an ad hoc and uncoordinated basis.

An ESMS can be easily revised and adjusted. An expensive system that does not generate the expected benefits can be modified for cost-effectiveness. The cost implications relating to an ESMS are described in Section 5.5.

2.1.4 Developing E&S Risk Management Can Increase Access to Capital

For access to international funding, local FIs are generally required to meet the funding agency's E&S standards. Traditionally, the funding agencies are the international financial institutions (IFIs), whose standards include operational safeguards, technical standards, and exclusion lists. IFIs—at a minimum—require

local FIs to comply with the host country's regulations, although they may also recommend that an ESMS that meets the nature, scale, and risk of its activities be implemented. In essence, should the IFI-funded project be high risk in terms of E&S (e.g., financing of large infrastructure projects), the local FI—to be eligible for IFI resources—can apply a full set of safeguards to the loans relating to the project. Should the program be considered low risk (e.g., trade finance), the local FI may only be required to comply with the host country's regulations and implement an exclusion list.

Since the adoption of IFC's Sustainability Framework¹⁹ in January 2012, the E&S standards of IFIs continue to expand, and now include labor, health, and safety issues. Similarly, the scope of E&S assessments has broadened to cover indirect E&S impacts (off-site and cumulative impacts) and the role of suppliers (impacts of supply chains).

Access to international funding is increasingly being provided through sources other than IFIs. With regard to climate change, for example, one of the main funding sources is the Global Environment Facility (GEF).²⁰ Others include the Adaptation Fund,²¹ Green Climate Fund,²² and Carbon Fund, the latter under the Forest Carbon Partnership Facility.²³ While these funds originally channeled their resources through IFIs and the United Nations agencies, they now partner with local entities (including NDBs) that will execute their projects. These funds require local entities to implement sound E&S risk management practices, as part of their eligibility criteria, to enable them to act as executing agencies. For example, under the Adaptation Fund ruling, institutions receiving financing from this fund are required to identify and manage the E&S risks of their activities (Adaptation Fund, 2013). In the case of national agencies, they should have sufficient institutional E&S capacity in order to be accredited. Under

¹⁹ http://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_site/IFC+Sustainability/Sustainability+Framework.

²⁰ <http://www.thegef.org>.

²¹ www.adaptation-fund.org.

²² <http://gcfund.net>.

²³ <http://www.forestcarbonpartnership.org>.

the Green Climate Fund, national implementing agencies can be nominated to have direct access to funding, as long as they apply best practice E&S safeguards (Green Climate Fund, 2011). This also applies to the Carbon Fund (Forest Carbon Partnership Facility, 2013). A similar approach is being adopted by the GEF (GEF, 2011).

These trends confirm that there are real opportunities for NDBs to access international funding for projects in the area of climate change; however, in order to capitalize on those opportunities, developing and implementing an adequate E&S management capacity is essential.

2.2 How to Convince a Skeptical Banker

Bankers are often circumspect when presented with the concept of implementing E&S management within their loan processing, not only because it introduces a type of risk that was not structurally addressed previously, but because the risks associated with E&S issues are more difficult to quantify. As often occurs, the introduction of E&S management can meet with resistance from staff who may perceive it as either difficult to implement, irrelevant, or out of the bank's scope of business. To convince a skeptical banker of the relevance of an ESMS, one can make four arguments, which are relatively easy to counter, as is shown below.

“There is hardly any E&S risk in my portfolio, so why bother?”—Yes, that is possible. Not all clients carry high E&S risk and do not require a thorough analysis. That is exactly why you need to develop a risk classification matrix to enable you to differentiate between the clients who may not require an E&S assessment and those who do.

“I’m a banker. I do not know anything about E&S risks and issues.”—You do not have to be a specialist to identify key E&S issues. One might not know everything about E&S risks and issues, but with the use of simple, well-known methodologies, bankers are able to pose the necessary minimal questions to their

clients in order to identify potential risk. The information and the methodologies are relatively simple to structure and to apply and they are usually sufficient for bankers to detect the risks. In doing so, the risks do not have to be analyzed by the bankers. Like other risk areas, where further investigation is needed, the bank can assign internal resources or an external expert to assess the risks in more detail.

“My clients do not wish to talk with us about E&S issues; they will go to our competitors.”—Although it might be a new topic for a bank, companies are already familiar with E&S issues. Sustainability is increasingly on the private sector agenda and firms have no option but to address it, with some better prepared than others. Those already addressing it will have no issue in sharing their experience; those who have not yet done so can be divided into three groups. The first group consists of enterprises that do not yet acknowledge the relevance of E&S issues, but could benefit from an increased awareness. The second group does acknowledge the relevance, but does not have sufficient knowledge to address sustainability. This group will most likely welcome a bank that will raise the issues and which will provide access to finance to enable it to address the matter, leading to more opportunities. From a bank's viewpoint, this group of businesses can be the most interesting as the bank can promote its knowledge on E&S management as a value addition to its client. Lastly, the third group—although small and steadily decreasing in size—consists of companies that believe that E&S issues are irrelevant, in which case FIs may see this as indicative of the quality of their management practices and commitments (as shown by corporate ratings) and not wish to consider them as potential clients. There is clearly an increasing leveling of the playing field as more banks apply the same requirements.

“I do not really have a responsibility to address these issues.”—If not you, then who? While there may not be a specific legal requirement in your country, E&S risks are considered to be part of a bank's fiduciary

Box 4. Example of a Responsible NDB

Financiera Rural, a Mexican agency that provides Tier 1 and Tier 2 funding to economic activities in rural areas with less than 50,000 inhabitants, is currently in the process of designing and implementing an ESMS with the support of technical experts. Currently in pilot phase, the system has been applied to 10 clients, including on-site due diligence visits. While environmental legislation is well developed in Mexico, Financiera Rural considers it essential to take responsibility for verifying compliance with E&S requirements. The reasons are threefold: (i) a public development bank has a clear mandate to promote sustainable development and should work with its clients to achieve this; (ii) a financial institution is a stakeholder that is directly exposed to E&S risk and should, therefore, make its own assessment; and (iii) while domestic regulations are important filters, there remain some gaps and areas for further development, which have been identified by Financiera Rural, such as social issues and land-use planning.

responsibility to protect investor and depositor interests. Banks can be liable for E&S impacts, regardless of whether they manage the risks or not.

2.3 How to Link an ESMS with a National Regulatory Framework

NDBs, given their public mandate, are stringently bound to comply with local regulation. They may, in some cases, consider the development of an in-house ESMS a burden with little added value. Experience in developing and using ESMS by a number of NDBs in the LAC region, however, has shown the opposite. The implementation of an ESMS can be very useful and effective, while adhering to national regulations, and can enhance the efficiency of the credit approval process. It can systematize the requirements and the credit approval process, compile the reporting information required by national law, improve transparency, provide

a global view of the portfolio's key risks and, in some cases, shorten the approval period. In particular, an ESMS can support FIs to efficiently monitor compliance with local regulation. While local regulations in the LAC region continue to evolve and may be complex and numerous (at the national, regional/provincial, and local levels), a well-designed ESMS—customized to the FI's specific needs—will prove to be an efficient tool in complying with legislation and be sufficiently flexible to fill requirement gaps in relevant legislative frameworks.

An ESMS will enable an FI to address reputational and potential disaster risks that may not be covered by local legislation. For example, local legislative frameworks often focus more on environmental issues rather than on social issues, such as community involvement and the resettlement and protection of vulnerable groups. Compliance to local legislation, therefore, may be insufficient to address certain types of reputational risk, access international funding (e.g., from multilateral development banks), or address the FI's own commitments or mandate towards civil society.

