A practical manual for the development and implementation of an ESMS in financial institutions

Environmental Risk Management System (ESMS)
eco.business Fund-Sub-Saharan Africa

Volume I

Initial diagnostic of the financial institution's exposure to environmental and social risks

ERM

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Contents

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Executive Summary

In view of the growing importance and exposure to environmental and social problems, it has become necessary to deal more appropriately with the risks related to these issues in the banking sector. For this reason, financial institutions are increasingly involved in developing and implementing systems to identify and mitigate this type of risk. In some cases, these initiatives respond to national government regulations or the requirements of international development finance institutions.

This guide is the first volume of a three-part series of publications that aim to provide tools related to the phases for developing and implementing a Social and Environmental Risk Management System (ESMS) in financial institutions. The first volume focuses on phase 1, which refers to the diagnosis of the institution. (**Figure 1**).

Figure 1 - Stages for the development and implementation of an ESMS

Phase 1 - Initial diagnostic of environmental and social issues Tenor: 2-3 months		
Diagnostic of environmental and social sensitivity Verifies the level of exposure of the financial institution to environmental and social issues according to the characteristics of its clients. (Sector, size and location) and types of credit operations they carry out (products, volume, duration and guarantees).	**Gap Analysis** The level of compliance with the legislation of the country in which the financial institution operates is verified against IFC's international best practices.	**Diagnostic of practices** Once the environmental and social sensitivity of the financial institution has been verified, the expected environmental and social risk management practices are defined based on the gap analysis. Subsequently, the level of compliance of the financial institution with the expected practices is verified, and what changes are needed in the credit process is identified.
Phase 2 – Design of ESMS Tenor: 2-3 months		
Definition of practices, processes and procedures Creation of a process flow based on the expected practices verified in the sensitivity diagnostic and gap analysis.	**Creation/revision of policies and tools** Policies and practices for the implementation of ESMS processes are reviewed or created based on the diagnostic of practices.	**Team training and awareness raising** Once the practices, policies and tools have been approved, the team must be trained and sensitized on how to use the tools and the importance of their implementation.
Phase 3 – Pilot implementation of ESMS Tenor: 8-12 months		
Pilot implementation Implementation of ESMS in the selected portfolio (covering some sectors, types of operations and/or regions) for the evaluation of the system.	**Pilot evaluation and revision** Analysis of the pilot results: efficiency of the system, commitment of the financial institution to implementation and its ability to implement and maintain the system. ESMS weaknesses need to be reviewed for full implementation.	**Full implementation** Progressive expansion of the revised ESMS, into other portfolios of the financial institution – in addition to those covered during the pilot. In this phase, further training and continuous monitoring of results are essential.

The first section of this guide provides details on how to determine a financial institution's environmental and social sensitivity, i.e., the level of environmental and social risks to which it is exposed. This sensitivity is calculated based on the principles of relevance (the total risk to which the institution is exposed, according to the sectors, scale, and location of the clients in its portfolio) and proportionality (the level of risk exposure considering the type, size, and tenure of the institution's credit operations).

Subsequently, the degree of environmental and social sensitivity will define the how robustly the institution's ESMS needs to be designed, i.e., the necessary practices that will enable adequate management of environmental and social risks. The conditions to be applied will depend on two aspects: the regulatory requirements of the financial institution's area of operation and international best practices.

The second section of the guide indicates how to identify and assess the national regulations applicable to the financial institution's operations based on its level of environmental and social sensitivity to ensure that the institution and its clients comply with the regulatory requirements.

The following describes how to compare national regulation with international best practices and the International Finance Corporation (IFC) Performance Standards to identify gaps that the institution will need to fill. This will ensure that the institution meets the requirements of investors who demand environmental and social policies and safeguards before providing financing.

The third section presents the methodology for assessing the financial institution's current E&S risk management practices to ensure that the ESMS is aligned with the current credit process and does not have unintended impacts on the institution's operations. It also prevents ESMS from becoming a process that is not integrated with credit analysis or causes bottlenecks, additional costs, or delays in disbursement times.

Finally, the fourth section discusses the use of the results of the diagnostic phase and the implications for the subsequent phases of ESMS implementation.

The design and implementation phases of the system are covered in the next two volumes.

1. Introduction

Financial institutions play a vital role in the economy, facilitating the flow of financial resources to various sectors of the economy. Financial institutions finance many productive activities. For this reason, there is a close relationship between financial institutions and real sector companies, in which they share risks and responsibilities for the impacts of the financed activities.

External factors and productive activities can generate both positive and negative impacts. These factors may affect the business's profitability and generate an impact on unrelated third parties. Impacts are the consequence of the materialization of risk, including those derived from environmental and social issues. Today, decision-makers and public opinion, in general, recognize the importance of these issues. Investors in financial institutions have been incorporating and demanding the implementation of mechanisms to manage environmental and social risks, as there is increasing knowledge and evidence of the threats they pose to businesses. (See **Figure 2**).

Figure 2 - Examples of impacts of environmental and social issues on companies and financial institutions in Africa

Africa: Africa suffers disproportionately from climate change – World Meteorological Society

3 September 2023

Africa: Africa's Fragile States are greatest climate change casualties

IMF – 30 August 2023

East Africa: Banks urged to steer clear of East Africa oil pipeline financing

Reuters - 1 March 2021

Horn of Africa: Drought in the Horn of Africa worse than in 2011 famine

Al Jazeera - 22 February 2023

Nigeria: Shell to pay $16m to Nigerian farmers over oil damage

BBC News - 23 December 2022

South Africa: Strikes Cost South Africa 1.6 Million Work Days in First Half

Bloomberg - 27 September 2022

Tanzania: Tanzania fines Acacia mine $130,000 for environmental breaches

Financial Times - 10 January 2019.

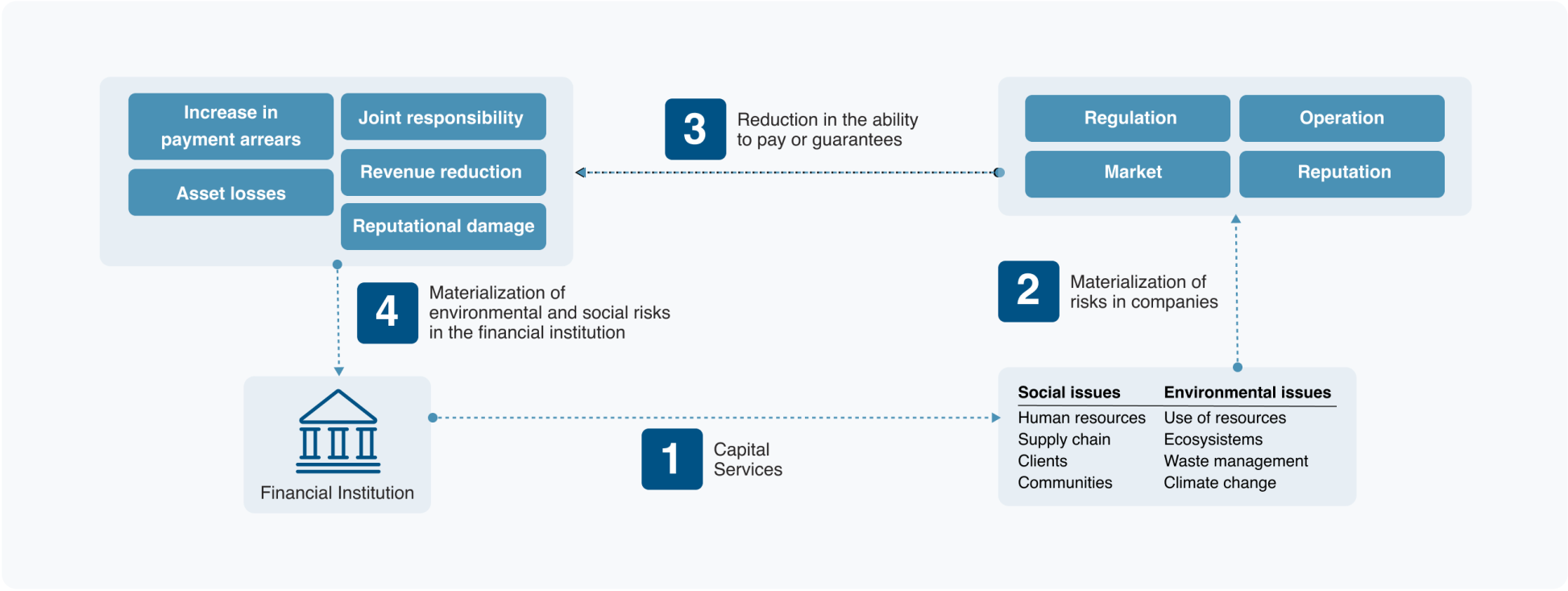
Sources: Reuters (2021), Al Jazeera (2023), BBC News (2022), Bloomberg (2022), Financial Times (2019); **Prepared by:** ThreeArrows Impact Partner

The materialization of such risks in companies can manifest in different ways:

- **Interruption of operations** by strikes, accidents, climate catastrophes, or the creation of additional barriers in the production process - for example, a shortage of a raw material.
- **Higher consumer demands** in relation to the sustainability of products and business practices, which may result in restriction of access to new markets or loss of participation in current markets.
- **The reputational impact** on the company for being involved in illegal business dealings related to questionable ethical practices or a high negative impact on society or the environment, resulting in loss of customers or an increase in the cost of attracting resources.
- **Penalties, fines, and the need for adaptation** to meet increasingly stringent regulatory demands and new market conditions.

Once an adverse event caused by an environmental or social risk has occurred, companies may experience shifts in cash flows, assets financed, and even guarantees granted. As a result, financial institutions could be affected, as their customers' ability to pay may be impaired. Although financial risk analysis is an intrinsic practice in this sector, environmental and social risks still need to be studied and understood. (See ***Figure 3***).

Figure 3 - Materialization of environmental and social risks and impact on financial institutions



Although most regulations in Africa typically do not make banks accountable for their clients' environmental and social risks, this issue is becoming increasingly important. For example, banks need to consider risks such as reputational risks when lending to clients. Large fossil fuel exposures in loan books and lack of policy on new fossil fuel lending can leave a bank potentially vulnerable to reputational risks and misaligned to climate targets.

Globally, the financial sector is increasingly considering environmental and social risks. Asia provides an example of this. In 2012, the China Banking Regulatory Commission (CBRC) released the Green Credit Guidelines[1] to encourage financial institutions to create lines of credit with positive environmental and social impacts (such as emission reduction and recycling) and to develop ESMSs. Subsequently, Indonesia, Mexico, and Turkey also developed initiatives along these lines.[2]

With regard to Africa, a just transition seeks to ensure that the substantial benefits of a green economy transition are shared widely, while also supporting those who stand to lose economically – be they countries, regions, industries, communities, workers or consumers. In South Africa, the Presidential Climate Commission, has set out a just transition framework that seeks to deal with practical issues relating to jobs, economies, social support and governance while companies decarbonise. Banks have a large role to play in the just transition in Africa.

Kenya and Mauritius are two examples of countries in Africa that have published or drafted prudential regulations related to environmental and social risks. In 2021, the Central Bank of Kenya issued the Guidance on Climate-Related Risk Management to commercial banks and mortgage finance companies. These binding principles require banks to integrate climate-related opportunities and risks in their governance structure, strategy, and risk management frameworks, as well as to report on climate-related information. In Mauritius, the Bank of Mauritius published draft guidelines to support financial institutions' integration of environmental risks in September 2021.

