Best-practice guideline
Environmental and social governance in investment and transaction decisions
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The nature and importance of ESG

INTRODUCTION
This guideline is aimed at companies seeking investment and their advisers. It seeks to demystify environmental and social governance (ESG), explore its application and benefits, as well as assess the challenges involved. A number of case studies will illustrate the importance of ESG for transactions.

WHAT IS ESG?
The analysis of ESG matters relating to the operations of a company is now increasingly seen as fundamental to the assessment of its value. The ESG agenda has developed within the investment industry over the last decade or so, particularly in the banking sub-sector in mature financial markets, and seeks to evaluate the sustainability and financial performance of potential investments.1 International financial institutions (IFIs) such as development banks initiated the concept of taking into account non-financial factors when investing in businesses or projects around the world.

Investors are incorporating ESG risk into their decision-making process to increase investor confidence by improving risk management and market transparency. By attempting to identify and quantify ESG risk and the process by which it is being managed, investors are able to gain an enhanced view of corporate risk and strengthen their investment appraisals and due diligence process.

VALUE OF ESG TO INVESTMENTS AND INVESTORS
Ultimately, the implementation of ESG systems must be of financial value to investors. The balance that investors need to strike through ESG is responsibility versus return. ESG can help investors effectively risk manage their investments on a long-term scale; with effective ESG management, the fund manager’s potential for a successful exit can be significantly improved. For example, if an underperforming industrial facility is upgraded incorporating all ESG standards expected of global operating businesses, then there is less potential for future divestments to be devalued due to the need to fill gaps in ESG performance. From an indirect perspective, the corporate social responsibility (CSR) and associated perception benefits from responsible investment and ESG systems can be of significant value to investors.

In relation to the investments themselves, the benefits may be substantial. The thorough consideration of ESG criteria often results in the use of best available techniques and practices at every stage of the project. This often leads to increased corporate performance through significant longer-term cost savings, increased management capacity and stronger relationships with suppliers through more efficient supply chains.

DRIVING ESG – WHY IS IT IMPORTANT AND TO WHOM?
ESG acts as a prospective area of growth for the corporate finance sector for a number of reasons:
• new opportunities for investment can be considered, with access to new markets and businesses;
• there are ever increasing financial risks associated with ESG criteria;
• more and more stakeholders expect that investors will deliver more than simply financial return on their investments;
• demonstrating adequate ESG risk management is increasingly becoming a standard requirement across an ever wider range of investment organisations; and
• it helps protect reputational risk and ‘goodwill’-related asset values.

Economic growth is directly related to ESG, with environmental and social capital and the governance of countries being essential to development. The economic downturn that followed the 2008 financial crisis exposed weaknesses in investment companies and identified a lack of appropriate governance at both company and country levels. ESG and responsible investment aim to create a sustainable economy based on long-term growth which will be able to support long-term liabilities.

There is increasing pressure from stakeholders for the development of responsible investment. This has partially resulted from the recent economic crisis which weakened stakeholder and public trust in financial institutions by revealing concerns of unethical operations. This has encouraged financial investment companies to publicise their awareness of the impacts that their investment decisions can have on the environment and societies globally.

The legal drivers are predominantly compliance with national environmental legislation, compliance with European standards for countries in the EU and other legally binding international agreements. There are no direct legal drivers as such that require an investor to invest responsibly, although all businesses and/or projects invested in should be in compliance with relevant legislation. However, ESG ensures that environmental and social assessment is undertaken using global leading standards which may often exceed national legislative requirements.

1. Figures from Ethical Investment Research and Information Service (EIRIS), a research specialist in responsible investing, show that Britain’s green and ethical retail funds rose from £3.57bn to £12.2bn from 2003 to 2013. See businesslife.co/Features.aspx?id=ethical-investing-a-pretty-picture
Environmental law continues to be developed at an international level. Within the EU, the establishment of the Polluter Pays and Precautionary Principles has identified and shifted environmental responsibility towards companies. Developing markets are also strengthening their environmental legislation; notably China, with sustainability investment in Asia anticipated to grow to over $2trn (£1.3trn) by 2020.

The establishment of the United Nations (UN) Principles for Responsible Investment (UN PRI) in 2006 and the extensive growth of signatories have shaped an ethos towards ESG and responsible investment. At the time of writing this guideline, the adoption of the UN PRI is evidenced by over $34trn (£21trn) in assets which adhere to these Principles.

### UN Principles for Responsible Investment

| Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes. |
| Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices. |
| Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest. |
| Principle 4: We will promote acceptance and implementation of the Principles within the investment industry. |
| Principle 5: We will work together to enhance our effectiveness in implementing the Principles. |
| Principle 6: We will each report on our activities and progress towards implementing the Principles. |

Source: Principles for responsible investment, unpri.org

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2. 1 USD = 0.617259 GBP, 30/09/2014
4. See footnote 2
5. [ft.com/cms/s/0/6fbc344e-2d17-11e3-8281-00144feab7de.html#axzz373SV8ycI](http://ft.com/cms/s/0/6fbc344e-2d17-11e3-8281-00144feab7de.html#axzz373SV8ycI)
Environmental and social concerns can highlight major risks and/or opportunities for investment. Where previously environmental and social factors and their future financial implications have been difficult to represent on a balance sheet, these areas are now being considered as new market opportunities (e.g., climate change adaptation). There are a number of priority areas such as the initial examples below. While it is important that a systematic approach is adopted in order to assess all impact areas, there are a number of key themes, described below, bringing ESG further into the investment agenda.

### Climate change

Climate change poses a number of threats to investments worldwide. With the Intergovernmental Panel on Climate Change (IPCC) continuing to model the impacts of global warming, investments ranging from infrastructure to agriculture could be threatened and ultimately lost. As a result of this, fossil-fuel-dependent industries have become less attractive to investors while renewable energy and sustainable technologies are in increasing demand.