The scope of an ESMS goes beyond legal risk; it aims to prevent reputational risk and the risks related to accidents and disasters. By taking a further step beyond local compliance with an ESMS, an FI will be able to identify the residual risks that could be appropriately mitigated. It may not be sufficient to require that clients hold local environmental licenses to avoid exposure to E&S risks in legal terms (e.g., fines, penalties, or suspension of operations), since these may not be adequate in relation to other types of E&S risks (directly or indirectly through clients). It is the responsibility of the FI, therefore, to manage their E&S risks without relying solely on national regulatory frameworks.

From a more global perspective, the financial community is increasingly taking responsibility, in addition to complying with legislative frameworks. Banks are increasingly embracing corporate social responsibility (CSR) as part of their core mandate and are moving beyond compliance to engage in activities

that further the social good. Examples include the following:

- Within the guiding principles of its Sustainability Risk Policy, the Dutch Bank, ABN AMRO, has included that the bank is responsible for its actions and that it bears full responsibility for the decision to engage or disengage with a business relationship, based on its own E&S standards.
- South African Standard Bank (awarded the FT/IFC Sustainable Finance Award for Africa/Middle East in 2013), likewise, states that it will proactively manage E&S risks, “seeking to go beyond compliance towards best practice performance.”
- In the LAC region, an example is Itaú Unibanco, which sees its role “to influence the market towards adopting best practices and leading international sustainability standards.”
- Another example is Banco Santander Brasil (awarded the FT/IFC Sustainable Finance Award for the Americas), which defined three clear sustainability themes: social and financial inclusion,

education programs, and support for social and environmental business projects. The bank is now the leading Brazilian private sector institution in microfinance, having loaned US\$1.1 billion for social and environmental projects.

These examples are indicative of banks willing to maintain a social license to operate and differentiate themselves as leaders in sustainability. Several initiatives and standards, such as the European Eco-Management and Audit Scheme, emphasize the continuous improvement of environmental performance beyond legal requirements. Signatories to different UNEP FI initiatives have included similar statements. The FIs listed above consider that there is a positive correlation between E&S performance and business performance and, therefore, are taking an integral approach to managing financial and nonfinancial issues. As the CEO of South Africa’s First Rand Bank stated, sustainable development is not a luxury, but a requirement to strategically position our economy for the 21st century.



3

Establishing an ESMS: The Building Process

3.1 The Foundation: Objectives and Scope

An ESMS is a streamlined and transparent system that should be fully integrated into an FI's regular operational and credit processes, influencing all stages of the finance process cycle and ranging from due diligence to monitoring and evaluation. It cannot operate as well as a stand-alone system; rather, it should be fully aligned with existing systems in terms of work flow and analyses. For an ESMS to be efficient, clear lines of responsibility and a firm commitment from senior management are essential. Supporting policies and procedures, likewise, should be well documented, updated on a regular basis, and made available to all relevant staff. A well-designed ESMS should include the following:

- Establishment of the FI's E&S policy objectives and senior management commitment
- Definition of the standards the FI expects its clients to adhere to, including verification of compliance with applicable environmental, social, health, and safety and labor regulatory requirements
- Design of the procedures and criteria to systematically identify, assess, and manage E&S risks associated with client transactions
- Capacity building and guidance for staff to

understand the potential impact of E&S risks on the FI's portfolio, and to manage these risks on an operational basis

- Procedures and documentation for clients to implement appropriate mitigation measures and for the FI to monitor their application

3.2 What Are the Building Blocks of an ESMS?

An ESMS consists of a set of building blocks (Figure 4). Depending upon the risk level, the ESMS should consist of a sufficient number of these blocks, as described below.

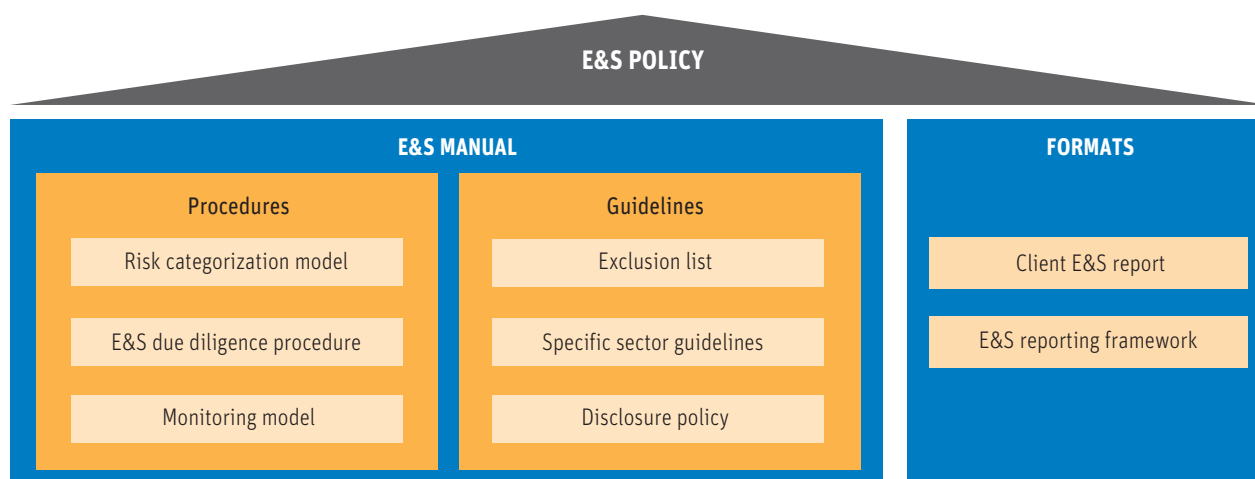
3.2.1 Environmental and Social Policy

The E&S policy should define the FI's intended role in relation to the environment and society and include the concise objectives of its ESMS. The policy should be approved and strongly supported by the FI's top management and evidenced in document form.

3.2.2 E&S Manual of Practices and Procedures

Exclusion list: This list usually appears first in the manual of practices and procedures. It includes specific activities for which an FI has decided not to provide

FIGURE 4. ESMS Building Blocks



Source: Steward Redqueen.

financing, due to their E&S impacts. In practice, the list is similar in scope and application to those adopted by international lenders, such as the IDB.²⁴

Risk categorization model: This model classifies E&S risks and their impacts and includes the level of due diligence and extent of mitigation planning required for each level. E&S risk levels range from low to high and will depend on the type and size of the financial transaction and the location and magnitude of potential impacts. The model can also include certain thresholds to exclude smaller transactions. Figure 5 outlines the typical E&S risk categories (A, B, and C) and provides some examples.²⁵

E&S due diligence procedure: Following risk categorization, the E&S due diligence procedure should describe, in detail, the steps to identify, evaluate, mitigate, and monitor the risks during the appraisal process, based on their assumed level. The manual should include clear lines of responsibility, as well as list the necessary documentation (e.g., client E&S report) and forms used during the process. See Section 4.1 for more information on the screening process.