Other African countries that have developed and adopted guidance for the banking sector on E&S risk management include Egypt, Ghana, Morocco, Nigeria, and Zimbabwe. Bank Al-Maghrib in Morocco issued Directive n°5/W/2021, a non-binding best practice guidance requiring credit institutions to identify and disclose potential sources of environmental risks and ensure their measurement, management, monitoring, and control. In South Africa, Prudential Authority guidelines highlight incorporating climate risk assessments into Own Risk and Solvency Assessment (ORSA) to evaluate the potential impact of climate change on both solvency and capital adequacy.

It is not only the regulatory bodies that have been responsible for promoting environmental and social risk management in the financial system, but also sectoral initiatives have been observed. For example, the Kenya Banker's Association provides online sustainable finance training programs through its Sustainable Finance Initiative.

While only a few countries have such initiatives across the continent, these are expected to increase in the coming years. (See ***Figure 4)***.

[1] Available at: China's Green Credit Guidelines | Green Finance Platform

[2] For more information: <https://www.ifc.org/wps/wcm/connect/da980744-987e-496d-82e8-e5f146895165/SBN_PAPER_G20_updated+08312016.pdf?MOD=AJPERES>.

Figure 4 – Examples of initiatives and protocols on sustainable practices in the financial sector in Africa.

Egypt: Mandatory ESG and Climate Disclosure Regulation for listed companies

Kenya: Sustainable Finance Guiding Principles, CBK Guidance on Climate Related Risks

Uganda: Bank of Uganda Strategic Plan 2022-27 encouraging financial institutions to meet ESG standards

Rwanda: Sustainable Finance Roadmap 2022-2029

Ghana: Sustainable Banking Principles

Nigeria: Sustainable Finance Principles by the Central Bank of Nigeria

Namibia: Namibian Stock Exchange's Directive for subscribers to the NamCode to appoint a social, ethics and sustainability committee

South Africa: South Africa's Treasury green finance taxonomy, BASA's Principles for E&S Risk, Johannesburg Stock Exchange's Sustainability Disclosure Guidance & Climate Change Disclosure Guidance

On the other hand, in most cases, development finance institutions (DFIs) and funds require that the financial institutions they work with put in place compliance with ESMSs. These international organizations maintain compliance requirements with environmental and social safeguards in their policies. In addition, the IFC has developed a set of standards called the Performance Standards that outline their investees' responsibilities for managing environmental and social risks. Many organizations and companies have adopted the Performance Standards as a key component of their environmental and social risk management.

For its part, the ESMS is a management tool that addresses a set of identified risks and has the potential to promote compliance with the country's local legislation and, in this sense, is one of the most useful tools to ensure compliance and alignment with local and international regulations on environmental and social risk management.

> "We recognize that we operate in markets and sectors that are rated as high ESG risk. Effective ESG risk management is therefore crucial to minimize direct and indirect harm to the environment and society arising from our operations."[i]
>
> Tulani Gcabashe
> Chairman of Standard Bank Group (South Africa)

It is also essential that the ESMS structure is aligned with IFC Performance Standard 1. If a financial institution's ESMS is effectively aligned with this standard, it will align with the requirements of most international financial institutions that provide resources.

In addition, environmental and social risk management must be supported by the financial institution's own environmental and social strategy or policy. The principles, guidelines, instruments, and operational procedures

promoted by this strategy or policy will enable the institution to meet its environmental and social objectives and will allow IFC Performance Standards to be applied more assertively. To this end, it is essential for the financial institution to develop the following elements, which will serve as pillars:

i) Criteria and guidelines for environmental and social risk management
ii) Internal governance structure
iii) Initiatives respect the needs of other stakeholders – customers, employees, communities, and those groups impacted by the FI's operation

The ESMS not only seeks to align the financial institution with the legal provisions or requirements of international financial institutions.

Implementing an ESMS also helps identify new business opportunities related to promoting sustainability and facilitating access to capital and international financing. It also brings other benefits to the institution's business, such as:

- Reduced exposure to credit, legal and reputational risks
- Increased visibility of credit opportunities in the portfolio, as it generates more information about the customer, which allows the Financial Institution (FI) to identify new business opportunities
- Lower costs of implementing an ESMS compared to potential losses otherwise.

That said, the ESMS is part of a broader environmental and social strategy. (**See *Figure 5***)

Figure 5 – The ESMS as part of a broad environmental and social strategy

The starting point for designing an ESMS is to study the degree of sensitivity of the institution to environmental and social risks present in the loan portfolio. To this end, there are two principles that allow for a deeper analysis:

i) **Relevance:** The level of environmental and social risk of the economic sectors supported by the financial institution, as well as the contexts of legal security, fragility of the biomes, and climate risks of the regions of operation.
ii) **Proportionality:** Degree of exposure to environmental and social risks of the institution's operations, i.e., types of products offered, loan amounts, tenure, and guarantees required.

If the portfolio is highly sensitive to environmental and social risks, a more robust ESMS will be required. Hence developing a *Sensitivity Assessment* will form the basis of any ESMS design. The following section explains in detail how to perform this analysis.

This guide reflects the knowledge acquired by eco.business Fund together with SITAWI's technical advice through its participation in consulting projects to design and implement ESMS. This first volume describes the step-by-step **process for completing the environmental and social sensitivity assessment** and the steps to follow for its correct implementation, as it will serve as a tool for financial institutions to design and implement an ESMS effectively.

The IFC Performance Standards are a rigorous framework for preventing, mitigating, and managing environmental and social risks and impacts. Therefore, it is strategically beneficial to evaluate and contrast national legislation against these standards. The findings will allow us to conclude whether compliance with regulations covers most of the environmental and social risks or whether there are gaps. This evaluation should also include an analysis of the formal and informal practices of the institution.

The development and results are presented in two reports: *Gap Analysis* and *Practice Diagnostic*.

Finally, the ESMS should be integrated into financial institutions' regular credit approval processes. For this reason, it must be designed according to the business dynamics and needs of the institution. Likewise, it must contribute to the institution's competitiveness, so it must be efficient in its implementation and execution. The success of an ESMS lies in making precise changes, and the additional procedures generated must align with the current credit process. Finally, the ESMS is an incentive to adopt good practices, so it is not intended to restrict credit but to improve the management of environmental and social risks. (See ***Figure 6***).

Figure 6 – Characteristics of the ESMS

Compatibility with standards:
Processes aligned with the regulations in force in the country of operation, as well as international funders

Tailor-made design:
Meets the institution's specific needs

Complementarity:
Avoids complete reformulation of stages and increased costs

Transversality:
Defines responsibilities for all areas involved in the credit process.

Incentive to the adoption of good practices:
It does not restrict credit but promotes the adoption of good environmental and social practices.

2. Methodology for the diagnosis of environmental and social sensitivity

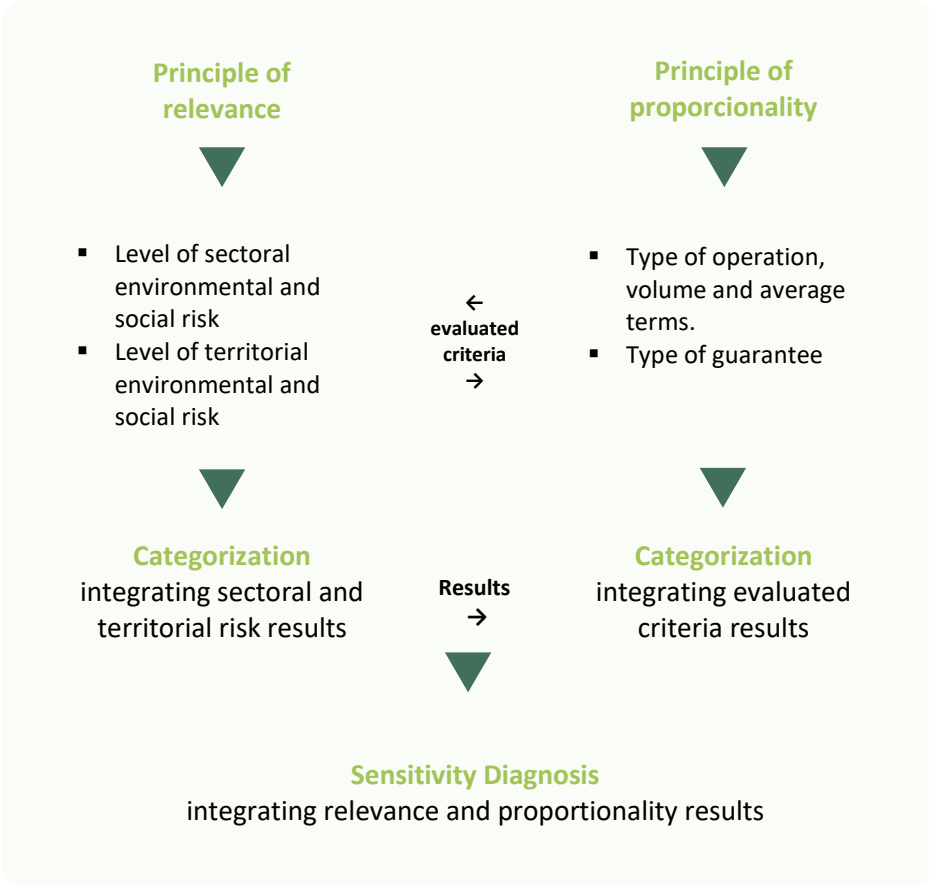
The first step is to identify the financial institution's needs and opportunities with respect to the ESMS. For this purpose, a diagnostic of the financial institution's loan portfolio's exposure to environmental and social risks must be carried out. For example, an institution that finances large infrastructure projects will have greater environmental and social exposure than one focused on microfinance and will, therefore, require a more robust ESMS.

As mentioned in the introduction, to design a tailor-made ESMS, we start with the *Sensitivity Diagnosis,* which enables us to understand the degree of environmental and social exposure. To this end, two principles must be considered: relevance and proportionality. These principles include criteria such as: (i) exposure to environmental and social risks based on the sector and the territory and (ii) the characteristics of the products and services offered.

Here is an example to represent a case that could be real: The ABC institution has a relevant portion of its portfolio with clients in the agribusiness, mining, infrastructure, and industrial sectors. Despite its effective environmental laws, it also operates in a country with high biodiversity risks and vulnerability to climate change. Entities cannot enforce such regulations without oversight. In social terms, the country has experienced mining conflicts and strikes in various economic sectors (aspects related to the principle of relevance); in the mining and infrastructure sectors, the institution provides bigger loans with longer tenure (aspects associated with the principle of proportionality).

Given the general characteristics of the ABC institution, the FI would be considered to have high environmental and social exposure and will therefore require a robust ESMS. However, it should be noted that having a high exposure is not a negative thing, as the institution can work with sectors of high environmental and social risk, and its clients can incorporate exemplary environmental and social practices. Knowing the degree of exposure allows the institution to implement processes that mitigate the risks. ***Figure 7*** shows how relevance and proportionality principles help develop a complete sensitivity diagnosis.

Figure 7 – Principles of relevance and proportionality



The primary input for the *Sensitivity Diagnostic* is the financial institution's portfolio data, containing the following information: date, segment, sector, sub-sector, economic activity, loan amount granted, purpose of the credit, limits per sector, and customer location.

Based on the principles of relevance and proportionality, it is possible to define the key elements of ESMS, i.e., the scope, practices, or procedures to address and mitigate environmental and social risks in the lending process. In summary, **the sensitivity diagnostic will determine the institution's needs regarding environmental and social management.**

2.1 Principle of relevance

Relevance refers to the environmental and social risk level of the economic activities that receive financial support. The recommended approach to identify relevance is based on two components, namely **sectoral and territorial**.

