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Project Finance Group Client Alert: The Equator Principles: How Will The Revisions Impact You?

The third revision (EP III) of the Equator Principles (EPs) will be launched on June 4, 2013, and it will affect applicable transactions signed on or after January 1, 2014. The EPs will continue to function in a substantially similar manner, but the EP III has, among other things, made the EPs applicable to a wider slate of transactions, expanded the scope of underlying review, and imposed additional disclosure and reporting obligations. Although there is time to internalize the revisions during the transition period, failure to comply with the EP III on a going-forward basis could put financial institutions in non-compliant scenarios, if proper arrangements are not made in advance of the effectiveness of these lending guidelines, as revised. This Client Alert provides some guidance about changes due to the EP III to help financial institutions assess related risks for future transactions.

WHAT ARE THE EQUATOR PRINCIPLES?

The EPs were adopted on June 4, 2003 by several key international lending institutions concerned with reputational issues created by projects that had resulted in widely publicized negative environmental and social impacts. As a result, these lending institutions adopted a voluntary set of environmental and social guidelines to serve as an industry benchmark for assessing and managing environmental and social risks inherent in financing large infrastructure transactions. The EPs continue to be based on the International Finance Corporation's (IFC) recently updated Performance Standards (available at www.ifc.org/ifcext/policyreview.nsf/Content/2012-Edition) as well as the World Bank Group's Environmental Health and Safety Guidelines (available at www.ifc.org/ehsguidelines).

More than 75 financial institutions currently adhere to the EPs (referred to as Equator Principles Financial Institutions or EPFIs). These EPFIs commit to finance projects exclusively with borrowers that pledge to adhere to the lending institutions' respective environmental and social policies and procedures. The EPs require lending institutions to assess projects based on their location, nature, size and effect, and to conduct corresponding environmental and social impact reporting and mitigation.

WHY WERE THE EQUATOR PRINCIPLES REVISED?

The EP III reflects a desire by the EPFIs to maintain the EPs as the global financing industry's "best practices" standard in a changing financial market. The EP III demonstrates the importance placed by the EPFIs on addressing new areas of concerns, such as climate change and human rights, and including new types of transactions not previously covered by the EPs. The expansion of the EPs reveals yet another data point in the continued and growing trend of reputational risk considerations in modern lending practices. The EPFIs voluntarily joined together to expand the scope of the EPs to ensure that high priority continues to be placed on environmental and social considerations in project-related transactions. The changes to the EPs reflect the EPFIs' desire to improve their environmental and social policies and to provide greater emphasis on mitigating adverse impacts. The recently published EP III is available on the Equator Principles Association homepage at http://www.equator-principles.com/resources/equator_principles_iii.pdf.

WHEN DOES THE EP III TAKE EFFECT?

Of key importance, the EP III revisions will take effect for all transactions signed on or after January 1, 2014. During the transition period between June 4 and December 31, 2013, financial institutions adhering to the EPs have the option of applying either the second or the third restatement of the EPs. While the EP III revisions will not apply retroactively to projects already in existence, EP III would apply to future retrofits or expansions of past projects should the renovations create impacts significantly greater than anticipated under the initial assessment.

HOW WERE THE EQUATOR PRINCIPLES REVISED?

After the EP III revisions take effect, the EPs will have an expanded scope and trigger assessment and disclosure requirements for a greater number of transactions. As revised, the EPs will continue to require assessments of environmental and social risks with respect to applicable projects and a categorization of such risks. The following table highlights the significant changes.

Subject Matter	Previous EP Requirements	EP III Revised Requirements
The Project Size	As revised in 2006, the EPs apply to project finance transactions with capital costs that exceed	The EPs now apply to: • Project Finance: All project finance transactions with project capital costs that