Decision authority: Policies and procedures should include the decision-making authorities, based on the

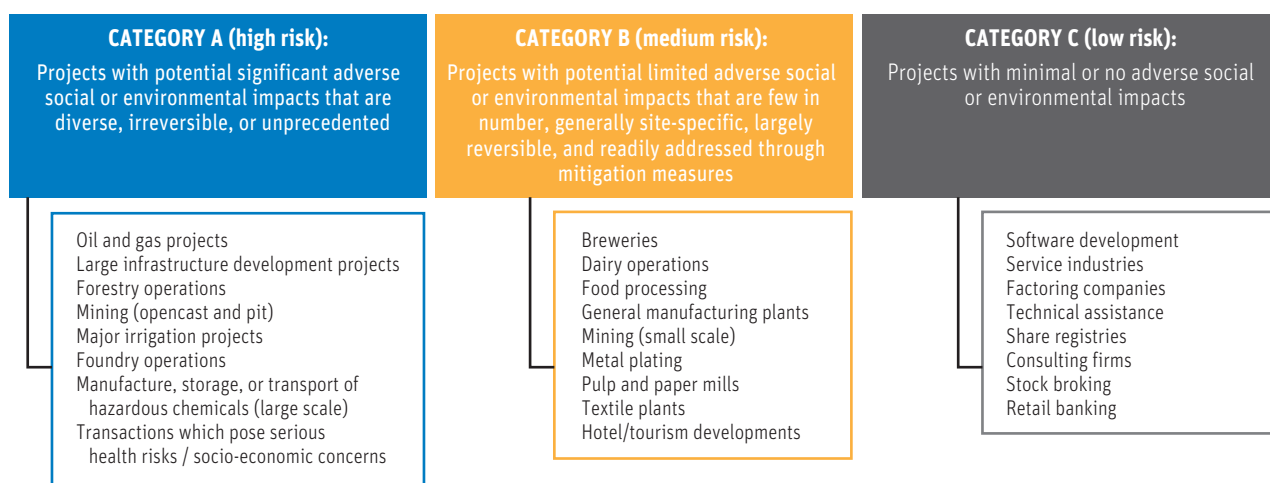
level of risk, outcome of the analysis, and other factors. Most banks will consider the size of the loan to determine the approval process. Essential to the decision-making process is the need to ensure that all information is available so that the risks are appropriately taken into consideration.

Specific sector guidelines: These guidelines depend on the type of sectors in which the FI is active. They should provide guidance—generally within a short document—for each sector (e.g., housing, energy, infrastructure) in order to identify and manage the relative risks and impacts. The guidelines should include potential risks, recommendations for mitigation, identification of business and market opportunities, and reference to national legislation, as well as examples of good practices within each sector. They should be available to all relevant staff. Brief sector guidelines (approximately three pages) that are regularly updated may be adequate. The European Bank for Reconstruction and Development (EBRD) and

²⁴ See, for example <http://indesvirtual.iadb.org/mod/resource/view.php?id=16781>

²⁵ For a more extensive categorization list, see http://www.ebrd.com/environment/e-manual/documents/r031risk_%28Categorisation_List%29.pdf

FIGURE 5. Environmental and Social Risk Classification for a Transaction



Source: Steward Redqueen, based on the categorization models used by IFC and the EBRD.

the IFC have each developed detailed guidelines for reference.²⁶

Disclosure policy: The disclosure policy should require the FI to disclose information—at a minimum—to stakeholders and those who could be affected by projects with a high E&S risk factor. In the case where a bank is bound by banking secrecy regulations, the bank should convince the client to disclose this information. The FI can also implement a mechanism, not only for communities to be informed of high-risk projects in a timely manner, but also to provide a grievance platform for those who have been affected by a project’s impacts.²⁷

Monitoring model: Monitoring enables the FI to periodically check, evaluate, and report on the E&S risks within its portfolio. It should be based on quantitative indicators that define the risks at the sector and client levels, and should be updated regularly to reflect changes.

3.2.3 Sustainability Reporting

Client E&S report: This report should carefully document the different steps and decisions taken during the E&S due diligence process, as well as the conclusions and recommendations as a result of the exercise. This

report will enable relationship managers and credit analysts to systematically track the E&S issues relating to a firm’s activities during the credit process, as well as provide them with information to adequately monitor the project and have mitigation measures in place.

E&S periodic reporting: A periodic (annual) reporting system will enable the FI to adequately comply with reporting requirements regarding the risks and impacts on the loan portfolio. Annual reports, in general, should contain information on material E&S issues that the FI had to face over the year and include the exclusion list.²⁸

²⁶ See the EBRD’s e-Manual, Electronic Environment and Social Risk Management Manual at <http://www.ebrd.com/environment/e-manual/af6guide.html>, and IFC’s Environment, Health, and Safety General Guidelines at <http://www.ifc.org/wps/wcm/connect/554e8d80488658e4b76af76a6515bb18/Final%2B-%2BGeneral%2BEHS%2BGuidelines.pdf?MOD=AJPERES>.

²⁷ See, for example, http://www.scotiabank.com/ca/en/files/12/03/statement_of_disclosure_policy_and_practices_and_mandate_of_disclosure_committee_new.pdf.

²⁸ Examples of E&S reports can be found on the websites of FIRST for Sustainability (<http://firstforsustainability.org>) and the Global Reporting Initiative (<https://www.globalreporting.org/resource/library/FSSS-Complete.pdf>).



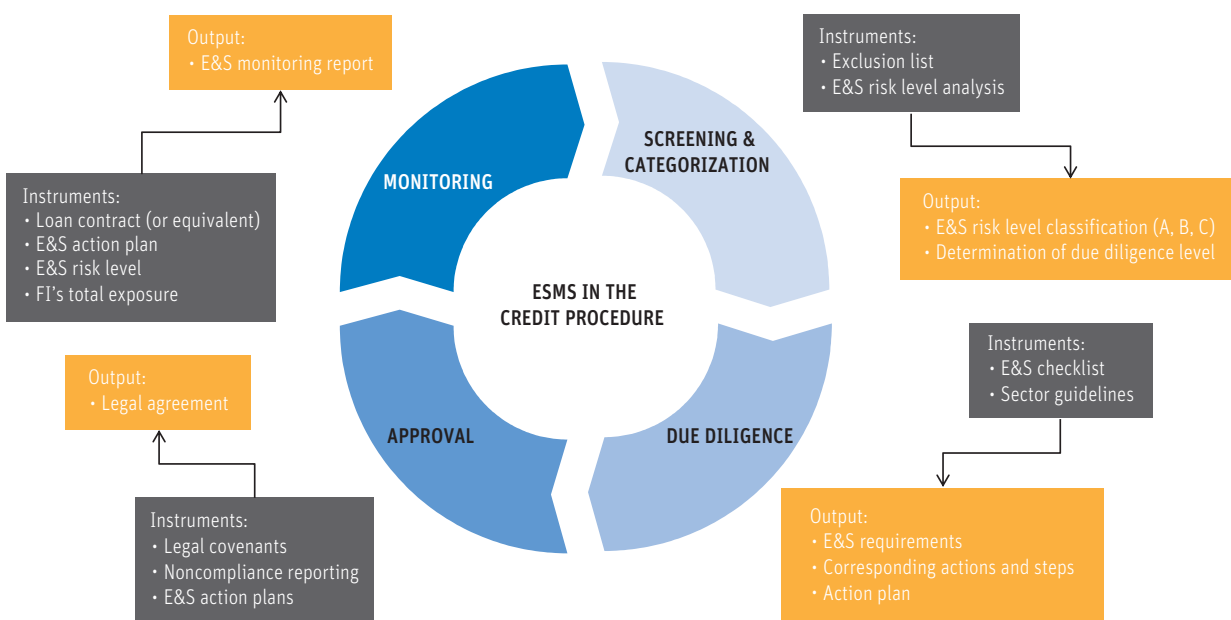
Application of an ESMS to Daily Operations

4.1 Integration into the Credit Cycle

This section will describe the internal processes required to ensure systematic and consistent application of an ESMS framework to an FI's operations and its adherence to E&S requirements. As seen in Figure 6,

procedures will cover the entire credit cycle and will include data gathering and analysis, roles and responsibilities, expected outputs, and the key issues to be addressed during the screening, due diligence, approval, and supervision stages.

FIGURE 6. ESMS in the Credit Process



Source: Steward Redqueen.

Screening and categorization: During the screening phase of a transaction, the scope and nature of the transaction should be identified in order to screen the credit application against the FI's exclusion list and to make a preliminary classification of its level of risk. The latter will determine the extent to which an evaluation is required and will define the E&S operational requirements and the steps to implement them.