> "Our process considers applicability during ESMS screening with the use of proceeds informing the level of enhanced due diligence we need to conduct. Our assessments are centered on IFC Performance Standards alignment."
>
> Paulo Branco
> Head of Environmental and Social Risk at Absa, Corporate and Investment Banking (South Africa)

2.1.1 Level of environmental and social risk by sector

Sectoral environmental and social risk is related to the characteristics of the economic activity underway. Some activities present greater risks than others; for example, a mining project is expected to have higher environmental and social risks than a textile industry. Another factor that can increase exposure to sectoral risks is the size of the activity; the larger the operation, the more risks may be prevalent.

In this context, the exposure of the institution's loan portfolio should be categorized according to its sectoral environmental and social risk; it is proposed the following categories should be used:

- **Category A (high risk)**
  Related to activities with potential negative social and/or environmental impacts that are diverse, irreversible or unprecedented.
  For example, the construction of a deep-water port has diverse and unprecedented environmental and social impacts. If the project does not have an environmental impact study and environmental management plan, the damage to biodiversity and marine currents could become serious and irreversible once the project is built.

- **Category B (medium risk)**
  Activities with limited or scarce social and/or environmental impacts, generally in specific areas, that are reversible and can be corrected through mitigation measures.
  For example, a food and beverage company generate environmental impacts, which, although limited, can affect the area in which it operates if there is poor waste and effluent management. However, impacts may be reversible with mitigation measures.

- **Category C (low risk)**
  Activities with no or low adverse social and/or environmental impact.
  For example, small or medium-scale retailers, tourism agencies, universities, and service providers generally have a low environmental and social impact.

Table 1 Indicates (in a non-exhaustive way) the economic sectors according to their typical environmental and social risk category. It is important to note that this categorization may change based on regional characteristics, for example, some countries may have better agricultural practices at the sectoral level than others. For this reason, the proposed classification should be adjusted according to the country or region where the financial institution operates. The same table also presents the proposed classification and scoring of portfolio exposure levels for environmental and social risk classification. Based on the percentage share of the sectors it finances and their sectoral risks, a score is established that will be used to determine the level of relevance.

Table 1 – Parameters for the definition of sectoral risk level

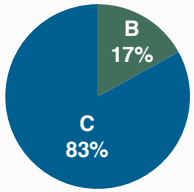
A (high-risk sectors)	B (medium-risk sectors)	C (low-risk sectors)
Examples of sectors and activities		
▪ Agriculture and livestock (large scale) ▪ Oil and gas ▪ Mining ▪ Infrastructure ▪ Processing industry	▪ Agriculture and livestock (small or medium scale) ▪ Food industry ▪ Transportation ▪ Industry (general) ▪ Manufacturing (medium or large scale)	▪ Trade ▪ Services ▪ Telecommunications ▪ Education
Level of sectoral risk of the portfolio according to its share in the portfolio		
A ≥ 20%	A < 20% & B ≥ 30% or A < 20% & B < 30% & A+B ≥ 30%	A < 20% & B < 30% & A+B < 30%
Scoring		
3 points	**2 points**	**1 point**

Box 1 (a-c) provides some examples of sectoral risk scoring in different financial institutions.

Box 1 - Examples of the level of exposure of the loan portfolio to sectoral environmental and social risks

a. Local development agency (credit bureau)

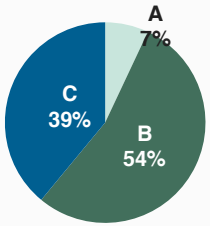
Local Development Agency A or *Credit Bureau A* has a portfolio focused on service providers (60%), small-scale traders (23%), and single-person loans (17%).



Result: Portfolio with **low sectoral environmental and social risk** (1 point awarded).

b. Commercial Bank

Commercial Bank B has a diversified portfolio: service providers (16%), traders (12%), transportation (7%), medium-scale manufacturing industries (27%), retailers (11%), food and beverage companies (7%), and small (13%) and medium (7%) large-scale construction.

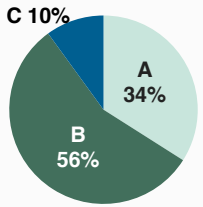


Result: Portfolio with **medium sectoral environmental and social risk** (2 points awarded).

[3] Available at: <https://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Sustainability-At-IFC/Policies-Standards/Performance-Standards>.

c. Development Bank

Development Bank C has in its portfolio several infrastructure projects (14%), hydroelectric power plants (8%), heavy industry financing (7%), and large-scale civil works development (5%). In addition, it finances the manufacturing industry (25%), food and beverages (22%), and small-scale real estate projects of a municipality (9%). Finally, it has a line of credit targeting small traders and service providers (10%).



Result: Portfolio with **high sectoral environmental and social risk** (3 points awarded).

2.2 Level of territorial environmental and social sensitivity

The second factor to assess is the sensitivity of the clients' activities according to their location, as the environment can significantly affect their exposure to environmental and social risks. For example, a chemical factory within an industrial zone is less likely to generate social or environmental impacts than a chemical production unit near a residential area where residents may be affected by emissions, noise, or effluents.

By applying this methodology, the sensitivity of the portfolio regions is also categorized as high, medium, or low, as shown in ***Table 2***, based on key risks outlined in IFC's Performance Standards[3] and the *World Bank's Environmental and Social Standards* – WB ESS.[4] In the same way that the level of sector risk was defined, the sensitivity of the location of customers can also be classified as high, medium, or low, as indicated below:

[4] Available at: <https://www.worldbank.org/en/projects-operations/environmental-and-social-framework/brief/environmental-and-social-standards>.

Table 2 – Topics for the analysis of the territorial sensitivity of the credit portfolio[5]

Topic	A (Territories with high sensitivity)	B (Territories with medium sensitivity)	C (Territories with low sensitivity)
Areas of high conservation value or fragile biomes	▪ Fragile or densely forested biomes ▪ Territories belonging to areas of high conservation value (e.g., national parks).	▪ Biomes with medium density forest areas ▪ Territories bordering areas of high conservation value (e.g., national parks).	▪ Urban or rural areas that are already deforested, with low forest density. ▪ Regions without areas of high conservation value
Presence of natural hazards	▪ Areas of geological instability, high flooding history, and/or susceptible to large-scale fires.	▪ Areas with moderate risk of geological instability, flooding, and/or susceptible to fire.	▪ Areas without identified natural hazard risks
Access to Natural Resources	▪ Areas with a high probability of resource use conflicts (or ongoing conflicts)	▪ Areas with a moderate probability of resource use conflicts or with temporary resource availability restrictions	▪ Areas with high availability of resources or easy access to resources (without the need to use local resources)
Indigenous peoples and communities	▪ Areas where traditional groups coexist ▪ Possible or already ongoing conflicts due to issues of proximity and overlapping of indigenous territories with other areas	▪ The region is close to indigenous peoples, with a reasonable level of integration and a low level of conflict.	▪ The project is not located in a region close to indigenous peoples.
Cultural or historical heritage	▪ Areas near World Heritage Sites (UNESCO) ▪ Regions belonging to traditional communities	▪ Areas close to traditional communities, national heritages, or with a moderate probability of discoveries of archaeological material of limited importance.	▪ Areas without cultural heritage or close to traditional communities
Regulatory environment[6]	▪ Regions/countries with weak environmental and social laws and regulations and/or where enforcement capacity is limited	▪ Regions with existing adequate laws and regulations, but limited enforcement capacity	▪ Regions with strong laws and regulations and adequate enforcement capacity.
Civil society	▪ Regions with ongoing armed conflicts ▪ Regions where many civil society groups have negative perceptions of business activities and violent protests against such activities are widespread.	▪ Regions with potential for armed conflicts ▪ Regions in which certain civil society groups have negative perceptions of business activities and violent protests against such activities happen frequently.	▪ Regions without ongoing armed conflicts ▪ Regions in which no or few civil society groups have negative perceptions of business activities and violent protests are rare.

[5] The territory is linked to the place of execution of the client's operations and not necessarily to its administrative headquarters. ESMS may indicate the need for the financial institution to visit processes or systems to capture the required information for each variable listed in Table 2. For sensitivity diagnosis, which is more general and focused on the portfolio, the impact on the lack of such information may not be as relevant. However, when implementing policies and systems, the risk assessment should be specific to the possible impacts of the client.

[6] Whereas the topics on Regulatory Environment and Civil Society are not part of the IFC Performance Standards, IFC's Interpretation Note on Financial Intermediaries highlights that E&S risk of investment activities depends (among other factors) on contextual risks, for example conflicts with civil society, and that an FI's approach to addressing these risks will depend (among other factors) on the existing regulatory framework.

The territories where the institution has operations should then be evaluated according to the different levels of risk presented in ***Table 2.*** For this purpose, the final sensitivity must be assigned according to the highest risk topic in each locality (state, province, department). The relative participation of the regions in the portfolio, according to their risk level, will define the overall territorial risk level of the portfolio. (***Table 3***). According to the portfolio's classification (A, B, or C), the contribution score will be defined to determine the relevance and the total sensitivity of the financial institution's portfolio.

Table 3 – Parameters for the definition of the territorial risk level

A (high territorial sensitivity)	**B (medium territorial sensitivity)**	**C (low territorial sensitivity)**
Sensitivity of the region (state/department)		
One or more high-risk issues	One or more medium-risk issues, with no high-risk issues identified	All low-risk topics
Geographic risk level of the portfolio according to its share of the portfolio		
A ≥ 20%	A < 20% & B ≥ 30% O A < 20% & B < 30% & A+B ≥ 30%	A < 20% & B < 30% & A+B < 30%
Scoring		
3 points	**2 points**	**1 point**

Box 2 (a-c), in turn, provides some examples of territorial sensitivity scoring in different financial institutions.

Box 2 - Examples of the level of exposure of the loan portfolio to territorial environmental and social risks

a. Local development agency (credit bureau)

Topic	Portfolio evaluation	Portfolio %	Sensitivity Level
Areas of high conservation value or fragile biomes	The portfolio is located in a biome with a medium risk of deforestation (forests)	100%	Medium
Risk of natural hazards	No critical natural hazards were identified	0%	Low
Access to Natural Resources	Production areas have abundant resources	0%	Low
Cultural or historical heritage	There is a possibility of archaeological sites of limited importance in 77% of the portfolio (agricultural areas)	77%	Medium
Indigenous people	No indigenous territories or reserves were identified	0%	Low
Enforcement of environmental and social legislation and regulatory agencies	The state's environmental and social regulation does not address certain issues	100%	Medium
Civil society interest	There is a history of preventing activities with high potential environmental and social impacts in the state	100%	Medium
TOTAL			**Medium**

Result: Portfolio with **medium territorial sensitivity** (2 points).

b. Commercial Bank

Topic	Portfolio Evaluation	Portfolio %	Sensitivity Level
Areas of high conservation value or fragile biomes	Less than 20% of the portfolio is located in regions with moderate deforestation risk (forests)	20%	Low
Risk of natural hazards	Most of the portfolio is located in urban areas with flooding potential	60%	Medium
Access to Natural Resources	Production areas have abundant resources	100%	Low
Cultural or historical heritage	There is a possibility of archaeological sites of limited importance in half of the construction areas	10%	Low
Indigenous People	No indigenous territories/reserves were identified	0%	Low
Enforcement of environmental and social legislation and regulatory agencies	Environmental and social regulations in regions representing more than 30% of the portfolio do not address certain issues	30%	Medium
Civil society interest	There is a strong track record to prevent activities with high potential environmental and social impact in the state	100%	Medium
TOTAL			**Medium**

Result: **Portfolio with medium territorial sensitivity** (2 points).

c. Development Bank

Topic	Portfolio Evaluation	Portfolio %	Sensitivity Level
Areas of high conservation value or fragile biomes	The infrastructure works and all the hydropower plants are located in regions with an increased risk of deforestation and near protected areas	22%	High
Risk of natural hazards	Most of the above-mentioned operations face geological instability risks	22%	High
Access to Natural Resources	These operations are in areas with little access to water	22%	High
Cultural or historical heritage	No historical or cultural heritages were identified	0%	Low
Indigenous peoples	Most infrastructure and hydroelectric projects affect traditional communities	22%	High
Enforcement of environmental and social legislation and regulatory agencies	Socio-environmental regulations in regions representing more than 30% of the portfolio do not address certain issues	30%	Medium
Civil society interest	Mobilizations are underway to prevent the development of the activities mentioned above	22%	High
TOTAL			**High**

Result: Portfolio with **high territorial sensitivity** (3 points).