On the other hand, threats to investments arising from climate change are also creating new opportunities for investment. With increasing development in emerging market economies, new markets are being created with opportunities including renewable energies, flood defence and sustainable transport planning.

### Resource scarcity

Resource scarcity threatens to be a significant challenge to the global economy. With many technological products requiring the sourcing of rare minerals, and with questions around the sustainable production of goods worldwide, opportunities lie in the sustainable sourcing and production of goods, while putting pressure on practices that are unsustainable.

### Human rights and social impacts

Investment in projects and businesses have impacts on people’s lives, in particular in the developing world where vulnerability to any changes is often more significant. The social impact of these investments has become a significant, if not dominant, topic within ESG. Related issues include the regional economic benefit of investment in new projects, improved social mobility associated with increased employment, or negative impact issues such as forced resettlement, economic displacement within communities or impacts on health or crime. For example, conflict minerals are a strong topic area in ESG. With the mining of tin, tungsten, tantalum and gold in some areas of the world being associated with funding civil wars, domestic abuse and unfair working conditions, there is pressure for investees and investors to demonstrate that product components have not been sourced from conflict associated mines.

These key risks and opportunities (as well as many others) are central to the ESG assessment of an investment, and resulted several years ago in the establishment of performance standards for investments, published by IFIs such as the World Bank, the International Finance Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD). This was followed by a set of standards that has been adopted by commercial banks on a voluntary basis (e.g., some commercial banks are signatories of UN PRI). The adopted criteria should be applied when evaluating the impacts of a potential investment.
Assessing investments

In order to identify whether an investment is responsible, investors must assess the impact of an investment based on ESG criteria. Companies could choose their own, but many tend to follow established criteria such as the performance standards by the IFC, the performance requirements by the EBRD, other IFI standards (eg, African or Asian development banks) or the Equator Principles for commercial banks.

Organisations need to implement a systematic approach to ESG. This should include:

• establishing a corporate process to continually assess ESG criteria as part of investment planning;
• conducting assessments of specific investment impacts; and
• establishing the specific position in relation to the selected environmental and social guideline criteria.

By following this approach, investors will be able to develop a portfolio of responsible investments. During the period of investment, ESG requires the assessment of the progress of implementation of improvements, best practice and compliance with national and international standards and agreements. Having completed the ESG process during an initial investment, follow-on funding becomes easier.

FROM CORPORATE POLICY AND SYSTEMS TO INVESTMENT TECHNICAL ASSESSMENTS

The implementation of ESG arrangements within financial institutions has two main areas relating to the investor’s business processes.

• A corporate environmental and social policy needs to be developed, along with implementation systems. This will allow the investor to assess implications for strategic investment planning and undertake initial specific investment ‘screening’.
• Arrangements then need to be implemented to conduct detailed assessments of environmental and social issues on a specific project-by-project basis, along with investment action and mitigation planning.

The development of a corporate environmental and social policy and governance implementation systems is important to provide a clear commitment to ESG criteria and to outline the key features of these commitments and their relevance to the businesses’s operations. This is also important because it provides a clear statement of intent which can be used in relation to future investment decision making, and assessing future strategic direction, types of investments or focus areas. These corporate governance systems will also define a process for the undertaking of initial ‘screening’ assessments for specific investments.

THE ENVIRONMENTAL AND SOCIAL POLICY

This policy should provide details of the organisation’s commitments concerning how it will ensure adequate ESG within its investment decisions and within its own investments.

The policy can vary from a short (1 or 2 page) statement of overall commitment, intent and organisation process summary, through to a detailed coverage of policy criteria across a whole series of risk categories. Many IFI policy documents range from 50 to 100 pages. The most important feature of the policy is that there is a clear and defined set of investment commitments which can form the basis of later decision making. Importantly, where the briefer policy route is chosen, there also needs to be a very clear reference to other detailed ESG criteria and standards which will be used to inform the decision-making process.

THE CORPORATE-LEVEL PROCESS

To ensure that the environmental and social policy is complied with, good governance starts with a corporate process that will include key elements such as:

• investment initial screening and direct exclusion criteria;
• investment categorisation to ensure the level of investment specific assessment is appropriate to the nature and scale of the activities and also the potential level of impacts, risks and positive environmental and social opportunity;
• the process to undertake detailed project due diligence assessment;
• due diligence criteria to be followed, reporting and disclosure requirements;
• the process to undertake key environmental and social action planning and ensure this is integrated into the investment agreement processes;
• processes for final investment sign off and approval, integrating the ESG criteria; and
• processes for ongoing action monitoring and performance reporting, post-investment.

Overall the corporate process needs to ensure that the detailed committed ESG criteria are implemented into specific investments. This could be achieved through the development and implementation of an environmental and social management system (ESMS). The system should align with specific institutional characteristics (eg, EBRD Performance Requirements) to address the environmental and social risks associated with its financing activities.
A variety of sustainability indices exist, which act as an indicator of the performance of global companies in relation to widely recognised standards. Examples such as the FTSE4Good Index Series and the Dow Jones Sustainability Index track the stock performance of leading sustainability-driven companies worldwide (based on economic, environmental and social criteria) and provide reliable benchmarks for companies wishing to implement and/or improve the management of environmental and social risks. The recognition of some of the leading indices is powerful enough to affect stock value, so gaining entry to such an index can be particularly beneficial for an individual business. Investors can use this as an analysis tool to determine companies’ corporate sustainability performance as well as future performance potential. This will allow the identification of potential investment opportunities and transparent decision making throughout the ESG process.