Due diligence: During the review process, the FI will gain an insight into the nature and scope of a client's operation, using E&S information forms, checklists, and sector guidelines. Due diligence on the project may be minimal; however, if the project is deemed high risk, on-site visits and a full assessment will be required, as well as technical expert analysis. Desk assessments should be adequate for lower-risk operations, supplemented by relevant questionnaires and other streamlined procedures. Based on the review, the FI will be able to determine the E&S requirements and include them in the E&S Action Plan, described below.

Approval: Subsequent to the due diligence exercise, the transaction documentation, with the E&S risks clearly defined, is prepared and submitted for approval to the FI's credit committee and/or the established decision-making authority. Approval will lead to the negotiation of a loan agreement and Action Plan between the FI and the borrower, wherein the E&S requirements will be included, as well as the reporting and supervision provisions. The transaction includes the following:

- *E&S Action Plan:* the plan describes, in detail, the actions necessary for the borrower to meet agreed E&S requirements;
- *Legal covenants:* the borrower commits to the requirements of the Action Plan. The covenants should include clear provisions for addressing non-compliance and include clear lines of responsibility between the borrower and the FI;
- *Non-compliance reporting:* the borrower should report periodically to the FI on its E&S compliance and immediately report any non-compliance.

It is easy to determine the scope of the prerequisites and reporting and supervision activities, such as those indicated above, for projects that are clearly defined. However, when the FI lends for working capital purposes or trade finance, for example, it is necessary to analyze the company's entire operation.

Monitoring and evaluation (M&E): Monitoring requirements result from the preceding categorization and due diligence processes. The borrower's E&S performance is taken into account with regard to the requirements defined in the loan agreement and the actions defined in the Action Plan. The FI will determine whether or not there are any changes in the borrower's E&S risk level and, in which case, the FI's level of exposure. A change may indicate non-compliance and the FI may need to determine mitigating measures to ensure that the client complies with the initial requirements in the loan agreement. An E&S monitoring report (or performance evaluation) will include the findings and conclusions.

4.2 Roles and Responsibilities: Recommendations

Implementation and management of an ESMS requires adequately trained staff, who will have an understanding of sustainability issues in order to efficiently carry out the necessary processes and procedures in their day-to-day operations. In addition, their roles and responsibilities should be clearly defined to ensure efficient implementation of the ESMS. The following include key positions considered essential for an ESMS.

NDB Survey: Does your organization have dedicated E&S risk management staff?

Yes, a department / division / unit:	38%
Yes, a full-time coordinator:	31%
No:	31%

Executive board member: strong support and communication: A representative of the Executive Board should be assigned to advocate and promote E&S programs and policies, both to the FI staff and to external stakeholders. The executive board member should strongly support the E&S coordinator, and also be periodically informed of the institution's E&S management program, either by the E&S coordinator or a senior risk manager. Increasingly, IFIs are requesting their local executing partners to also designate a board member for E&S issues and fiduciary accountability.

Senior risk manager: operational oversight and responsibility: A senior risk manager should have ultimate responsibility for E&S evaluations and conditionality recommendations that have been discussed with the Credit Committee. He/she will oversee the activities of the E&S coordinator and is directly involved in the design and maintenance of the ESMS. The senior risk manager should report to the designated E&S Executive Board member on the FI's ESMS-related activities.

E&S coordinator: system maintenance and operational support: An E&S coordinator acts as an expert within the organization on E&S issues and the application of the ESMS, and should have appropriate training. He/she is accountable for its development, as well as for the updating of procedures and documents. The coordinator will oversee the application of the ESMS to FI operations and provide assistance in the case of complex issues or high E&S risk. At the portfolio level, the coordinator will monitor the E&S risk levels of the bank as a whole, and ensure adequate capacity among staff, providing training when necessary. The position is usually assigned to the risk management department, and the coordinator will take responsibility of E&S matters either on a full-time or part-time basis, depending on the volume of the FI's banking activities and the E&S risk level. The coordinator generally reports directly to the senior risk manager and, in some cases, to the executive board member.

Operational staff: application processing: Staff members who are responsible for the FI's credit applications (relationship managers, credit analysts, legal officers, portfolio analysts) are also responsible for applying the ESMS at the transaction level. They should evaluate the E&S risks at the investment level, discuss and negotiate E&S management measures with the client, and monitor the client's performance. All relevant staff should work closely with the E&S coordinator throughout the application process. Depending on the size and nature of the organization, FIs can vary the allocation of their resources. Smaller banks can centralize responsibility for the ESMS to one position on a part- or full-time basis; larger banks usually designate the responsibilities to various staff members. Many FIs have dedicated E&S analysts, who are sector specialists and are involved in the credit process, as well as credit analysts.

4.3 Customizing an ESMS for Different Banking Activities

As noted above, an ESMS consists of various building blocks: the more extensive the ESMS, the more elements it will consist of in terms of risk management. The extent to which it should be developed largely depends on the risk profile of the FI, which is predominantly determined by its loan activities. NDBs, in general, can be active in six different business activities. Below is a short description of the typical E&S risk level related to each of the financing activities.

Microfinance: The E&S risk level for microfinance is generally low, due to their low number; the short-term duration of the projects; the relatively small scale of the clients (individuals or micro entrepreneurs); and their relatively low-risk impacts. The risks are low, given that the majority of microfinance institutions deliver financial services to various sectors of the poor and, while E&S impacts can be high in certain sectors, such as agriculture and commerce (e.g., metal workshops, textile workshops, dry cleaners, etc.), the risk level is

more often low due to the small size of the institution. If projects are concentrated on a specific group of clients or within a specific geographic area, they can be considered as a single activity with a potentially cumulative E&S impact that can be moderate or low. It would be sufficient for the FI to only review excluded activities. In an effort to engage with their clients in terms of environmental protection and social performance, microfinance institutions often provide awareness programs on best practices.

Small- and medium-sized enterprises: The potential E&S impacts of small- and medium-sized enterprise (SME) projects can vary substantially, depending on

“The scope of an ESMS depends on the risk profile of an FI”

the size of the company, the sector in which it operates, and the type of financing involved (short-term versus long-term loans). Impact is generally low in relation to small-sized entrepreneurs (in the local economic context) in commercial sectors (services) that require short-term capital, whereas the risk can be higher in relation to larger SMEs that operate in the industry and infrastructure sectors and which require long-term capital. E&S requirements will, therefore, depend on the risk level of the client, although it should be sufficient to include a basic E&S checklist to verify the client’s E&S compliance and performance.

Corporate lending: Corporate lending portfolios usually have a high E&S risk level profile due to the size of the firms they may take on as clients. The business activities of client companies are often diverse, ranging from services and trade to manufacturing and heavy industry, in which case the E&S impacts could be significant. In order to adequately manage their

portfolio risks, banks will need a full ESMS, described in Section 3.2.

Housing: In the housing sector, where finance is provided to individuals in the form of insurance, mortgages and/or home improvement loans, E&S risk is generally low. If the house, however, is situated in an environmentally sensitive area (e.g., prone to natural disaster), the E&S risk level could be considered as medium. Risk tends to be medium or high in relation to real estate development, depending on whether an FI is exposed to real estate development and mortgage lending within the same project. A basic, customized checklist can be sufficient to assess the risks associated with this type of financing (e.g., illegal land acquisition, involuntary resettlement, soil contamination, antiseismic building codes, disaster risk).

Trade: Trade transactions are generally low risk, since they do not have a direct E&S impact. On the other hand, if the trade transaction involves a product with a potentially high risk of E&S impacts (e.g., palm oil, soy, timber, gold), the risk level is usually low or medium. Most trade financiers apply the exclusion list to their operations.