2.3 Integrating the analyses: sectoral and territorial sensitivity risks

Once the level of exposure of the loan portfolio to sectoral environmental and social risks and the sensitivity of the territory has been assessed, it is possible to analyze these results by applying the *Principle of Relevance*. (***Figure 8)***. The sum of the sectoral environmental and social risk and the territory's sensitivity scores defines the *final relevance*. (***Table 4***).

Figure 8 - Relevance principle matrix

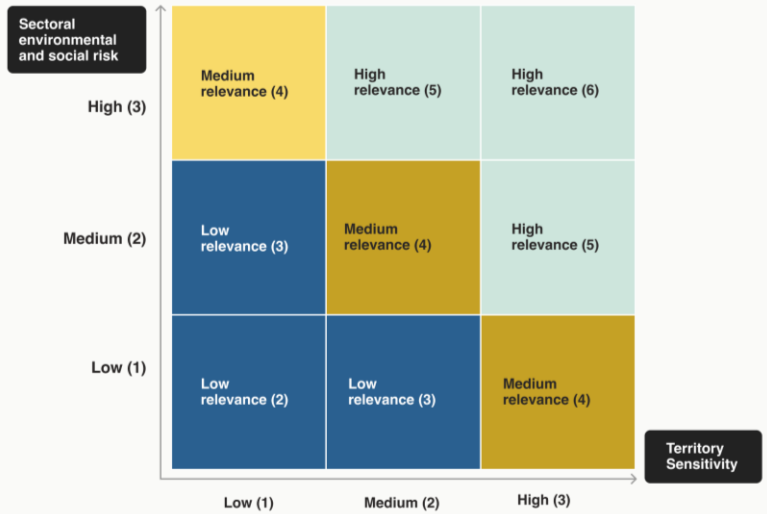


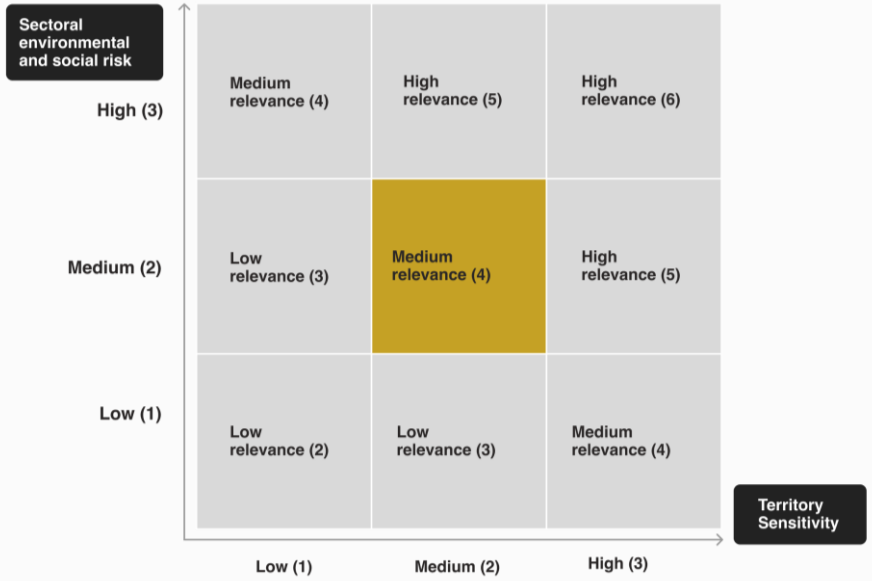
Table 4 – Relevance principle scoring

Sum of scores	Relevance principle
5-6	A (high relevance)
4	B (medium relevance)
2-3	C (low relevance)

Box 3 (a-c), the following includes some examples of how to calculate the final score of the relevance principle and interpret these results. Examples of the following cases are a local development agency (credit bureau), a commercial bank, and a development bank.

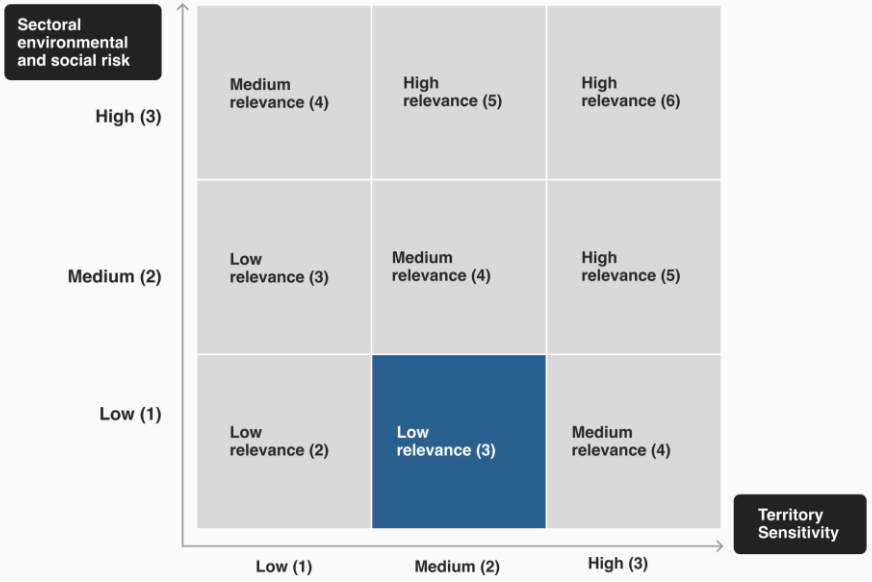
Box 3 – Examples of the definition of relevance

a. Commercial bank
Sectoral risk: medium (2 points)
Sensitivity of the territory: medium (2 points)



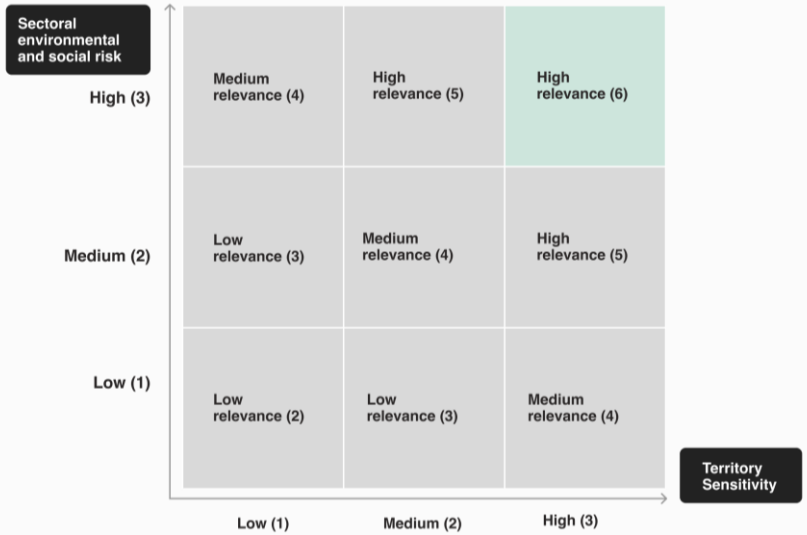
Result: Portfolio with **medium socio-environmental relevance** (4 points)

b. Local development agency (credit bureau)
Sectoral Risk: low (1 point)
Sensitivity of the territory: medium (2 points



Result: Portfolio with **low environmental and social relevance** (3 points)

c. Development bank
Sectoral risk: high (3 points)
Sensitivity of the territory: high (3 points)



Result: Portfolio with **high socio-environmental relevance** (6 point

2.2. Principle of proportionality

2.2.1 Type of financial products and services

The second principle for the Environmental and Social *Sensitivity Diagnostic* of a financial institution's portfolio is related to the type of products and services offered. Once again, it is proposed that these be evaluated by the level of risk (in this case, the level of exposure to risks considering three categories):

- **Category A (high exposure):** Products and services with large loan amounts and longer tenure, such as *project finance operations*.
- **Category B (medium exposure):** Products and services with medium loan amounts and tenors, such as *leasing*.
- **Category C (low exposure):** Products and services with small loan amounts and short tenors, such as microfinance.

Therefore, the categorization of proportionality is based on three variables:

Types of offerings: Different financial products and services generate exposure to environmental and social risk at different levels. The risk will depend on the level of involvement of the financial institution in the financial operation and the underlying projects.

- **The size of financial operations:** the larger the size of the operation, the greater the institution's exposure to environmental and social risks.
- **Duration of operations:** Like the previous variable, the longer the tenor, for longer operations it does not necessarily take longer for E&S risks to materialize, but the risks that they materialize is greater.

The evaluation of the level of exposure of each of the three variables related to the principle of proportionality is performed according to an overview of the institution's loan portfolio.

Table 5 presents the parameters used to establish the portfolio exposure for each variable (A - high, B - medium, C - low).

For the **size of operations** variable, it is essential to highlight that the level of exposure varies according to the size of the financial institution. Therefore, four ranges are established in relation to the institution's total assets.

Table 5 – Suggested parameters for the definition of social and environmental proportionality

Variable		A (high exposure)	B (medium exposure)	C (low exposure)
Type of financial operation		▪ Project finance ▪ Syndicated loans ▪ Equity ▪ Mortgages ▪ Large corporate loans	▪ Export credit ▪ Guarantees ▪ *Leasing*	▪ Deposits ▪ Personal loans
Size[7]	**S1**	> USD 6,000,000	≤ USD 6,000,000 > USD 1,500,000	≤ USD 1,500,000
	S2	> USD 1,500,000	≤ USD 1,500,000 > USD 750,000	≤ USD 750,000
	S3	> USD 750,000	≤ USD 750,000 > USD 250,000	≤ USD 250,000
	S4	> USD 250,000	≤ USD 250,000 > USD 100,000	≤ USD 100,000
Term		>60 months	≤60 months >24 months	≤24 months

The incidence of each exposure range is evaluated by variable, according to its percentage share in the portfolio. (***Table 6***). After this analysis, a score is determined for each variable according to the rank with the highest participation.

Table 6 – Parameters for the level of exposure according to the percentage share in the portfolio

Parameter	A (high exposure)	B (medium exposure)	C (low exposure)
Rank	A ≥ 20%	A < 20% & B ≥ 30% O A < 20% & B < 30% & A+B ≥ 30%	A < 20% & B < 30% & A+B < 30%
Scoring	**3 points**	**2 points**	**1 point**

It is important to note that verifying the incidence (number of operations) by range is crucial to determine the volume and term variables. In other words, the exercise does not focus on estimating the average value of volume or duration but on identifying the frequency of each exposure range in the portfolio. For example, a large-scale financial institution (S1) has an average disbursement of USD 7 million. However, suppose the number of operations ranges between USD 3 million to USD 4 million. In that case, the institution will have a medium exposure to this variable, contributing two points to the total analysis of the relevance of environmental and social risks in the institution's portfolio.