The remainder of this guideline focuses on the specific use of investment ESG criteria such as IFI standards or the Equator Principles, rather than indices of corporate sustainability strategy.

**INVESTMENT ESG CRITERIA: ESG STANDARDS**

**WHAT CRITERIA ARE AVAILABLE?**

There are a number of environmental, health, safety and social (EHSS) benchmarks and standards that are easily accessible and available in the public domain. Often these also cover associated ESG areas such as labour standards and good general financial governance. As previously mentioned, such standards have been developed and are used by IFIs, including multilateral and regional development banks, export credit agencies and government aid programmes, as well as commercial banks, private equity companies and other international and national commercial organisations to audit projects and programmes, prior to approval of their financing.

There are also generic or sector-specific supporting guidelines available that enable those conducting assessments to understand and practically assess the key EHSS risks and impacts to identify deficiencies, gaps, shortfalls, weaknesses and non-compliances associated with the management techniques and the technologies employed relating to the ‘project’. In the EU, there are sector-specific EU BAT Reference (BREF) notes that identify best available techniques (BAT) that should be adopted. During the environmental and social due diligence (ESDD) process, the project is assessed against the standards while the guidelines can be used to focus on the key issues to determine the extent of compliance against the standards.

An important component of an ESDD assessment is also to evaluate the company’s corporate management arrangements and capacities. As part of the loan or financing agreement, mutually agreed mitigation measures are identified and presented in an action plan that becomes incorporated into the ‘project’ after the ESDD process. In these projects, the EHSS criteria are identified to guide the implementation of internationally accepted best practice, while also achieving compliance with relevant national and international level requirements. This ensures that international standards of EHSS management are embedded into the loan agreements or equity investments. The action plan should present actions which are attainable and the plan should clearly present the specific implementable actions, reference the relevant laws or standards, the resources and indicators required for successful implementation and a timetable by which they should be completed.

**WHICH CRITERIA TO CHOOSE?**

Although there is no single universal approach to integrate ESG issues into investments, these standards can be used or can form the basis for investors to develop their own strategies, techniques and methodologies for ensuring their investments are considered to be sustainable. A hybrid approach for the use of standards may be useful for some projects, and the level of assessment should be commensurate with the type, size and the potential impacts associated with the project. These can easily be adopted by any organisations involved in investments including merger and acquisition transactions. For example, export credit agencies use either World Bank Safeguard Policies or IFC Performance Standards, dependent on the type of project. World Bank Safeguard Policies include sector-specific coverage such as dam safety and international waterways.

Private equity investors, for instance, can adopt or adapt such standards to ensure investments can be rigorously evaluated from an EHSS perspective, with improvements identified and implemented within the project. Each set of standards will have its merits in terms of its coverage and, as discussed above, applicability. There are no standards that are considered superior. The selection of standards used is often decided on a case-by-case basis.

In the past, some investors sought to invest in only ethical projects and would invariably avoid certain sectors such as nuclear, armaments and tobacco industries. This may be viewed as outdated and simplistic now, as the approach of continual improvement incorporated into the investments seems more appropriate in these times, even in industries that previously had often been avoided. Furthermore, with other issues such as climate
change, among others, that are now high on the environmental agenda, there is now a different focus. For example, the replacement of fossil fuels with renewable sources is currently very important. The assessment of pre- and post-investment carbon emissions is often taken into account in the ESDD process and alternatives are sought if a threshold of tonnes of carbon dioxide (CO\textsubscript{2}) (equivalent) is exceeded.

Nonetheless, the policies of IFIs and other financial organisations do often include an exclusion list, not necessarily by sector, but more of a prescriptive list of activities that essentially contravene national and international laws, international conventions, agreements, bans or phase-out. Typically, projects are screened as follows.

<table>
<thead>
<tr>
<th>Screening stage</th>
<th>Implications/scope</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is the project on an exclusion list?</td>
<td>If so, then the project should not be financed.</td>
</tr>
<tr>
<td>Is the project considered to be a high-impact project?</td>
<td>If so, there is a more formalised and participatory ESDD process with a greater scope of assessment as there would be potentially significant adverse environmental and social impacts that are not readily identified and assessed. The project may require a detailed environmental and social impact assessment (ESIA) beyond the requirements in the specific country.\footnote{Equation}</td>
</tr>
<tr>
<td>Is the project considered to be a low-impact project?</td>
<td>If so, the ESDD process involves an assessment with the requirements judged on a case-by-case basis. Potential adverse environmental and social impacts are limited and readily identified and can be addressed by mitigation measures.</td>
</tr>
<tr>
<td>Is the project considered to have minimal impact?</td>
<td>If so, the scope of assessment can be limited.</td>
</tr>
</tbody>
</table>

The first ESG decision will be the project-screening stage to determine whether the project can proceed (if it is not on an exclusion list) and if so, the categorisation based on potential impacts and mitigation.

Financial organisations often use experienced third-party consultants to undertake the ESDD, including any specialist or component studies that may be needed. Following the finalisation of the programme of investment, there will typically be a requirement for information to be provided relating the progression of the action plan. This forms part of the loan agreement, and financial organisations may often retain advisers to undertake site visits and assessments to verify the information.

Examples of environmental and social benchmarks and standards of supranational institutions include the following.

**Equator Principles**

The Equator Principles (EPs), which have been in place since 2003, comprise a risk management framework and are a set of investment guidelines agreed by the signatories to ensure that EHSS and labour standards are adequately considered and addressed on projects in lower income or developing countries. In essence, implementation of the requirements should ensure projects being developed in these regions are undertaken with management techniques and standards in line with those expected in ‘high-income’ countries. Captured ‘projects’ have a wide range: from new energy projects and industrial developments, to new roads, airports or even major agricultural developments.