Infrastructure: Given the size and nature of infrastructure and its associated E&S impacts, lending to such projects tends to be high risk, although the risk decreases to a medium level if the project is small in size or consists mainly of maintenance work. Infrastructure projects usually will require full E&S due diligence, sometimes performed by an external expert.

In sum, an ESMS should reflect the risk structure of the FI’s portfolio and of each operation; the higher the risk, the more extensive the process. In some cases, a basic ESMS application will suffice to screen and mitigate individual subprojects. If the FI portfolio is considered to be at low risk, the ESMS may not be required beyond the exclusion list and verification of compliance with local laws and regulations.

4.4 An ESMS for Tier 2 FIs

Tier 2 FIs need different approaches in their E&S management, given that they do not have direct contact with their funding beneficiaries. On the other hand, they have an important leverage potential that could substantially impact the entire local financial services sector.

As noted in Section 1.2.2, only 14 percent of the Tier 2 NDBs that were surveyed in the LAC region have an ESMS in place (as opposed to 50 percent of Tier 1 banks). Some believe that they are not subject to E&S guidelines, while others will apply E&S eligibility criteria for their Tier-1 bank counterparts.

Tier 2 FIs should develop their own set of eligibility criteria for Tier 1 FIs (or other types of executing agencies). They should undertake an assessment of the overall E&S management capacity of participating Tier 1 institutions and thus focus on their capacity to include E&S requirements in their operations. Tier 2 NDBs may be required by international lenders to have an ESMS in place to access finance. Some multilateral banks have established guidelines and safeguards for FIs, including resources for technical cooperation. Overall, the potential leverage of Tier 2 banks depends strongly on capacity building and the strengthening of the local commercial banking sector.

Box 5. BANCOLDEX: How to Ensure Implementation as a Tier 2 Bank

As a Tier 2 bank, the Colombian National Development Bank (BANCOLDEX) depends on its financial intermediaries for compliance with the bank's E&S requirements. As only the financial intermediaries are in direct contact with final beneficiaries, it is their delegated responsibility to ensure compliance with the E&S standards of BANCOLDEX.

To ensure that the monitoring process takes place, BANCOLDEX requires its financial intermediaries to apply a basic ESMS that will adequately meet the standards defined by BANCOLDEX. It also organizes in-house training sessions for their staff regarding E&S risk management. The training sessions include the business case for sustainability and capacity building regarding E&S risk. BANCOLDEX has already trained 15 FIs in Colombia, with a view to increasing that number.

Doris Arévalo, Director of Business Intelligence, commented on the experience of BANCOLDEX in implementing E&S practices as a Tier 2 bank:

“It is not hard to explain the E&S requirements to our beneficiaries, who apply our model of social and environmental risks. These are companies that are familiar with managing and monitoring their E&S risks. Actually, the challenge is to generate awareness among financial intermediaries on the importance of identifying and managing these risks in order to improve the environmental performance of their customers and identify new funding opportunities for those customers.”



5

Development of an ESMS

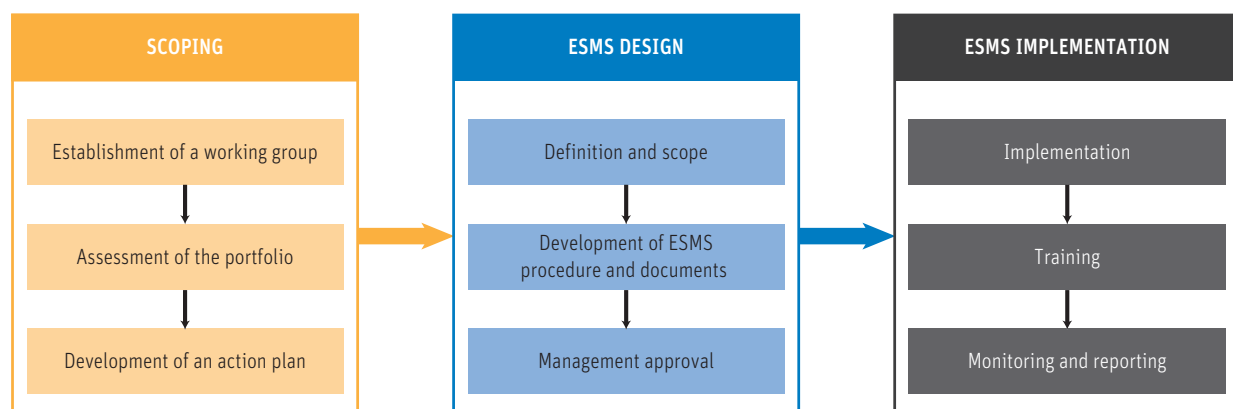
Developing an ESMS is a process that should be affected by the FI itself. It should be tailored to internal processes and procedures and be based on previous experience regarding the local market. External experts can provide the capacity to manage E&S risks at the start, but ownership and responsibility should, ultimately, lie with the FI. There is a great deal of knowledge and “open source” tools available online (see Section 5.4) that will enable a bank to assemble the building blocks, thus decreasing the need for external assistance. This section details each of the necessary steps to develop an effective ESMS, which are summarized in Figure 7.

5.1 Scoping

5.1.1 Establishing a Working Group

At the outset, full-time responsibility for coordinating the ESMS should lie with a senior staff member (with external technical support, if necessary). It is important to form a working group with a clear mandate from senior management to develop the system. The group should be composed of a senior manager responsible for E&S risk, an ESMS coordinator, an external expert (if necessary), and the FI’s operational staff. It is essential to involve those in the credit and commercial

FIGURE 7. Main Steps in the Development and Implementation of an ESMS



Source: Steward Redqueen.

departments, who will be involved with the system on a daily basis, not only for their buy-in, but also to ensure that the system is efficient and fully integrates the lessons learned from previous projects. The working group has the following responsibilities.

- *Risk analysis of the portfolio.* The analysis should identify those sectors and clients that have significant E&S risks and impacts and review current procedures to manage these risks. Based on the analysis and review, a gap analysis will define the type of procedures, policies, and documents that will need to be developed or updated to ensure that the ESMS will meet recommended standards.
- *Development of an action plan.* The action plan should define the actions, resources, responsibilities, timetable, and deliverables relating to the project. It should also include the stakeholder expectations and the FI's commitment to international initiatives (such as those described in section 1.3.1).

5.2 The ESMS Design

5.2.1 Definition and Scope

Building upon the FI's existing processes, the working group can develop an ESMS framework to define the sectors, standards, type of financing, and loan amounts to be applied. Early consultation with FI staff is important to ensure that the ESMS is applicable and practical to the project.

5.2.2 Development of ESMS Procedures and Documents

This phase of the design includes the development of policies and procedures (exclusion lists, relevant manuals, recommended standards, and sector guidelines) to support the ESMS. The working group will develop and explain them, in detail, among relevant staff. Draft documents should be circulated for staff input.

5.2.3 Management Approval

Once the ESMS and supporting material have been finalized, the working group should present them to the Executive Board for approval. The ESMS plan should include implications at the institutional and operational levels and contain an implementation plan, timeframe, and training program.

5.3 ESMS Implementation

5.3.1 Implementation

Once the Executive Board approves the ESMS, it should be introduced gradually as a pilot phase to assess its functionality within the credit cycle, focusing on a limited number of operations in different sectors at varying risk levels. The outcomes should be carefully evaluated, with adjustments made, where necessary, prior to full rollout. The system should normally apply only to new operations.

NDB Survey: Who has received E&S training in your organization?