[7] The letter "S" indicates the size of the institution, as follows:
- S1 = multiple banks, commercial banks and investment banks with assets ≥10% of the domestic GDP.
- S2 = multiple banks, commercial banks and investment banks with assets ≥1% & <10% of the domestic GDP.
- S3 = multiple banks, commercial banks and investment banks with assets ≥0.1% & <1% of domestic GDP.
- S4 = multiple banks, commercial banks and investment banks with assets <0.1% of domestic GDP.

Finally, the score for each variable needs to be summed, defining the institution's final environmental and social proportionality (***Table 7***).

Table 7 - Categorization of final environmental and social proportionality

Sum of the score of each variable	Environmental and social proportionality
8-9	A (high proportionality)
5-7	B (medium proportionality)
3-4	C (low proportionality)

El ***Box 4 (a-c)*** shows examples of how to score each analyzed variable based on the principle of proportionality. The examples below are presented by type of financial institution.

Box 4 - Examples of the definition of proportionality

a. Local development agency (credit bureau)

Variable	Portfolio	Portfolio %	Level of exposure
Type of operation	Most of the portfolio is earmarked for **working capital**, with some consumer transactions	Working capital (95%) Consumer credit (5%)	Low (1 point)
Volume	The institution is categorized as S4. There are no operations over **USD 100,000** in the institution's current portfolio.	≤ USD 100,000 (100%)	Low (1 point)
Terms	There are no operations exceeding **24 months** in the institution's current portfolio.	≤ 24 months (100%)	Low (1 point)

Result: Portfolio with **low proportionality** (3 points)

b. Commercial bank

Variable	Portfolio	Portfolio %	Level of exposure
Type of operation	The portfolio is diversified, with operations in working capital, fixed capital investment, *project finance,* and consortium.	Working capital (53%) Investment in fixed capital (32%) *Project finance* (8%) Consortiums (7%)	High (3 points)
Volume	The institution is categorized as S3. *Project finance* operations have high value (> USD 750M) and some fixed capital investments.	> USD 750,000 (14%) ≤ 750,000 > USD 100,000 (36%) ≤ USD100,000 (50%)	Medium (2 points)
Terms	*Project finance* transactions and most investments have long terms.	> 60 months (35%) ≤ 60 months > 24 months (10%) ≤ 24 months (55%)	Medium (2 points)

Result: Portfolio with **medium proportionality** (7 points)

c. Development bank

Variable	Portfolio	Portfolio %	Level of exposure
Type of operation	The portfolio is diversified, with operations in working capital, fixed capital investment, *project finance,* and consortium.	Working capital (34%) Investment and fixed capital (30%) *Project finance* (36%)	High (3 points)
Volume	The institution is categorized as S1. Project finance operations have a high value (> USD 6 MM) and some fixed capital investments. The others fit in the medium and low range.	> USD 6,000,000 (25%) ≤ USD 6,000,000 > USD 1,500,000 (67%) ≤ USD 1,500,000 (8%)	High (3 points)
Terms	Project finance operations and most investments have long terms.	> 60 months (70%) ≤ 60 months > 24 months (25%) ≤ 24 meses (5%)	High (3 points)

Result: Portfolio with **high proportionality** (9 points)

2.2.2 Additional variable: guarantees

Guarantees can also be a source of environmental and social risk for a financial institution's operations. When a guarantee is executed for default on a transaction, the financial institution inherits all liabilities related to the guarantee. In the case of real estate guarantees, such as land, the property's intrinsic value must be evaluated. To do so, the legal documents, environmental quality of the site, and obligations with environmental entities, among other possible aspects that may cause the balance of the operation to be negative, must be verified.

Although the factor guarantees are not directly included as a variable in proportionality, it is essential to consider the types of guarantees typically received by the organization to design robust assessment procedures for ESMS effectiveness.

2.3 Sensitivity Diagnosis: integrating the principles of relevance and proportionality.

Based on the assessment of the principles of relevance and proportionality, it is possible to estimate the overall level of environmental and social sensitivity (***Table 8***) of the financial institution based on a matrix that integrates the financial institution's results (***Figure 9***).

Figure 9 – Sensitivity Diagnosis

Table 8 – Sensitivity of a financial institution

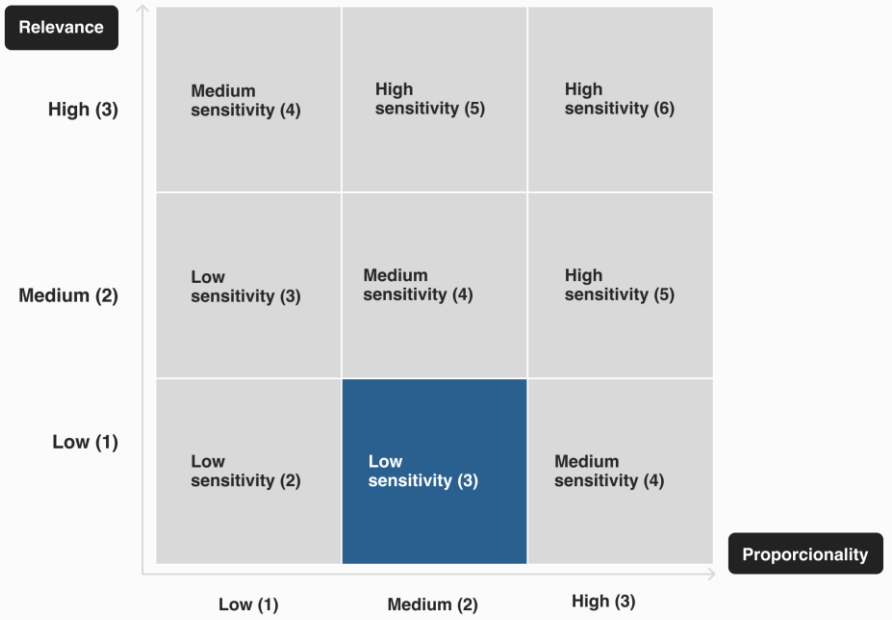
Sum of scores (relevance + proportionality)	FI size	Environmental and social sensitivity
5-6	S1-S2	A (high sensitivity)
	S3-S4	B+ (medium-high sensitivity)
4	S1-S4	B (medium sensitivity)
2-3	S1-S4	C (low sensitivity)

It should be noted that an S3 or S4 institution cannot reach the high sensitivity level. Generally speaking, this type of financial institution, even with high levels of relevance and proportionality, does not generate significant environmental and social impacts as it is not exposed to environmental and social risks at the same level as S1 and S2 size institutions. Large commercial banks and national development banks usually represent the latter two. The B+ (medium-high sensitivity) category is incorporated to distinguish between financial institutions by size.

Box 5 (a-c) shows examples of the final sensitivity score, following the types of financial institutions discussed throughout the Guide.

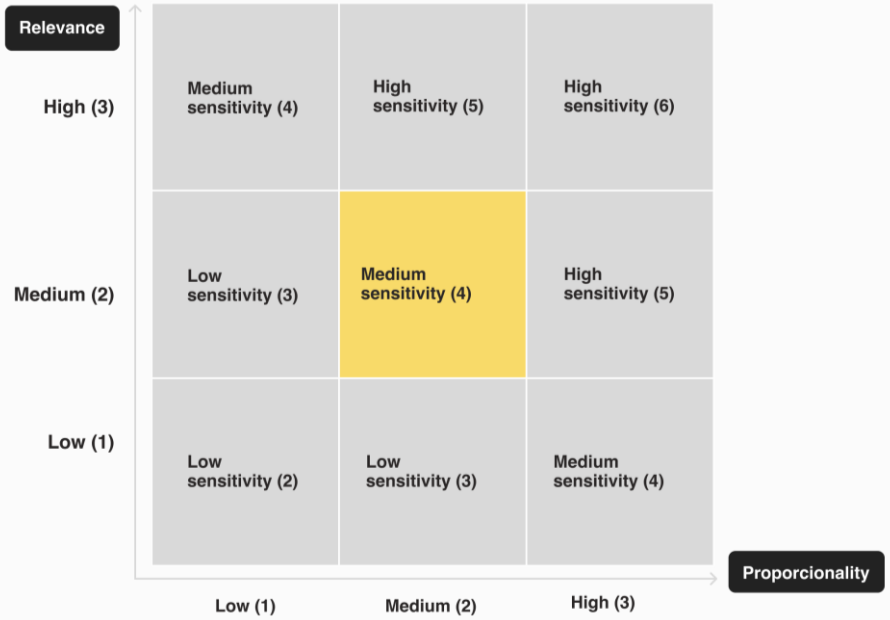
Box 5 – Examples of environmental and social sensitivity identification

a. Local development agency (credit bureau)
Relevance: low (1 point)
Proportionality: medium (2 points)
Financial institution category: S4



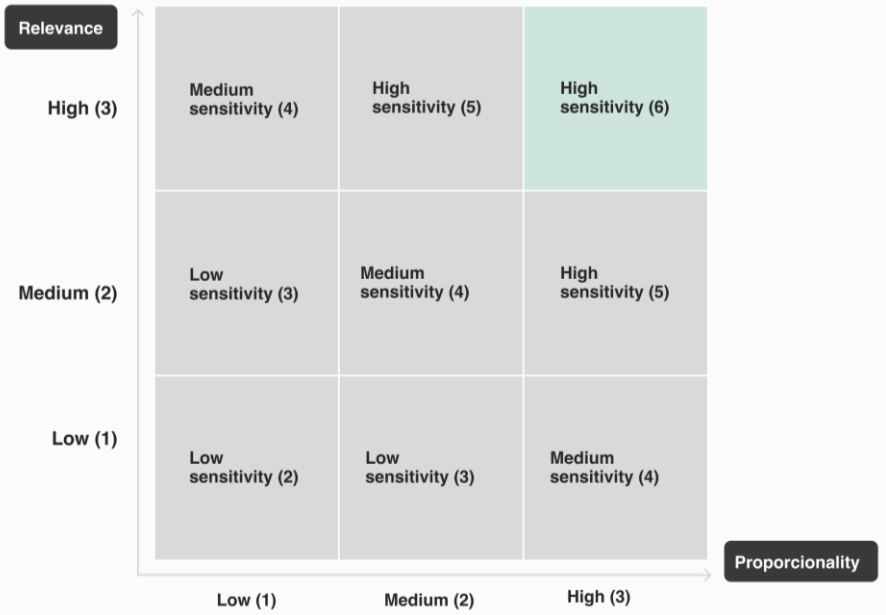
Result: Portfolio with **low environmental and social** sensitivity (3 points)

b. Commercial bank
Relevance: medium (2 points)
Proportionality: medium (2 points)
Financial institution category: S3



Result: Portfolio with **medium environ**

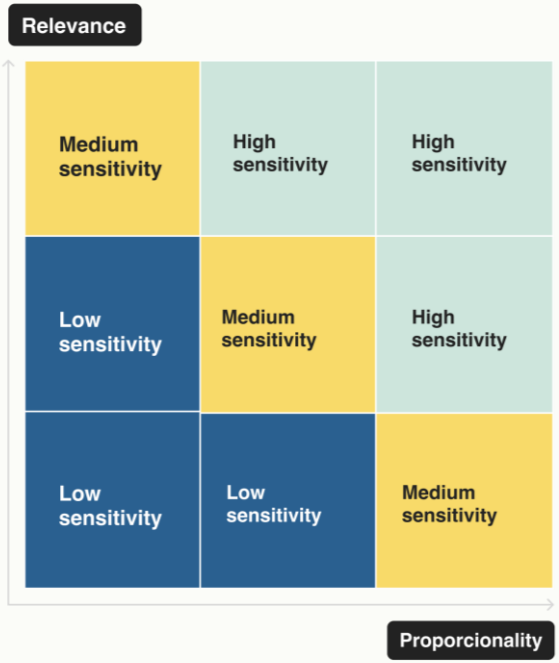
c. Development bank
Relevance: high (3 points)
Proportionality: high (3 points)
Financial institution category: S1



Result: Portfolio with **high environmental and social sensitivity** (6 points)

Finally, a summary of the categorization is shown according to the methodology developed (see ***Figure 10***).