The EPs are voluntary and, at the date of this guideline, there are 80 signatory financial institutions in 34 countries, covering over 70% of international project finance debt in emerging markets. The latest (third) version of Equator Principles (EP III) is well aligned with other similar standards established by development banks and other IFIs, such as the IFC Performance Standards and EBRD Performance Requirements.

Financial institutions that adopt the EPs (the Equator Principles Financial Institutions or EPFIs) will only provide project finance and project-related corporate loans to projects that meet the requirements of Principles 1–10.

| Principle 1: Environmental and Social Review and Project Impact Categorisation |
| Principle 2: Environmental and Social Assessment |
| Principle 3: Applicable Environmental and Social Standards |
| Principle 4: Environmental and Social Management System and Equator Principles Action Plan |
| Principle 5: Stakeholder Engagement |
| Principle 6: Grievance Mechanism |
| Principle 7: Independent Review |
| Principle 8: Covenants |
| Principle 9: Independent Monitoring and Reporting |
| Principle 10: Reporting and Transparency |

Source: equator-principles.com

\footnote{The requirement for a full ESIA is defined in the standards of IFIs or the Equator Principles (eg, see IFC PS1).}
International Finance Corporation (IFC)
Tied to the World Bank, the IFC was created in 1956. It became financially independent from the World Bank in 1984. Environmental and social review procedures and safeguard policies were first launched in 1998, and in 2001 mainstreaming sustainability in all investment transactions became the norm. In 2003 the 10 top international banks that adopted the Equator Principles applied new environmental and social development standards to their project finance lending based on IFC standards. The IFC’s Sustainability Framework outlines their Performance Standards (PS) 1–8 as follows.

PS 1: Assessment and Management of Environmental and Social Risks and Impacts
PS 2: Labour and Working Conditions
PS 3: Resource Efficiency and Pollution Prevention
PS 4: Community Health, Safety and Security
PS 5: Land Acquisition and Involuntary Resettlement
PS 6: Biodiversity Conservation and Sustainable Management of Living Natural Systems
PS 7: Indigenous Peoples
PS 8: Cultural Heritage

Source: Performance Standards on environmental and social sustainability, January 2013, ifc.org

The IFC has created an assessment engine called the ES-Toolkit, which assists fund managers in assessing and managing the environment and social risks and opportunities associated with their investments. Based on a standard approach to investment (screening, appraisal, management and exit), users are guided through the environmental and social tasks of each phase in parallel with the financial aspects.

An illustrative assessment against IFC Performance Standards is shown on p11 of this guideline.

European Bank of Reconstruction and Development (EBRD)
The EBRD was established in 1991 to help build a post-Cold War Europe. Today the bank operates in 35 countries in Central and Eastern Europe, Central Asia and the Southern and Eastern Mediterranean. The EBRD Environmental and Social Policy (2008) provides 10 Performance Requirements (PRs) that projects need to meet. An updated Policy and PRs have been issued in November 2014.

PR 1: Environmental and Social Appraisal and Management
PR 2: Labour and Working Conditions
PR 3: Pollution Prevention and Abatement
PR 4: Community Health, Safety and Security
PR 5: Land Acquisition, Involuntary Resettlement and Economic Displacement
PR 6: Biodiversity Conservation and Sustainable Management of Living Natural Resources
PR 7: Indigenous Peoples
PR 8: Cultural Heritage
PR 9: Financial Intermediaries
PR 10: Information Disclosure and Stakeholder Engagement

Source: Environmental and Social Policy, ebrd.com

World Bank
The World Bank has environmental and social safeguard policies that comprise an operational manual containing operational policies (OPs) and bank procedures (BPs). Of these, 10 are classed as environmental and social safeguard policies.

OP/BP 4.01: Environmental Assessment (this is the umbrella policy)
OP/BP 4.04: Natural Habitats
OP 4.09: Pest Management
OP/BP 4.10: Indigenous Peoples
OP/BP 4.11 Physical Cultural Resources
OP/BP 4.12 Involuntary Resettlement
OP/BP 4.36: Forests
OP/BP 4.37 Safety of Dams
OP/BP 7.50 Projects in International Waterways
OP/BP 7.60: Projects in Disputed Areas

Source: Operational Manual, worldbank.org

The World Bank also has an additional set of Performance Standards (1–8) for private-sector activities, the requirements of which are largely aligned with the IFC Performance Standards.
Organisation for Economic Co-operation and Development (OECD)

The OECD Working Party on Export Credits and Credit Guarantees (ECG) has established common approaches for taking environmental and social issues into account when providing officially supported export credits. There have been agreements and recommendations since the late 1990s relating to measures members should take to address the potential environmental and social impacts of projects for which official export credit support is requested. This requires applying the following common approaches for addressing environmental and social issues relating to exports of capital goods and/or services and the locations to which these are destined. It recommends benchmarking non-project-finance projects against either all 10 World Bank Safeguard Policies or all 8 IFC Performance Standards, and limited or non-recourse project finance projects against the relevant aspects of all 8 IFC Performance Standards. Members can benchmark projects against the relevant aspects of the standards of a major multilateral financial institution that is supporting the project.

European Investment Bank

The European Investment Bank (EIB) is the EU’s bank and was founded in 1958. The bank’s Statement of Environmental and Social Principles and Standards requires projects to comply with EU environmental law and, if necessary, be supplemented by other good international practices. Emission, ambient and procedural standards are the environmental areas for consideration. Projects financed outside the EU should also be compliant with national law. A human-rights-based approach is adopted for social standards. Other key areas are cultural heritage; consultation, participation and public disclosure; biological diversity; and climate change.