E&S department/specialist:	69%
Loan officers:	44%
Credit analysts:	44%
Board members:	19%
Senior management:	19%
Nobody:	19%

5.3.2 Training

A training program is required for those employees at the operational level, who will be involved in application of the ESMS, to ensure that they become familiar with practices and procedures. The program should also include incentives to identify new E&S business opportunities. Hands-on training sessions, using case study material and interactive tools, should be provided.

“Approximately 44 percent of NDBs surveyed have an annual report that includes reporting on financial and E&S issues. An estimated 6 percent plan to do so within the next two years.”

5.3.3 Monitoring and Reporting

Once an ESMS is in place, the risks and impacts within the institution’s portfolio can be monitored and reported periodically, both internally and externally. The reporting framework should (i) fit into the FI’s regular reporting schedule and (ii) harmonize the various reporting requirements from IFIs or other donor entities. This will minimize the effort spent on reporting, without compromising E&S reporting requirements.

5.4 Available Resources

Various online tools and instruments are freely available, which provide the necessary information to either develop an ESMS or improve upon an existing one. Experts in the field have recommended the following.

5.4.1 Finanzas Carbono Platform

The Finanzas Carbono website has a community of practice for financial institutions, which includes more than 50 online webinars, e-learning material, chats, information on events, and a library with more than 1,400 case studies and publications relating to the experience of FIs in the design and promotion of green financing instruments.²⁹

5.4.2 FIRST for Sustainability

FIRST for Sustainability provides online resources, solutions, and tools for financial institutions relating to the benefits of E&S risk management and how to identify and take advantage of business opportunities. FIRST provides a comprehensive guide and tools to understand and manage the risks, including ways in which to implement an ESMS, conduct E&S due diligence, create

a new project pipeline, and develop new products and services, tailored to the needs of clients.³⁰

5.4.3 IDB BeyondBanking

BeyondBanking is a global sustainability program, developed by the IDB that seeks to promote sustainable

Box 6. The Experience of Caixa Econômica Federal

Founded in 1861, Caixa Econômica Federal of Brazil has grown to become the largest public bank in Latin America, with a customer base of 34 million people. Due to its ambition to be the leading bank in the financial services sector, in 2005 Caixa began to structurally address E&S risk in all its transactions. By 2007, Caixa had revised its credit policy to include a section relating to E&S risk management and has formed a new Sustainability Department to analyze E&S risk.

Within six months of Caixa’s application of E&S requirements to credit applications in 2008, the Sustainability Department developed—with the help of an external expert—a complete set of procedures and tools to operationalize the bank’s new E&S requirements. It also provided relevant staff training. Over time, the policies and procedures were refined.

According to the Head of Caixa’s E&S Risk Management, José Maximiano de Mello Jacinto, the combination of rapid implementation and continuous improvement was key to Caixa’s success.

“We realized that, we would never be able to complete the development of our policies and procedures theoretically. They had to be applied to real cases, so we decided to apply them as a pilot project and, based on the experience gained, we continuously improved them. This turned out to be an excellent starting point for developing a comprehensive, yet practical, set of procedures and tools, since they have all been (and still are) tested and improved upon. This approach has helped save time, while enabling us to be in line with our client’s reality.”

²⁹ For more information, see <http://finanzascarbono.org/>.

³⁰ For more information, see <http://firstforsustainability.org>.

environmental, social, and corporate governance principles among LAC FIs through financial and technical cooperation. BeyondBanking refers to six strategic pillars: strengthening financial strategies, strengthening corporate governance, innovative technologies and information, diversity and gender equality, learning and financial literacy, and green banking. It offers loans and capacity building to develop pilot projects within these pillars.³¹

5.4.4 EBRD Electronic Environmental and Social Risk Management Manual

The European Bank for Reconstruction and Development (EBRD) provides an online guidance manual to assess E&S risk. While this is for the use of EBRD's financial partners (e.g., banks with EBRD credit lines), other FIs can refer to it. EBRD has designed the procedures to be easily integrated into existing transaction appraisal processes.³²

5.4.5 IFC Performance Standards

IFC's performance standards form the main international benchmark for identifying and managing E&S risk, and have been adopted by most development and commercial banks and by many investors, such as pension fund and asset managers as a key component of their E&S risk management. IFC's Environmental, Health, and Safety (EHS) General Guidelines provide support relating to international general and industry-specific examples of good practice to meet its eight performance standards.³³

5.4.6 UNEP Finance Initiative

The UNEP FI provides several tools, among which are an E&S risk analysis online course and various workshops, the Human Rights Guidance Tool for the Financial Sector (see <http://www.unepfi.org/humanrightstoolkit/>), and the E&S Risk Briefings in order to facilitate the implementation of sustainable finance policies and procedures. The guidance tool is designed as an online

signposting tool, which provides information to lenders regarding human rights risks. The briefings provide an overview of headline issues, E&S risks, key considerations, and relevant resources for 10 sectors.³⁴

5.4.7 World Business Council for Sustainable Development Tools

The World Business Council for Sustainable Development offers a portal with links to several useful tools, such as the Sustainable Forest Finance Toolkit and the GHG Protocol Initiative standards.³⁵

5.4.8 Ecobanking

Ecobanking, INCAE Business School, the German Aid Agency (GIZ), and the UNEP FI have consolidated a number of tools, primarily in Spanish.³⁶

5.5 Implications Relating to Time and Budget

5.5.1 Time and budget for developing an ESMS

The time required to develop an ESMS depends largely on the complexity of the system and the nature and size of the financial institution. NDB feedback from the survey and interviews, as well as from the experience with other FIs, reflects that, in general, an ESMS can be developed within a year. To develop a basic ESMS is often sufficient for FIs with a low risk profile (e.g., those operating in micro finance, trade finance, and SME lending), taking approximately six to eight months to build. Those carrying a higher risk profile require a more

³¹ See <http://www.iadb.org/es/recursos-para-empresas/beyondbanking/beyondbanking-banking-on-global-sustainability,1961.html>.

³² See <http://www.ebrd.com/environment/e-manual/af6guide.html>.

³³ See http://www.ifc.org/wps/wcm/connect/c8f524004a73daeca09afdf998895a12/IFC_Performance_Standards.pdf?MOD=AJPERES and <http://www.ifc.org/wps/wcm/connect/554e8d80488658e4b76af76a6515bb18/Final%2B-%2BGeneral%2BEHS%2BGuidelines.pdf?MOD=AJPERES>.

³⁴ See <http://www.unepfi.org/index.html>.

³⁵ See <http://www.wbcsd.org/home.aspx>.

³⁶ See <http://www.ecobanking.com>.

sophisticated system and a broader range of supporting instruments. Experience has shown that this could take approximately eight to ten months to produce.

While developing an ESMS will cost time and money, the resources are relatively limited when compared to other systems development (e.g., IT systems development, credit policy revision, etc.). In most cases, the bank will put together a project team consisting of an E&S coordinator to develop the ESMS and a risk management and credit management representative, the latter two to ensure consistency with risk procedures and commercial operations, respectively. Many FIs hire experts to assist the coordinator in the development of the ESMS, which can save time, although it can increase the budget. The cost of developing an ESMS is estimated to start at approximately US\$15,000 for a relatively small FI with a limited number of banking activities. Most of the project work is done internally with limited external expert involvement. On the other hand, the cost can rise to US\$100,000–US\$150,000 for a large bank with a complex organizational structure and various banking activities, where increased external technical support is required. The research for this report has not reflected the cost to exceed this amount.

5.5.2 Time and Budget for Implementing an ESMS

Since a new ESMS should be applied to a number of transactions in order to be properly tested, the duration of the pilot phase will depend on the time it takes for a transaction to be processed within the credit cycle. On average, a pilot phase can take up to three months.