Figure 10 – Level of environmental and social sensitivity according to the principles of relevance and proportionality.

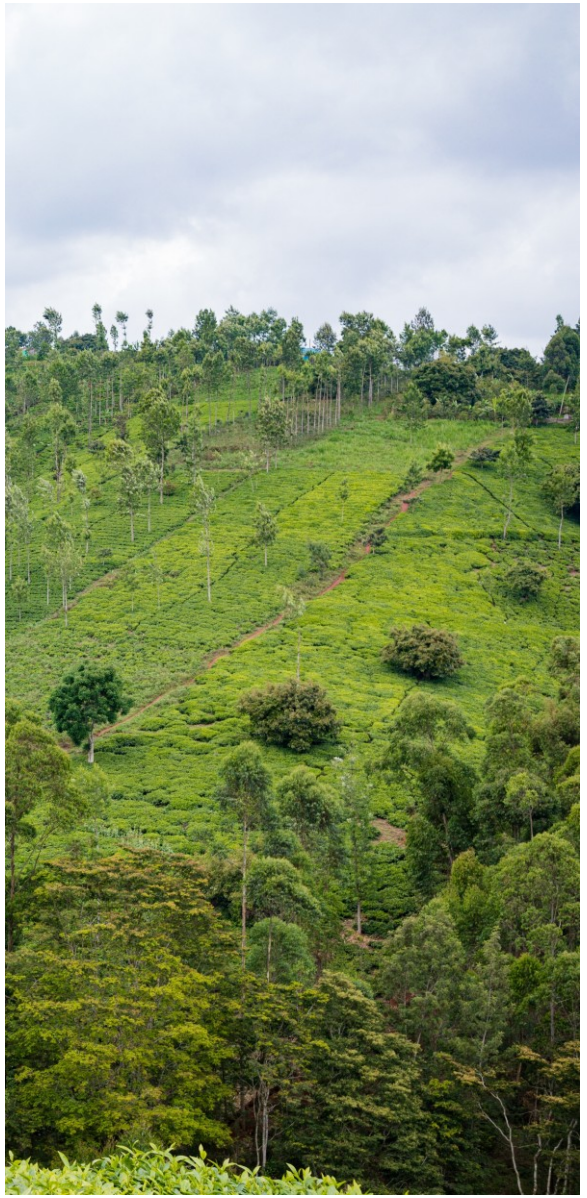


Principle of relevance

- Level of environmental and social risk according to economic sectors in the portfolio
- Level of legal certainty in the region
- Level of fragility of biomes
- Climate risks

Principle of proportionality

- Products and services offered
- Value of operations
- Term of operations
- Guarantees



3. Methodology for conducting a gap analysis between international best practices and local legislation

The next step in building an ESMS is to verify the regulatory requirements for the institution and its clients in the following areas: environmental, social, and governance. This assessment is contrasted with the level of environmental and social sensitivity defined in the previous *Sensitivity Diagnosis* stage. On the other hand, it is necessary to verify how, and to what extent, national environmental and social regulations align with international best practices, for which it is proposed the IFC Performance Standards are used as the benchmark.

In general terms, the financial institution should be aware of the country's environmental and social legislation and verify that its clients comply with regulatory requirements. In some cases, such as financing large projects with high environmental and social risks, the applicable legislation may be insufficient to mitigate the risks. The *Gap Analysis* of the legislation determines whether the financial institution would adequately manage environmental and social risks by complying with local regulations. If this is not the case, adjusting the institution's processes to comply with the necessary standards will be required.

The IFC Performance Standards provide a framework for understanding and managing environmental and social risks. Therefore, one should compare local legislation against these standards and identify gaps. A good understanding of environmental and social regulations and potential incompatibilities ensures that the financial institution effectively assesses the principal risks and impacts that could be associated with a financial transaction, especially high-risk ones.

It is important to note that if any aspect of the Performance Standard is 100% covered by local regulations, i.e., "effective," it does not necessarily mean that its application and enforcement are practical. National regulation may lack strength due to the weakness of control and oversight by the responsible authorities.

In summary, the Gap Analysis includes a list of all the standards in the country and contrasts them with the requirements of the IFC Performance Standards, indicating the existing gaps. ***Table 9*** lists the IFC Performance Standards, and the degree of coverage is displayed according to the following ranges:

Table 9 – Gap analysis of local environmental and social legislation

Topic	Best practices	Local legislation applicable	Legal requirements	Gaps	Level of coverage
Performance Standard 1 - Management of Environmental and Social Risks and Impacts	Policies and practices that effectively cover environmental and social risks per the institution's environmental and social sensitivity level.	List of laws, rules, and other regulations that the institution is obliged to comply with and/or to request from its clients	Details of the requirements of applicable laws and regulations	Differences between local regulation and international best practices	●Effective ●Satisfactory ●Limited ●Insufficient
Performance Standard 2 – Labour and working conditions					
Performance Standard 3 – Efficient use of resources					
Performance Standard 4 – Community Health and Safety					
Performance Standard 5 – Involuntary Resettlement					
Performance Standard 6 – Biodiversity Conservation					
Performance Standard 7 – Indigenous People					
Performance Standard 8 – Cultural Heritage					
Additional references					

- **Effective:** Local regulation covers 100% of international best practices.
- **Satisfactory:** Local regulation covers ≥70% and <100% of international best practices.
- **Limited:** Local regulation covers ≥40% and <70% of international best practices.
- **Insufficient:** Local regulation covers <40% of local international best practices.

"Our partners engaged our entire team in the review of our ESMS. They conducted thorough due diligence and identified specific areas where we can improve and fill gaps in order to meet the expected standards."

Kwaku Oppong Kyeremeh, Credit Evaluation and Review Manager, Fidelity Bank (Ghana)

When conducting the Gap Analysis, it is essential to note that each Performance Standard has several specific topics to be analyzed. To this end, the country's legislation related to the following topics should be reviewed: environmental, labor, social (communities and indigenous peoples), and cultural heritage.

For example, Performance Standard 1 - Management of Environmental and Social Risks and Impacts contains the following topics:

- Environmental and social evaluation and management system
- Environmental and social policy
- Identification of risks and impacts
- Management programs
- Organizational capacity and competence
- Monitoring and evaluation
- Emergency preparedness and response

Each topic should be evaluated according to the proposed methodology.

Table 10 shows an example of how to approach the analysis, using the first topic of Performance Standard 1 in a financial institution in South Africa.

Table 10 – Analysis of the requirements of Performance Standard 1: Management of Environmental and Social Risks and Impacts in South Africa

Performance Standard 1 – Management of Environmental and Social Risks and Impacts	
Subject: Environmental and social evaluation and management system	
Summary of the requirement	The client must undertake an environmental and social assessment process and develop and maintain an ESMS according to the nature and scale of its project and the level of risk of environmental and social impacts.
Local legislation applicable	In accordance with the Environmental Impact Assessment Regulations 2014 (as amended in 2017), the Ministry of Environmental Affairs in the Republic of South Africa requires that an environmental impact assessment be undertaken for activities that are likely to have a significant impact on the environment and submitted to the competent authority for consideration. The environmental sustainability of a development proposal must consider the following: disturbance of ecosystems and loss of biodiversity, pollution and environmental degradation, disturbance of landscapes and cultural heritage, and waste. The assessment must contain, in addition to the impacts, their respective mitigation measures to be implemented if an impact cannot be avoided.
Gaps	There are no significant gaps between the South African legislation and the requirement.
Coverage level	**Effective**

Source: Department of Environmental Affairs of the Republic of South Africa; own preparation

The same criteria presented in the previous example should be replicated for the other topics of each Performance Standard. This analysis will also help the following evaluation, which is focused on the institution's usual practices and how these could go beyond local requirements, if necessary.

Some countries have specific environmental legislations, such as Kenya (Environmental Management and Coordination Act (EMCA) of 1999). In addition, countries such as Kenya, Nigeria, and South Africa also have several laws on environmental issues, such as waste management law, water resources law, pollution control law, etc. Therefore, it is essential to identify and study the various pieces of legislation related to each Performance Standard.

On the other hand, the scope of the country's legislation must also be considered. Each of the 36 states in Nigeria has its own environmental protection bodies. For example, the Lagos State Environmental Protection Agency ("LASEPA") has several environmental laws and regulations for the state, including the Lagos State Environmental Management and Protection (Amendment) Law (2017). Therefore, it is important to study the legislation applicable to each project to be financed. The following factors may help in the gap analysis, taking Nigeria as an example, which has different levels of scope: federal, state, and municipal. (See ***Table 11***)

Table 11 – Analysis of the requirements of Performance Standard 1: Management of environmental and social risks and impacts in Nigeria

	Example of Nigerian legislation
Scope of the law	▪ **Federal level:** They apply to the entire national territory, and there are a series of legislations depending on the subject to be addressed: Environmental Impact Assessment Act, Harmful Waste (Special Criminal Provisions etc.) Act, Endangered Species (Control of International Trade and Traffic) Act, National Oil Spill, Detection and Response Agency Act, Water Resources Act, among others. These legislations at the federal level by the National Environmental Standards Regulations and Enforcement Agency (NESREA) should be the first to be reviewed in relation to the Performance Standard. ▪ **State level:** They apply to the state territory in some states. For example, the Lagos State Environmental Protection Agency (LASEPA), a parastatal of the State Ministry of the Environment, is an implementation organ of the state's environmental policies. There are a number of regulations that are adapted and domesticated by LASEPA, such as on sectors such as textile, as well as on sanitation and waste control, and noise standards. ▪ **Local level.** They govern at the local level (there are 774 local government areas in Nigeria) and are responsible for the delivery of services. Nigerian Constitution requires state governments to confer by law such environmental responsibilities (expressly including sewage and waste disposal, among others) on the local government councils within the state.
Where to find the information?	▪ To begin researching the country's environmental and social legislation, it is recommended to first locate the responsible environmental entity at the federal level. For example, in Nigeria, the National Environmental Standards and Regulations Enforcement Agency (NESREA) is responsible for enforcing the country's environmental laws, regulations, guidelines, and standards. ▪ Given that some of the topics covered by the Performance Standard are quite specific, once the related law is found, it is recommended to use keywords from the Performance Standard to find the specific issue contained in the law.

4. Methodology for the diagnosis of the financial institution's practices

The evaluation of the environmental and social sensitivity of the financial institution (*Sensitivity Diagnostic* stage) and the analysis of national regulations and international best practices (*Gap Analysis*) are necessary to enter into a more specific analysis of the financial institution's practices. Thus, existing policies, practices, processes, procedures, and tools on environmental and social risk management (e.g., the environmental and social risk categorization system for operations and its integration into the credit process) need to be reviewed.

The third and final step, the *Diagnostic of Practices*, must be carried out to verify the effectiveness of each policy and practice and their respective tools, allowing for the identification of practice creation, improvement, and automation points.