Case study 1: ESG in a major new category A project

Teghout CJSC mine development, Armenia

EKF is a Danish credit export agency and Equator Principles signatory that supports companies outside of Denmark in purchasing Danish exports. EKF is committed to working to a high level of environmental standards in the transaction. EKF screens and assesses all transactions for environmental and social sustainability and applies international standards during assessments, in alignment with its strategy. Teghout CJSC is within EKF’s current transaction portfolio. Teghout CJSC is a mining company which is currently developing a copper and molybdenum mine in Armenia. An environmental and social review of a new copper and molybdenum mine in Armenia was undertaken on behalf of EKF ahead of its investment. This has led to the development of an EHS management system in order to sustainably manage the potential impacts of the mining project across the lifecycle of the mine. The project developer and the financer commissioned WSP to ensure that the range of management plans, including stakeholder engagement, waste management, water management, biodiversity and health and safety are implemented in alignment with international standards. The initial assessment identified gaps, in particular regarding the establishment of a social and health baseline and assessment of the overall impacts and benefits of the project on the community.

The category A project is being assessed against the IFC’s Performance Standards. The key ESG focus areas have included: mine waste management and tailing leachate control systems design, EHSS management systems development and implementation, hydrological flows assessment for all surrounding waterways, construction management planning, social and health baseline assessment and development of social and health indicators, biodiversity surveying and management planning.

A series of management plans and an international certifiable EHS management system are being implemented in order to ensure there will be appropriate management of the identified risks in alignment with international standards. WSP consultants continue to provide support in this area.
EVALUATION DURING DECISION MAKING

The ESG evaluation should be considered during all decision points and particular attention should be paid where environmental and social risks are considered high. In order to facilitate this process, the ESG assessment should be integrated into corporate evaluation models. Following the ESG evaluation and identification of the ‘baseline’, the investor should work with the borrower in order to develop a series of indicators and initial improvement programmes as well as identifying the ESG information for disclosure. The following steps are typically followed before investment.

<table>
<thead>
<tr>
<th>Top-level screening</th>
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<tbody>
<tr>
<td>Initial check on the alignment of the potential investment with the investor’s values, principles and policies including an exclusion list.</td>
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<tr>
<td>High-level evaluation of geographical and sector risks specific to ESG.</td>
</tr>
<tr>
<td>Categorisation of the project (high, medium, low risk).</td>
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</tbody>
</table>

<table>
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<tr>
<th>Profiling</th>
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<tbody>
<tr>
<td>Evaluation of ESG risks and opportunities specific to the project.</td>
</tr>
<tr>
<td>Understand the borrower’s capacity to manage ESG risks.</td>
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<table>
<thead>
<tr>
<th>Environmental and social due diligence</th>
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</thead>
<tbody>
<tr>
<td>Define the scope of the assessment.</td>
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<tr>
<td>Undertake an independent review of the investment project and the borrower.</td>
</tr>
<tr>
<td>Identify current performance and areas for improvement against the investor’s values, principles and policies.</td>
</tr>
</tbody>
</table>

TOP-LEVEL SCREENING

During the early stages of the investment, it is likely that limited ESG-specific information will be available and therefore only a high-level assessment is needed. The following elements should be considered at this stage.

- Initial checks to ensure that the potential investment will be aligned to the investor’s values and policies. This will prevent unnecessary time and expense being spent on progressing potential investments that will not be advanced on ESG grounds (ie, specific checks against an exclusion list). Investors should ensure that their values and policies are well communicated internally and are well embedded into the initial investment analysis in order to assist with this screening.

- Evaluation of project-specific sector and geographical ESG risks. This evaluation should be completed in order to understand the project categorisation (at least a preliminary categorisation with verification later on in the process) determined by the ESG risks faced in the project-specific sector and geography. This high-level assessment will determine the level of further ESG evaluation and appraisal going forward.

- ESG risks and opportunities that are presented as within the entire ‘value chain’ of the borrower. This will also require the defining of an ‘area of influence’ of the project, and undertaking a high-level assessment of the ESG benefits and impacts faced within this area.
Illustration: ESG risks and opportunities for a food manufacturing company in Egypt

<table>
<thead>
<tr>
<th>Raw Material</th>
<th>Transport</th>
<th>Conversion</th>
<th>Packing</th>
<th>Trade</th>
<th>Consumption</th>
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</thead>
<tbody>
<tr>
<td>Responsible sourcing of raw materials – resource scarcity</td>
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<td></td>
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<tr>
<td><strong>Risks:</strong></td>
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<tr>
<td>Climate change, water scarcity and increasing populations may cause stress on raw materials and manufacturing processes.</td>
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<tr>
<td><strong>Opportunities:</strong></td>
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<tr>
<td>Identification of alternative and sustainable sources of raw materials supply.</td>
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</tbody>
</table>

| Emissions and discharges to the environment |
| **Risks:** |
| Compliance requirements and associated taxes. |
| Energy use and the associated costs. |
| Greenhouse gas contribution. |
| **Opportunities:** |
| Implementation of energy efficient techniques and technologies. |
| Improved environmental management. |

| Waste |
| **Risks:** |
| Generation and responsible disposal/recovery of waste and hazardous waste. |
| Costs associated with disposal to landfill. |
| **Opportunities:** |
| Increased recycling and recovery of waste. |
| Introduction of recyclable materials for packaging. |

| Food safety and hygiene |
| **Risks:** |
| Potential source of risk if the company’s products do not meet industry standards. |
| **Opportunities:** |
| Improved food safety management and standards. |
| Supplier selection based on food hygiene standards. |

Once this top-level screening has taken place and indicates that further assessment is needed, a team of technical specialists, familiar with the technical issues and company processes, should be assembled to undertake the evaluation.