The final step prior to ESMS implementation is the training of staff. While a half-day workshop is sufficient, more time is needed to organize it, depending on the nature and size of the organization. While two days should be adequate for centralized small-sized FIs, more time is needed for larger FIs with an

Box 7. Can the Cost of an ESMS Be Quantified?

As described earlier in this document, Financiera Rural, a Mexican agency that provides Tier 1 and Tier 2 funding for economic activities in rural areas, is currently designing and implementing an ESMS. During the early design phase, the staff held discussions regarding the time it would take to develop and the cost. The technical experts anticipated delays and costs to be relatively small. The ESMS required an additional eight hours in project due diligence, resulting in a slight delay. While staffing requirements are estimated at 5 full-time equivalents (FTE) (one FTE being able to process a maximum of 200 operations a year within the ESMS), the total at Financiera Rural was approximately 1,000 FTEs.

Banco Cuscatlan, now owned by Citibank, operated a first-rate ESMS for a US\$2 billion portfolio with 1.5 direct FTEs at a total annual cost of less than US\$75,000 (2003–08). The small team involved was credited for avoiding the loss of tens of millions of dollars and for the creation of two new profitable product lines, aimed at financing E&S risk mitigation.

extensive branch network. In most cases, the training has taken two to three months, after which the ESMS was fully applied.

The pilot phase and training period generally require a budget in addition to expert fees, estimated at less than US\$10,000–US\$20,000. The FI should ensure sufficient resources are available for training, an essential component of the system. A Tier 2 FI may allocate resources to the half-day training sessions of its Tier 1 intermediaries, covering logistics, material, travel, and per diem allowances. A Tier 1 FI may also need to allocate a travel and per diem budget.



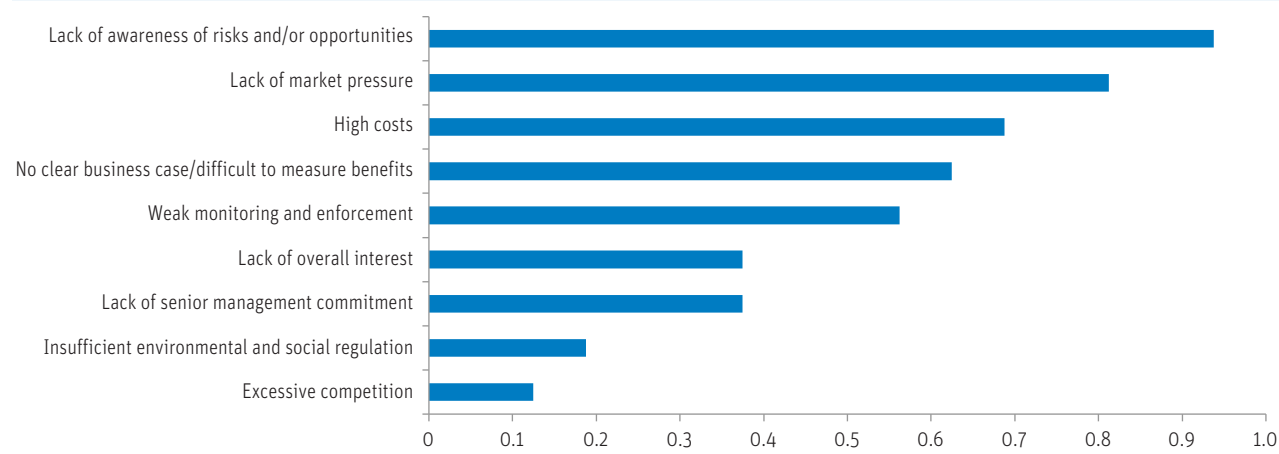
6

Lessons Learned

Prior to integrating E&S risk management, the NDBs surveyed perceived a number of challenges, such as adverse market pressure and expected high costs, as well as a lack of awareness among clients on the risks and/or opportunities of E&S risk management. The latter is closely linked to E&S risk management in terms of its commercial benefits, which is not sufficiently clear to two-thirds of those surveyed. Despite these challenges, a majority of the NDBs expressed interest—and senior management commitment—to implement E&S risk management. Figure 8 shows the importance of informing NDBs on the risks, opportunities, potential commercial benefits, and estimated costs of the design and implementation of an ESMS.

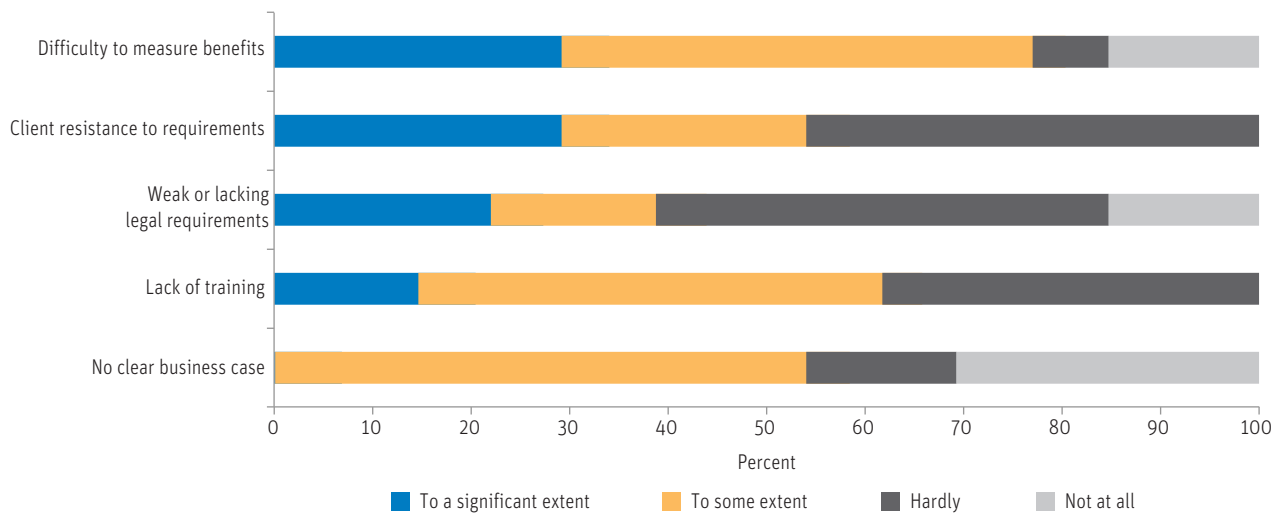
During the development and implementation process, NDBs surveyed indicated that they had experienced five major obstacles (see Figure 9), the most serious being the difficulty to measure the benefits, given that it was challenging in itself to translate mitigated risks into monetary terms. Without quantifiable evidence, it was not easy to convince skeptics within an organization of the added value of E&S risk management. Commercial staff, in particular, feared there would be client resistance in the face of additional requirements, assessments, and paperwork—a major barrier. Without adequate training, there was insufficient understanding and buy-in, which seriously hampered the implementation and eventual success of an ESMS.

FIGURE 8. Integration of E&S Risk Management: Perceived Challenges



Source: NDB Survey.

FIGURE 9. Integration of E&S Risk Management: Greatest Challenges Experienced by Surveyed NDBs



Source: NDB Survey.

7

From Risk Management to Business Development

Financial institutions are not only interested in acquiring portfolios that minimize E&S risks; they also seek opportunities to capitalize on new business opportunities that will emerge from sustainable development. As noted by the UNEP (2011), a broad range of financial developments have emerged that support transition to a green economy, such as investments in sustainable energy, cleaner energy technologies, and the creation of carbon markets. Financial institutions have already invested significantly in the renewable energy sector, while other markets and instruments are still emerging. Buildings (property, in general), forestry and sustainable agriculture, low-carbon transport, waste management, and freshwater provision are all sectors in which FIs have identified environmental opportunities for financing sustainability. Social opportunities include access to finance through financial inclusion and working with low-income markets that were previously underserved.