Subject Matter	Previous EP Requirements	EP III Revised Requirements
	US $10M. The EPs apply to all transactions with capital costs in excess of US $50M.	exceed US $10M; • Advisory Services: All project finance advisory services[1] with project capital costs that exceed US $10M; • Corporate Loans: All corporate loans if: (i) related to a single project over which the client has effective operational control, (ii) the total aggregate loan amount is at least $100M, (iii) the EPFIs' individual commitment is at least $50M and (iv) the loan tenor is at least 2 years; and • Bridge Loans: Loans with a tenor of less than 2 years that are intended to be refinanced by the above project financing or project-related corporate loans.
Expected Climate Impact	The EPs do not expressly address a given project's expected contribution to global carbon emissions.	The EP III has an increased focus on climate change. • Borrowers must now publicly report on emissions for projects emitting over 100,000 tons CO_2 equivalent per year and conduct an analysis to identify less carbon intensive alternatives. • This new reporting requirement is likely to expand further, as it is not as strict as the current IFC 25,000 ton CO_2 equivalent benchmark.
Compliance With Host Country Law	The EPs do not establish a timeline for compliance with host country law.	The EP III has expanded host country compliance requirements. • The EP III requires compliance with relevant regulations in a project's host country "in the first instance," with the benchmark for the assessment process requirements established by the host country's "designation." • Further, the Equator Principle Association discussed its commitment to developing a comprehensive outreach strategy targeted at China, India and other priority markets.
Human Rights	Human rights compliance obligations in the EPs differ according to a country's categorization under the OECD, and require addressing both forced labor and child labor issues.	The EP III expanded their human rights considerations to mirror the IFC's Performance Standard updates. • The EP III now requires Free, Prior and Informed Consent for projects in certain "designated" countries (as listed on the EP website, which is no longer tied to the OECD categorization). • The new language acknowledges the importance of human rights in expanded areas of the due diligence process. • Borrowers and lenders will need to screen and monitor third-party participants up the supply chain to address safety issues that may result in fatalities.
Impact Disclosures	The EPs focus on impact disclosures before the project's initial approval.	The reporting requirements have increased. • Borrowers have an obligation to publish a summary of the environmental and social impact assessment online. • The EPFIs have certain obligations to report on transactions that have reached Financial Close and on their respective EP implementation processes and experience. • Reporting is not required for bridge loans.

[1] Defined in the EP III as the provision of advice on the potential financing of a development where one of the options may be Project Finance.

WHAT IS THE IMPACT OF THE EP III REVISIONS FOR LENDING INSTITUTIONS?

The EP III presents an opportunity for greater corporate social responsibility and reputational advancement; yet, it creates additional monitoring and disclosure requirements for lending institutions and their partners with important industry implications. Below are three overarching compliance challenges created by the EP III.

Increased Application

Since the EP III can now apply to certain project finance advisory services, corporate loans, and bridge loans, and not just to project financings, new groups within even experienced institutions may need to get up to speed on how to navigate environmental and social risks and how the EPs may impact new ventures. In addition, the expanded scope of the EP III may present implementation difficulties for industry groups unfamiliar with the EPs.

Legal Implications

The EP III revisions did not add legally binding language. Although the EPs remain voluntary and self-enforcing by nature, the new reporting and disclosure requirements and expanded applicability resulting from the EP III will increase publicity as well as the importance to maintain compliance. In addition, the EPs have now integrated legal obligations with host country laws and contractual covenants. The EP III imposes new requirements for the sharing of implementation information between EPFIs, but this could potentially raise proprietary and client confidentiality concerns, which lending institutions will need to consider further.

Compliance Costs

Impacted entities should consider the transition to the new EP III requirements in their processes in advance of the effective date and should discuss changes and increased responsibilities with other groups not considered before (advisors, supply chain providers, etc.). Because of the stricter reporting, monitoring and due diligence requirements under the EP III, both lenders and borrowers should identify any potential implementation issues and assess any increased compliance costs related to EP III application.

LOOKING AHEAD

The Equator Principles Association provides publicly available guidance on incorporating environmental and social considerations into loan documentation. It is important to harmonize the EP III requirements with additional obligations imposed by many multilateral lending institutions and export credit agencies into the documentation process through representations and warranties, conditions precedent to disbursements and completion, covenants, and events of default. A greater understanding of the interplay between the EPs and each relevant institution's policies is critical to ensure conformity with and consistency through the documentation, as well as the project evaluation process. Failure to understand and adequately address such issues during the course of negotiation and documentation can result in significant delays in disbursements, and may even result in deals being stopped at credit committee. In addition, there could be an adverse impact to the reputation of institutions that fail to comply with the new EP III requirements.

While this Client Alert is limited to a discussion of the EP III revisions, Milbank is available to discuss a full range of questions related to the EPs. Additionally, Milbank is well positioned to help clients navigate these changes and advise on how to best and most cost effectively comply with the new EP III requirements.

PROJECT FINANCE GROUP

Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any of the members of our Project Finance Group.

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