PROFILING

The profiling phase of the project will require a more detailed assessment of the sector-specific and geographical ESG risks specific to the investment project and the borrowing company. Site visits may often be required in order to gain a full understanding of the business and proposed investment plans.

The visit should also be used as an opportunity to understand the scope of the ESG management team within the borrowing company. The following aspects should be considered.

- **Forward thinking?** The visit and discussions with the company should be used as an opportunity to understand the commitment to sustainable practices.
- **Capacity:** Understand whether there is a dedicated EHSS team that will be responsible for performance and progression to ensure alignment with the investor’s requirements.
- **Current performance:** What is the current status of compliance with EHSS regulations and commitments? Understand whether there is effective management capacity, policies, procedures and systems in place. Does the company have any EHSS indicators that are being reported against?

ENVIRONMENTAL AND SOCIAL DUE DILIGENCE

The aim of the detailed due diligence is to assess the proposed investment in greater detail, in order to understand the associated risks that could impact the overall business case, value and reputation. The weighting of the risks will depend on the investor’s policies and values.

The scope of the assessment will vary depending on the category assigned to the project, the location, the sector and the nature and the activities of the borrower and therefore the relevance of evaluation criteria used in the assessment may differ, with some requiring more detailed analysis.

The investor would need a single specialist or a team to ensure the ESG risks and opportunities are covered in sufficient detail. The choice of the specialist due diligence team is an important one. The team should be chosen on the basis of expertise and experience and also on their geographical knowledge. If these skills and experience are not available within the investor organisation, then an external adviser(s) is likely to be needed. Typically, investors will employ consultants with sector-specific expertise, in-country knowledge and a clear grasp of the ESG criteria against which the project is being assessed.

The due diligence assessment will focus on the current and reasonable foreseeable ESG matters associated with the investment, in order to understand further the potential opportunities and risks. The assessment will be undertaken in alignment with the investor’s policies, values, requirements as well as national regulatory requirements, sector-specific standards and other non-regulatory commitments/schemes, as detailed previously.

Typically, the assessment will focus on the compliance with regulatory requirements and the investor’s standards. Other common criteria will include contamination liabilities, hazardous substances risks, labour standards, community impacts and stakeholder engagement and consultation. As already described, there is an array of ESG criteria that can be adopted by the investor to assess their investment projects.
The following example provides more detail on typical assessment topics to review current performance and the typical outputs associated with the assessment using the commonly used IFC Performance Standards.

**Illustration: assessment of a project against IFC Performance Standards**

<table>
<thead>
<tr>
<th>IFC Performance Standard</th>
<th>Typical topics to assess performance</th>
<th>Typical outputs</th>
</tr>
</thead>
</table>
| 1. Assessment and Management of Environmental and Social Risks and Impacts | • Project categorisation  
• National planning regulations in the project country  
• Investment plans  
• Site settings and key risk receptors  
• Management capacities and responsibilities  
• Existing EHS and HR policies, procedures and management systems  
• EHS expenditure and investment  
• EHS improvement programmes  
• Complaints and grievances | • Full project ESIA if a ‘category A’ investment project  
• Due diligence report – corporate review  
• Action plan to align performance with the standards |
| 2. Labour and Working Conditions | • Current workforce profile  
• Working hours  
• Terms of employment  
• Equal opportunities  
• Gender  
• Forced labour  
• Child labour – supply chain risks  
• Grievance mechanism  
• Plans for retrenchment  
• Management of contractors  
• Occupational health and safety  
• Health and safety performance statistics  
• Within an EU context eg, EU Seveso 2 – major accident hazard control | • Due diligence report – current working conditions  
• Internal grievance mechanism  
• Action plan to align performance with the standards  
• A retrenchment plan |
| 3. Resource Efficiency and Pollution Prevention | • Review of permits  
• Within an EU context, assessment of whether best available techniques (BAT) are in place and being operated (or featured within the design for new projects) for the management of polluting emissions and environmental impacts, for the specific sector. (This is detailed within the BREF notes)  
• Bulk storage practices  
• Energy and resource consumption  
• Greenhouse gas emissions calculations  
• Air emissions abatement and control systems  
• Wastewater treatment and discharge  
• Groundwater and hydrogeology conditions  
• Ambient air emissions and dispersion modelling  
• Point source air emissions and abatement techniques  
• Waste minimisation and alternative uses of wastes | • Due diligence report – current environmental performance  
• Design BAT evaluation  
• Action plan to align performance with the standards |
<table>
<thead>
<tr>
<th>IFC Performance Standard</th>
<th>Typical topics to assess performance</th>
<th>Typical outputs</th>
</tr>
</thead>
</table>
| 4. Community Health, Safety and Security | • Stakeholder engagement  
• Security arrangements  
• Ambient air emissions and modelling  
• Gender related issues  
• Ecosystems services assessment  
• Health and social baseline assessment  
• Review of emergency preparedness and response | • Stakeholder engagement plan  
• Grievance mechanism |
| 5. Land Acquisition and Involuntary Resettlement | • The need for land acquisition as part of an expansion  
• Involuntary displacement  
• Restrictions/changes in land use  
• Financial impacts on existing businesses  
• Economic displacement | • Resettlement action plan  
• Livelihood restoration action plan  
• Compensation framework  
• Grievance mechanism |
| 6. Biodiversity Conservation and Sustainable Management of Living Natural Resources | • Review of existing ecology baseline data and the potential impact from the project  
• Site settings and key features  
• Species and habitats impact assessment  
• Invasive alien species risk assessment  
• Review of potential impacts to ecosystems services  
• Assessment of sustainable management of living natural resources  
• Review of supply chain risks | • Biodiversity action plan  
• Biodiversity management and mitigation plans |
| 7. Indigenous People | • Assessment of adverse impacts on affected communities of indigenous peoples within the project area  
• Review of the baseline  
• Consultation and engagement with the indigenous people  
• Identification of opportunities for indigenous people, in alignment with the groups’ goals and preference  
• Consultation with the government, where necessary | • A time-bound management plan to minimise, restore and/or compensate for these impacts in a culturally appropriate manner  
• Grievance mechanism |
| 8. Cultural Heritage | • The identification of cultural heritage sites within the project area  
• Consultation with affected communities, where necessary | • Chance find procedure  
• Cultural heritage sites protection plan |
Case study 2: ESG requiring detailed studies and difficult decisions