This diagnostic also verifies the existing governance structure to assess capacity, competence, and, not least, commitment to the implementation of an effective ESMS. The environmental and social issues (labor, resource use, contamination, communities, involuntary resettlement, biodiversity, indigenous peoples, and cultural heritage) covered in the Performance Standards (2 to 8) must also be evaluated.

The result of this diagnostic is the analysis of the degree of maturity of the financial institution's environmental and social risk management policies and practices to meet legal requirements and international best practices. The maturity level of policies and practices is measured as follows:

- **Effective:** The policy/practice is fully implemented, widely recognized internally, incorporated into training materials, and regularly updated.
- **Satisfactory:** The policy/practice is restrictively implemented (for specific operations), is acknowledged by the team responsible for its implementation, is incorporated into the training materials of this team, and/or needs revision.
- **Limited:** The policy/practice is restrictively implemented (specific operations and not all of its requirements are applied), is acknowledged by the team responsible for its implementation, and is not incorporated into training material or needs revision.
- **Insufficient:** The policy/practice was discussed but was not converted into formal processes, procedures, or tools or did not have a defined team responsible for its implementation.

Finally, the degree of coverage of the institution's current environmental and social risk policies and practices against local legal requirements and international best practices can be measured as follows:

- **Effective:** The institution's policies and practices cover 100% of national legislation and international best practices.
- **Satisfactory:** The institution's policies and practices cover ≥70% and <100% of national legislation and international best practices.
- **Limited:** The institution's policies and practices cover ≥40% and <70% of national legislation and international best practices.
- **Insufficient:** the institution's policies and practices cover <40% of national legislation and international best practices.

Table 12 – Outline for presenting the Diagnostic of Practices

Topic	Practices of the institution	Maturity Level	Local Regulations		Best practices	
			Coverage Level	Gaps	Coverage Level	Gaps
IFC Performance Standard 1 – Managing environmental and social risks and impacts	▪ Policies ▪ Processes ▪ Tools	●Effective ●Satisfactory ●Limited ●Insufficient	●Effective ●Satisfactory ●Limited ●Insufficient	Differences between the institution's practices and local legislation	●Effective ●Satisfactory ●Limited ●Insufficient	Differences between the institution's practices and international best practices
IFC Performance Standard 2 - Labour and working conditions						
IFC Performance Standard 3 - Efficiency of resource use						
IFC Performance Standard 4 - Community health and safety						
IFC Performance Standard 5 - Involuntary resettlement						
IFC Performance Standard 6 - Biodiversity conservation						
IFC Performance Standard 7 - Indigenous people						
IFC Performance Standard 8 - Cultural heritage						
Additional references						

The following is a proposed list of the institution's documents or policies to be reviewed to carry out this diagnostic. In addition, the team in charge should hold meetings with those responsible for the credit process and support areas to collect information.

- Environmental and social policy or developing version.
- Other institutional policies: strategic direction of the institution (mission, vision, corporate objectives), corporate governance code, prevention of money laundering and financing of terrorism, supplier contracting policy, code of ethics and conduct/human rights, human resources policy, etc.
- Flow chart of the credit process, as well as process and sub-process maps, process and procedure manuals of the areas involved in the credit process (especially the environmental and social areas, if any).
- An organizational chart of the institution, procedures, and job profiles of the areas involved in the credit process.
- Description of business segments (e.g., Corporate, Business, SME, Microenterprise) and product lines.
- A list of documents and operational and financial information submitted by the client to the institution for the credit application (or the basis for the credit analysis).
- Reports generated in the credit process, including environmental and social reports or documents (e.g., visit reports, credit reports, collateral appraisals, etc.).
- Guides and supporting tools for environmental and social analysis: site visit guides and sectoral questionnaires (if available).
- The organizational structure of the E&S team, Terms of Reference , and key roles and responsibilities of all staff and management involved.
- Sample credit agreement.
- Last year's external auditor's reports or other audit reports/consultancy analysis of the bank's management processes.

When carrying out the *Diagnostic of Practices*, it is important to study the credit process in depth, the tools, the people in charge, and the training carried out so that an accurate analysis can be made of existing practices (whether formal or implicit). Finally, the aim is to take advantage of internal capabilities and to improve strategic aspects that will be the basis for ESMS implementation. Training is often required to enhance the use and development of an ESMS after design and implementation.

> "What is challenging about ESMS implementation is that it is a continuously evolving topic. An ESMS needs to be enhanced on an ongoing basis, as we have done, since we adopted the Equator Principles in 2009."
>
> Paulo Branco, Head of Environmental and Social Risk at Absa, Corporate and Investment Banking (South Africa)

Table 13 shows the proposed approach for the *Diagnosis of Practices* in relation to Performance Standard 1, which focuses on the credit process. Two of the seven topics to be considered for this diagnosis (policy, initial screening or exclusion list, risk categorization, risk assessment, risk management, environmental and social risk monitoring, and review and audit) are presented below.

Table 13 – Example of the diagnostic of practices under the requirements of Performance Standard 1 (theoretical case)

Stage and requirements (Performance Standard 1)		Analysis of the degree of maturity/coverage of the regulations.
a. Environmental and social policy: General policy defining the environmental and social objectives and principles that guide the project to achieve good environmental and social performance		
Local legislation requirements	However, the country has a "Sustainability Protocol," a sectoral initiative. The purpose of the Protocol is to implement a sustainable finance strategy in the country. The purpose of the Protocol is to implement a sustainable finance strategy in the country.	● **Effective** The institution is aligned with the country's legal/sectoral requirements.
Performance Standard Requirements	According to Performance Standard 1, the environmental and social policy must constitute a framework for the environmental and social assessment and management process that the project or business activity requires. The policy should also indicate who is responsible for ensuring compliance within the organization and who will communicate the policy to all levels of your organization.	● **Limited** The institution has an Environmental Policy, which needs some improvement points to reach an effective level: This policy should be disclosed to employees through training. In addition, the responsible parties must be established to enforce compliance with the policy.
Financial institution practices	To date, the institution has implemented an Environmental and Social Risk Policy. The policy's last update took place seven years ago, and it is not disclosed among the different areas of the bank. Likewise, the policy does not establish responsibilities for managing environmental and social issues.	● **Limited** To reach an advanced level, the institution must establish periodic reviews and updates of its policy (between 3 and 5 years). Likewise, it must establish responsible parties for environmental and social management and provide training on the issues addressed in said policy.
b. Environmental and social risk categorization: Define environmental and social risk categories for the portfolio to facilitate the identification of the project's environmental and social risks and impacts.		
Local legislation requirements	The country's legislation does not require financial institutions to implement a methodology to categorize their clients according to the environmental and social risk level, as is the case in Kenya and Nigeria.	**Not applicable**
Performance Standard Requirements	Performance Standard 1 establishes that a process must be in place to identify a project's environmental and social risks and impacts. In cases where the project includes both physical elements and facilities, the client must also analyze the environmental and social risks and impacts in the context of the project's area of influence, related facilities, and cumulative impacts.	● **Limited** The institution does not have a methodology to categorize the environmental and social risk level. Credit analysts, if necessary, gather information on social or environmental issues so that they can raise the risk level of the operation. This is done tacitly, hen analyzing the client.
Financial institution practices	In accordance with the credit manuals and the environmental and social policy of the financial institution, there is no procedure in place to categorize the environmental and social risk level of its clients.	● **Insufficient** To achieve an effective level, the institution must implement an automated categorization of the environmental and social risk level, establishing the parameters described in the *Sensitivity Diagnostic* (relevance and proportionality). Likewise, those involved in credit should be trained on the environmental and social issues to which the different sectors are exposed.

Based on the table above, it is important to note that the institution complies with the country's regulations in both areas; however, it is not aligned with international best practices. This happens regularly in Sub-Saharan Africa, and it should be noted that it is not enough to comply with local legislation for the financial sector, but the institution needs to go beyond it.

The analysis of Performance Standards 2 to 8 cover the following topics: labor, resource efficiency and pollution management, community health and safety, involuntary resettlement, biodiversity, indigenous peoples, and cultural heritage. ***Table 14*** shows the approach for the *Diagnostic of Practices* in relation to Performance Standard 3 and 6 on resource efficiency and use and biodiversity, respectively. The same methodology should be replicated for the other Performance Standards.

Table 14 – Diagnosis of practices under the requirements of Performance Standards 3 and 6

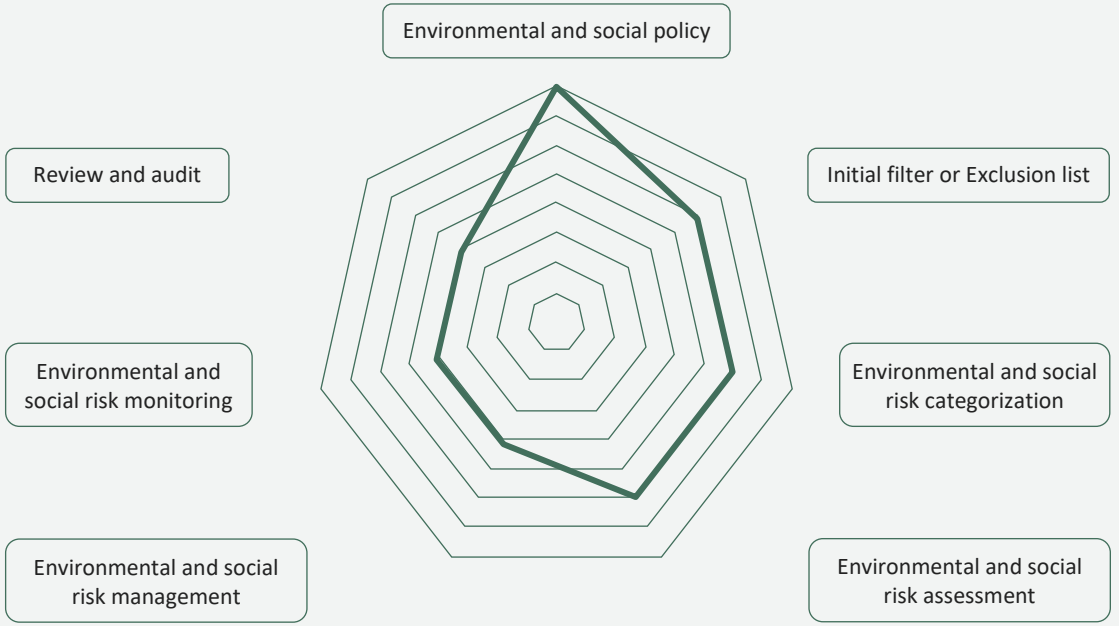
Performance Standard and requirements		Analysis of Maturity Level / Coverage of the Standard
Performance Standard 3: Resource and Pollution Efficiency		
Local legislation requirements	According to the financial institution's activity, the Environmental Law (which includes issues of resource use and pollution prevention) does not affect the direct operation of the institution.	**Not applicable**
Performance Standard Requirements	Although financial institutions are not as intensive in using natural resources as other industries, having institutional policies on sustainability and the environment helps to be aligned with international best practices in the sector.	● **Limited** The institution does not operate according to plans or policies on the management of the use of resources. Measures such as defining the institution's environmental footprint and defining energy-saving plans and policies regarding the use of paper, help to reduce the institution's impact and approach international best practices.
Practices of the financial institution	The institution does not evaluate criteria related to its clients' eco-efficiency and resource use.	● **Insufficient** To reach a consolidated level, the bank should assess the impact of its clients on resource efficiency and pollution, including consumption of water, energy, inputs, and pesticide management. These should be aligned with the sector's exposure and the client's activity, through a correct environmental and social categorization of the sector and subsequent environmental and social evaluation. Likewise, training should include these topics for the correct approach aligned with the interests of the institution.
Performance Standard 6: Biodiversity		
Local legislation requirements	According to local legislation, financial institutions do not have co-responsibility in this matter.	**Not applicable**
Performance Standard Requirements	Performance Standard 6 recognizes that the protection and conservation of biodiversity, the maintenance of ecosystem services and the sustainable management of living natural resources are fundamental to sustainable development.	● **Insufficient** The financial institution does not have biodiversity criteria in its credit process.
Financial institution practices	Financial institutions have the potential to positively influence biodiversity conservation and sustainable management of living natural resources, since funded projects may negatively impact these issues. According to the institution's Credit Manuals and Environmental and Social Policy, to date there are no criteria for evaluating the impact of its clients on biodiversity, or the level of exposure to this topic.	● **Insufficient** To achieve an effective level, the institution must include biodiversity in the environmental and social categorization so that, by knowing the level of environmental and social risk of the client, it is possible to determine which environmental permits are required and the level of depth of the environmental and social assessment carried out in this regard.