The role of FIs is critical in greening different economic sectors. Public FIs, such as NDBs, have a particularly important role to play, as public finance is able to function as a catalyst of public and private collaboration, in particular as a guarantor of risk. By providing long-term public funding, NDBs can contribute significantly to the scaling up of financing for these sustainability sectors. Their public mandate positions them to focus on research and development, as well as on demonstration projects, generating private sector financing when new technologies have reached the investment phase.

For sustainability opportunities, carbon is generally recognized as a value driver in most of the sectors. FIs have significant potential investment opportunities in the carbon market and its related businesses. Globally, several mechanisms have emerged and IFIs, such as the IFC, are very active in this market. For instance, the IFC provides financing to projects that generate carbon credits and can also take project and credit risk by guaranteeing the delivery of carbon credits.





Conclusions and Recommendations

8.1 Key Findings

Based on research, the survey, and on the interviews conducted for this report, the following three key findings on E&S management among NDBs have emerged:

The main reasons for an NDB to start addressing E&S issues are related to risk and compliance.

Most NDBs implement an ESMS because of three main drivers: (i) potential financial, legal, and reputational risk associated with adverse E&S impact; (ii) public mandate that requires an NDB to consider the impact of its financing on society and within the country it aims to operate in; and (iii) intrinsic motivation of an NDB to operate in an environmentally and socially responsible way. Also, shareholders and regulators have been most influential in putting E&S issues on the agenda of NDBs, thereby making it a compliance issue.

A majority of NDBs apply E&S standards, mostly based on their legal framework, but they often lack a structured and consistent approach.

Almost every NDB surveyed applies E&S standards to its lending operations, either through a formal

procedure or on a case-by-case basis. Due to the legal framework in which they operate, NDBs are particularly thorough in verifying a transaction's compliance with national E&S legislation. However, a minority of NDBs has developed a framework that includes transparent policies, standardized procedures, and clear responsibilities regarding E&S management and they apply this in a structured way. Limited financial and human resources are among the most often-mentioned reasons for this.

NDBs find the implementation of an ESMS challenging, but they see numerous benefits once the system is in place.

Those NDBs that have implemented an ESMS in their operations have faced various internal and external challenges in this process. Internally, staff members lack awareness on E&S issues and they are often ill-equipped to evaluate the impacts and risk of a transaction. Externally, clients underestimate the relevance of sustainability to their business, both in terms of risk and opportunity. Once the ESMS is up and running, however, NDBs find the system a useful tool for improving portfolio quality and, moreover, they perceive it as a useful basis for developing new sustainability-based financing opportunities and for improving client relationships.

8.2 Recommendation to NDBs

Implementing an ESMS does not have to be difficult and is, in essence, not different from any other managerial change at a bank. Just as during those changes, however, there are some rules to follow to ensure successful implementation. The successful development of an ESMS relies on the FI's level of ownership, dedication, commitment and planning. Some of the key lessons learned, based on experience of specialists who have been involved in many ESMS implementation processes at financial institutions, are described below.

Gain support from top management.

For gaining staff buy-in on the ESMS, it is important to convince involved staff members that top management is committed to the topic. Top management should clearly and strongly communicate this message and advocate the need for E&S management in order for staff to pick it up and to work accordingly. Conversely, if top management is not or does not seem committed, staff will never buy into the topic.

Fully embed the ESMS in operations.

A good ESMS only works when it is fully integrated in a bank's operational procedures and documentation. If the ESMS works parallel to the credit process, it is not efficient and will create too much delay in transaction handling. In order to match the ESMS procedure with the credit process, both should be carefully analyzed and mapped to ensure maximum synergy.

Piggyback on other change management projects.

As the ESMS has to be incorporated in the credit operations and, as these are often relatively static and difficult to modify, it would help to select a strategic moment to incorporate the E&S elements in procedures and documentation. Strategic moments may exist during a credit process revision, a modification of

IT systems and workflows, or during annual maintenance of procedures and documents.

Keep it practical and concrete for staff and clients.

If a client's E&S performance merits improvement, it is not hard to come up with a wish list of improvement measures. The key, however, is to identify the most important items on the list. Come up with a limited number of key priorities, instead of burdening the client with a long list, and then define practical and concrete key performance indicators with clear objectives and outputs for the client. This keeps it feasible for both client and bank.

Continuously evaluate, adjust, and improve the ESMS.

The relevance and priority of topics in E&S management will change over time and today's standards will not suffice tomorrow. Policies, procedures, and tools should, therefore, be evaluated and improved periodically. In particular, tools such as questionnaires and checklist should be updated and filled with knowledge gathered by the bank in the process of applying them to clients and transactions. Be sure to ask operational staff for input, when evaluating the ESMS and its supporting tools, as they are involved in the daily application of the system and will have valuable feedback.

Improve the ESMS gradually.

Environmental and social risk is often intangible and cannot be captured by the quantified risk approaches that bankers are used to, which is why people need time to get used to this new way of working. As with other processes that require an internal culture change, it is two steps forward and one step back. And that is just fine. It is better to start modestly and generate small successes in implementation that keep momentum going than to ask for revolutionary change with the risk of losing people's buy-in, when results are out of sight. So start small, scale up fast, and let's

not forget that the advanced banks took a long time to get where they are now.

Just start—and learn by doing!

Banks are always running different internal projects simultaneously and, indeed, there's often a fatigue among staff for yet another new policy or

procedure. Banks, therefore, look for the right time to start new and time-consuming internal projects, such as ESMS implementation. But there is never a right time—just as there is always a reason to postpone. When implemented, the ESMS will not be perfect, but it does not need to be. The best way to go about this is just to start; the process will get better along the way!



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Annex

NDB Survey Participants

The following NDBs and organizations participated in the NDB Survey and phone interviews.

SURVEY

Agencia Financiera de Desarrollo	Paraguay
Banco Agrario De Colombia	Colombia
Banco Agropecuario - Agrobanco	Peru
Banco do Brasil	Brazil
Banco do Nordeste do Brasil	Brazil
Banco de Desarrollo de El Salvador	El Salvador
Banco De La Nación Argentina	Argentina
Bancoldex	Colombia
BNDES	Brazil
Caixa Econômica Federal	Brazil
Centro de Energías Renovables	Chile
Corporación Financiera de Desarrollo	Peru
Corporación Financiera Nacional	Ecuador
Fideicomisos Instituidos en Relación con la Agricultura	Mexico
Financiera del Desarrollo Territorial	Colombia
Nacional Financiera	Mexico
Sociedad Hipotecaria Federal	Mexico

PHONE INTERVIEWS

Agencia Financiera de Desarrollo	Paraguay
Bancoldex	Colombia
Banco General (private bank)	Panama
BNDES	Brazil
Caixa Econômica Federal	Brazil
Financiera del Desarrollo Territorial	Colombia
Financiera Rural	Mexico
Grupo Financiero Banorte (private bank)	Mexico
International Finance Corporation (multilateral bank)	United States
Nacional Financiera	Mexico

National development banks (NDBs) play a unique role in promoting sustainability. Due to their public mandate and contribution to the local credit markets, NDBs in the Latin American and Caribbean region are well positioned to support sustainable and low-carbon investments, and they can also effectively leverage private capital for these public goods. Many NDBs in the region have acted as pioneers in promoting sustainability in their respective countries. This publication presents reasons and incentives for financial institutions—and, in particular, NDBs—to implement environmental and social risks management systems. It also presents key success factors and practical recommendations for NDBs willing to design and implement this type of framework.

* * *

The **Inter-American Development Bank** (IDB) was created in 1959 to help accelerate economic and social development in Latin America and the Caribbean.



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