**Ombla hydropower plant, Croatia**

A proposed hydropower plant in Croatia was considered a category A project, under EBRD’s 2008 Environmental and Social Policy, due to the size of the underground dam and the potential significant impacts to a proposed Natura 2000 area. Over the course of three years, WSP worked closely with the EBRD and the borrower in order to assess the potential project against the EBRD’s performance requirements, EU Directives and national legislation.

An initial ESDD assessment was undertaken as well as the development of supplementary information to align the existing 1999 environmental impact assessment with EU standards and PR1. A stakeholder engagement plan, non-technical summary and environmental and social action plan (ESAP) were developed and disclosed for 120 days for public review and comment. Public consultation meetings were held across Croatia and Bosnia and Herzegovina.

The most significant potential risks were determined to be biodiversity and resettlement. The main output of the due diligence and ESAP was for further biodiversity studies, including an equivalent study to an ‘appropriate assessment’ and biodiversity management plan, to be completed in line with the EU Habitats Directive. These were developed and identified specific mitigation and/or compensation, as required by the Directive, to be completed. The study was completed and disclosed and further consultation was undertaken during a 30-day disclosure period.

WSP’s team of social experts developed a resettlement action plan to meet the requirements of Croatian law and the EBRD’s PR5. The plan aimed at achieving amicable agreements to compensate for any resettlement or loss of land. This was also included in the ESAP to prevent impacts on nearby cultural heritage sites and to appropriately manage and control the disruption to neighbourhoods from the construction traffic.

Following detailed consultations with the borrower, the lender and the local authorities regarding the findings of the independent expert studies, there were still outstanding areas of potential biodiversity impact for which sufficient mitigation was considered unlikely to demonstrate compliance with the lender’s ESG policy. After a series of detailed assessments and discussions, a decision was made to cancel the loan and support to the project in order to uphold the lender’s ESG policies.
The traditional ESG assessment is continuously evolving. Recently the scope of the assessments have developed to include the following elements.

- **Upstream and downstream considerations** – the ESG due diligence should consider the whole area of influence and value chain of the project. Coverage of wider environmental and sustainability issues such as resource scarcity and climate change are now important. Future potential impacts and risks can be ascertained from a wider audit scope.

- **Benefits** – the assessment should identify the opportunities and the positive impacts as well as the risks associates with the project. This will allow a holistic assessment to be undertaken and allows for a complete evaluation of the project.

- **Consultation** – depending on the nature of the project and the policies and values of the investor, the ESG process could involve a series of information disclosure and public consultation. Typically a project categorised as high impact would require this.

Essentially, the ESG due diligence assessment and subsequent report should not only evaluate the current performance of the borrower against the defined scope of the assessment and also articulate the risks and opportunities associated with the proposed investment, it should also identify the gaps in performance and the actions required in order to close these gaps to improve ESG performance and ensure alignment with the investor’s policies. The action plan can then be integrated into the loan agreement to ensure commitment from the borrowing company.

The issues identified during the pre-investment phase will form an action plan and a baseline for the borrower to report on developed future strategies going forward. It is advised that the investor should monitor and review the ESG management plan as part of the post-investment phase, and encourage the borrower to provide regular update reports throughout the life of the investment. As part of the monitoring, investors should consider a combination of undertaking site visits, commissioning an independent audit and obtaining reporting information directly from the borrower. This is also a good opportunity to identify whether there is a need for further assistance or capacity building initiatives to ensure that ESG risks are suitably managed.

**Case study 3: ESG implemented in a combined corporate and project deal**

**Lafarge Cement Russia**

In 2010, the EBRD agreed a full package of corporate investment with Lafarge Cement Russia, a major cement-producing business with operations across Russia. In order to progress this investment in line with the EBRD’s Environmental and Social Policy and Performance Requirements, WSP was commissioned to undertake a detailed corporate- and site-level review of Lafarge Cement’s operations throughout Russia. The head office and each site were visited and a detailed action plan was produced to meet the EU equivalent pollution control requirements demanded by the EBRD, as well as the range of environmental, safety and social areas of the EBRD’s 10 Performance Requirements. With this action plan in place, along with disclosure and stakeholder engagement agreed, the corporate-level investment could progress.

As part of the corporate-level investment package, a new greenfield cement plant was in design within Lafarge, to be built near Kaluga to the south of Moscow. This category A project required a full detailed ESIA in line with the bank’s policy and international best practice. WSP followed the corporate loan evaluation to deliver the full ESIA and disclosure package with Lafarge, as well as updating the overall environmental and social action plan. This ESIA process lead to a number of changes in the project, such as measures to ensure the protection of cultural heritage, addressing of initial local community concerns in relation to the project, and minimisation of potential impact areas such as air quality and noise. The plant, now in commissioning, benefited from the aspirations of the developer and the ESG policies of the lender, to ultimately deliver a world-class project.

Source: lafarge.ru/wps/portal/ru/en/5_3-downloadcenter
Concluding remarks

The implementation of ESG arrangements is now very well developed across IFI and commercial bank investors. This is now also becoming increasingly popular within other investment groups, in particular within private equity as a means to demonstrate that investments and projects are being managed in line with accepted best international practice. This protects and enhances the value of the investment and ultimately provides more secure shareholder and investor value.

The implementation of ESG criteria within a single or whole portfolio of projects requires a detailed and systematic approach involving the corporate business process, investment-specific consideration and planning, and often requiring a blend of technical and practical knowledge – wrapped together within the investment decision-making processes.

An effective ESG process requires both an overall corporate process and then detailed assessments of individual investments as needed. In order to provide consistency in the decision-making process, an ESG policy is required, along with a clear set of detailed commitment criteria. It is common to use guidelines available to provide these criteria, such as the IFC standards or the Equator Principles.

ESG has the potential to have a significant positive impact on decision making in relation to specific investments. Undertaken properly, there is potential that the overall projects are greatly improved, with a balance being found between economic, social and environmental pressures, but ultimately ensuring that the projects are delivered in line with international best-in-class standards. Effective ESG arrangements can provide an effective foundation to deliver sustainable finance and responsible investment. On occasions, tough decisions may also need to be made.
Neal Barker is a Director of WSP who heads up the Environment, Health, Safety and Social Assessment team in the UK and leads overall on Responsible Investment Services. Neal has worked across many regions of the world and delivered practical support to a wide range of investors, including commercial and development banks as well as private equity businesses and corporate clients. Neal is responsible for the delivery and management of a wide variety of ESG services, from EHSS pre-investment due diligence projects, to completion of ESIs, development of corporate ESG implementation systems and the delivery of training and capacity building. He has been a visiting lecturer in environmental management at the University of Manchester for the last 15 years. Neal’s 20 years of practical experience has included projects ranging from the upgrading of major industrial installations, development of new thermal and renewables power generation plants, through to agri-business, resources, oil and gas and major mining projects, often assessing against IFI guidelines and the Equator Principles. Neal has broad expertise in pollution control and abatement systems, environment, safety and social management and the development of holistic business sustainability strategies.

Stephanie Tyrrell is a Senior Consultant working in the Responsible Investment team. In this position, Stephanie provides technical support on a wide range of strategic EHSS management projects. A key focus area of this role is the successful delivery of a wide variety of Equator Principles’ projects. Stephanie’s extensive experience comes from a variety of EHSS due diligence projects completed ahead of potential investments; she has also been involved in ESIs and wider EHSS management projects. Stephanie has worked across a variety of sectors throughout Europe and Asia, auditing and aligning projects to various ESG criteria. Currently, Stephanie is project managing the long-term mining project in Armenia. This involves a multi-disciplinary team who are responsible for managing and mitigating significant EHSS risks in alignment with IFC standards. These range from stakeholder engagement planning, capacity building, biodiversity conservation and technical analysis of mining waste.

Scott Beaton is an Associate within the Global Responsible Investment team. Scott is a core member of the technical delivery team on a variety of EHSS due diligence projects. Scott has extensive experience working in alignment with a series of ESG criteria, with successful delivery of over 30 international projects, working extensively throughout Europe and Africa in many different sectors. Scott was project manager for the high-profile Ombla hydropower project. This project was carried out in alignment with EBRD Performance Requirements, with a specific Habitats Appropriate Assessment being completed to assess the impact on the Natura 2000 site. Scott managed a global, multi-disciplinary team who produced a 3D model of the proposed scheme, undertook a series of stakeholder engagement meetings across two countries and developed a management and mitigation strategy, including a resettlement action plan, in order to minimise EHSS impacts associated with the proposed power plant.

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Sean Allen is an Assistant Consultant who supports the Responsible Investment team in WSP. Sean has supported on the delivery of a series of EHSS due diligence projects aligned with certain ESG criteria. Sean has completed an extensive primary research project understanding the use of ESG criteria in London-based private equity companies. He worked as part of the project team on an unconventional oil project in Europe. The project attracted much public attention. Sean was responsible for preparing an ‘external factors’ report which identified potential stakeholder group interests, both positive and negative. This was in alignment with EBRD Performance Requirement 10.

WSP is a world-leading global professional services business with a strong engineering and environmental focus. With approximately 17,500 employees, in more than 300 offices based in 30 countries, WSP is ranked in the world’s top 10 professional consultancies. Working with governments, corporate finance and debt providers, lawyers and planners, WSP provides integrated solutions to every facet of business.

WSP’s Environmental Due Diligence team are the trusted advisor for businesses and funders involved in a variety of corporate mergers and acquisitions and real-estate transactions. The team has worked on over £4bn of completed commercial transactions in 2013, ensuring that both the risks and opportunities associated with the environment, health and safety, energy and sustainability are identified and managed effectively. The team combines technical knowledge with a commercial focus and applies these whether there are legacy issues such as contaminated land or asbestos, operational issues such as compliance or energy management/optimisation, or future issues such as climate change adaptation, stress-testing of assets and infrastructure impacts.

WSP’s Environmental Health and Safety Management and Compliance team delivers EHSS assessment projects ahead of potential investments. With an international team of EHSS experts, the team provides the range of required support to ensure that investments are structured to meet best-practice ESG standards, often aligned with IFI standards such as the IFC Performance Standards, EBRD Performance Requirements, or the Equator Principles. The team supports clients in managing and mitigating risks and liabilities, but also in identifying opportunities to improve the sustainability of their future investments. WSP has capability across all environmental, safety, social and labour-related issue areas, and it aims to develop effective management plans to bring corporate benefit and to demonstrate compliance with the ESG requirements of international funders. WSP’s practical support projects range from full ESIAs for large, high-impact projects, through to EHSS due diligence assessments, and covers investment areas such as industrial portfolios, energy generation, infrastructure development, agribusiness operations, and transport projects.
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