Box 6 - Examples of results of the diagnostic of practices by type of financial institution (Performance Standard 1)

a. Local development agency (credit bureau)

Environmental and social policy	● **Effective**
Initial filter or exclusion list	● **Satisfactory:** general exclusion list
Environmental and social categorization	● **Satisfactory:** categorization according to sector and customer size
Environmental and social assessment	● **Satisfactory:** permits and licenses are required in accordance with local regulation
Environmental and social management	● **Limited:** environmental and social clauses included in high-risk customer contracts
Environmental and social risk monitoring	● **Insufficient:** environmental and social monitoring of clients is not carried out
Review and audit	● **Insufficient:** no ESMS audit is performed

Results Performance Standard 1 – Local development agency

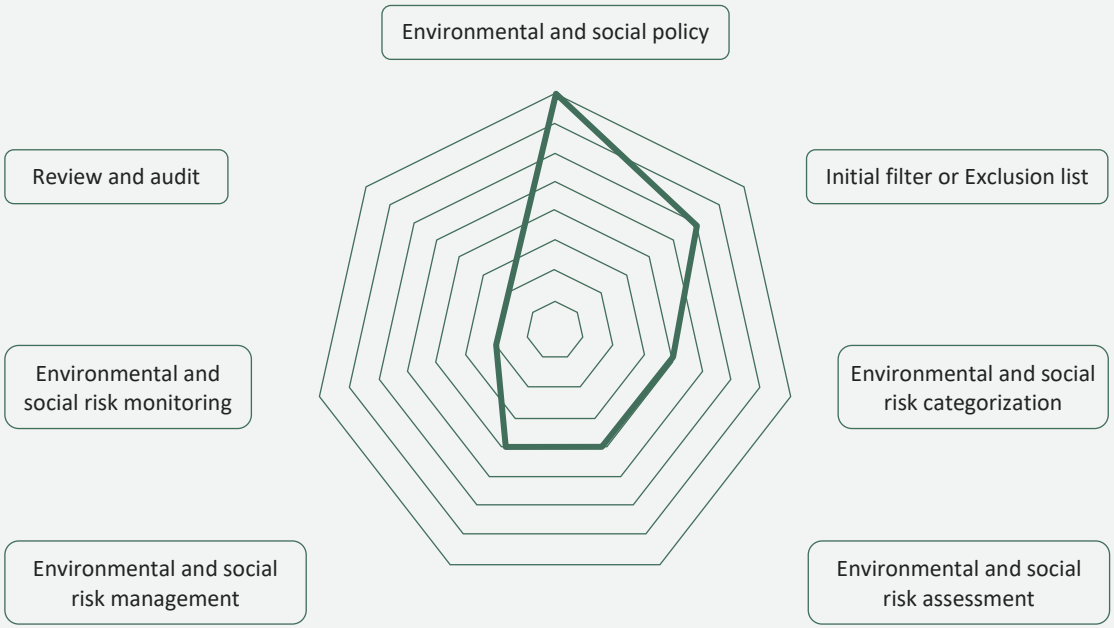


Overall result: The local development agency has an ESMS, in general terms, aligned to its needs. It has a general exclusion list, a three-level environmental and social categorization (A, B and C) and an environmental and social assessment (requiring environmental licenses/permits). Environmental and social clauses are not yet included in all contracts, nor is client monitoring or an ESMS audit performed.

b. Commercial bank

Environmental and social policy	● **Effective**
Initial filter or exclusion list	● **Satisfactory:** general exclusion list
Environmental and social categorization	● **Limited:** customer location has no influence on categorization
Environmental and social assessment	● **Limited:** assessment does not include client visits to identify risks/opportunities on site
Environmental and social management	● **Limited:** general environmental and social clauses included in high-risk customer contracts
Environmental and social risk monitoring	● **Insufficient:** environmental and social monitoring of clients is not carried out
Review and audit	● **Insufficient:** no ESMS audit is performed

Results Performance Standard 1 – Commercial bank



Overall result: despite having a ESMS in place, the bank has gaps in relation to its needs. The environmental categorization (A, B and C) considers only the client's economic interest (leaving aside the client's location and aspects related to natural hazards, access to resources, forests, indigenous peoples, cultural heritage). Also, the environmental assessment only requires environmental permits or licenses. Technical visits should be made to verify practices. Finally, the ESMS does not include environmental and social monitoring mechanisms or audits of the process.

c. Development bank

Environmental and social policy	● **Satisfactory:** includes ESMS issues. However, it does not include eco-efficiency, governance and stakeholder initiatives.
Initial filter or exclusion list	● **Limited:** general exclusion list, it is not aligned with the lists of international financial institutions.
Environmental and social categorization	● **Insufficient**: the location of the customer does not influence the categorization.
Environmental and social assessment	● **Limited:** the entity does not have a specialist in environmental and social assessment of the projects.
Environmental and social management	● **Insufficient:** does not have specific clauses aligned with environmental and social assessment in contracts with customers.
Environmental and social risk monitoring	● **Insufficient:** only high-risk clients are monitored by visits once a year.
Review and audit	● **Insufficient:** no ESMS audit is performed.

Results Performance Standard 1 – Development bank

General Result: The development bank is exposed to high environmental and social risks yet has a basic ESMS. The environmental categorization (A, B, and C) considers only the client's interests (leaving aside the client's location and aspects related to natural hazards, access to resources, forests, indigenous peoples, and cultural heritage). The environmental assessment only covers documentary requirements related to environmental permits or licenses. There is no specialist in environmental and social issues to lead the evaluation. On the other hand, environmental and social clauses are not included in the contract with clients, and monitoring is only done for A-risk clients. No audit of the process is conducted.

5. Considerations in the application of the ESMS model

The *Sensitivity Diagnostic* allows us to understand the needs of the institution in terms of environmental and social management. In summary, financial institutions that are more exposed to environmental and social risks require more robust and complex environmental and social management practices.

After identifying the level of environmental and social sensitivity, the practices (formal and tacit), processes, procedures, systems, and tools already developed by the institution should be analyzed. This avoids a complete overhaul of the financial institution's internal processes and ensures the ESMS is aligned with the institution's processes, capabilities, objectives, and commitments.

In sum, the *Practices Diagnostic* can be seen as a gap analysis between the financial institution's practices, the applicable national legislation, and international best practices (IFC Performance Standards). For the correct interpretation of the results of this diagnosis, it is important to highlight:

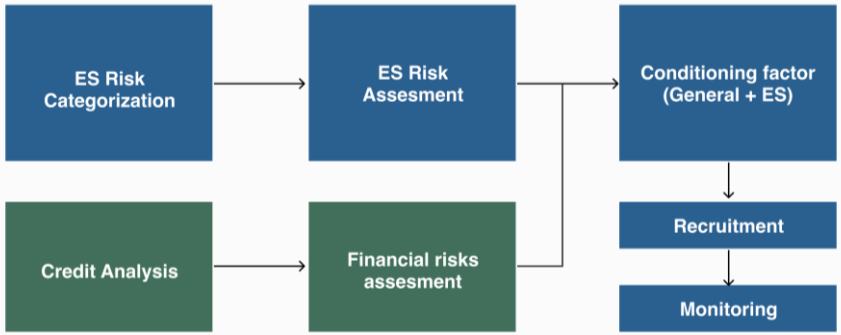
- **At a minimum, a financial institution's practices are expected to comply with national legislation.** For larger projects, any gaps between the Performance Standards and local legislation should be considered and requirements should be aligned with international best practices. Even for this type of project and even if the legislation is aligned with the Performance Standards, the degree of effectiveness of governmental/environmental authorities' enforcement of the legislation should be analyzed.
- **Evaluation of formal and informal practices.** On several occasions, financial institutions already perform (non-institutionalized) environmental and social procedures that need to be formalized. On the other hand, it is also necessary to modify official environmental and social practices that are not fully complied with or lack effectiveness.

With the results obtained from the previous analyses, the institution has sufficient information to identify the ESMS model best suited to its needs. Examples of ESMS models to be applied are shown in ***Box 7.***

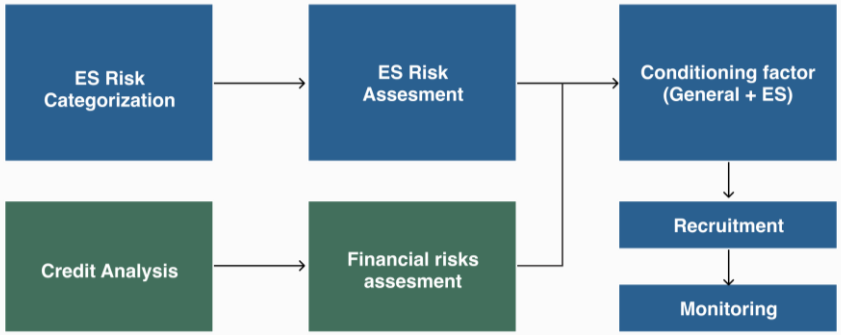
According to the previous results presented in **Box 5** – Examples of environmental and social sensitivity identification, some general ESMS models to follow are presented (note that the abbreviation E&S is used to refer to environmental and social):

Box 7 - ESMS models to be followed according to environmental and social sensitivity.

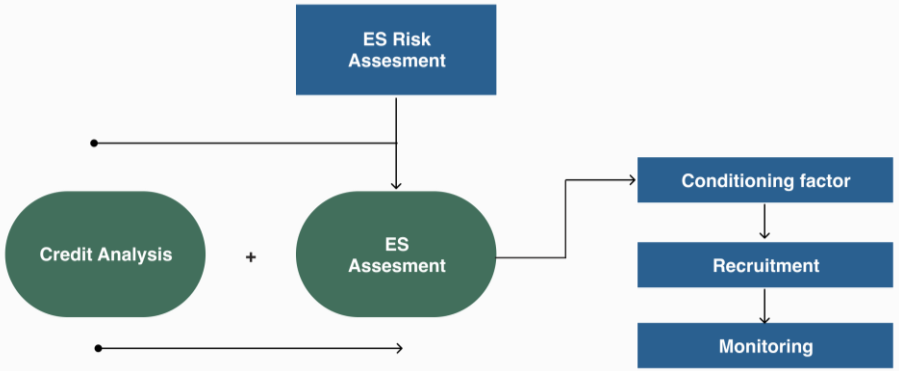
a) **Local development agency (credit bureau)**
Relevance: low (1 point)
Proportionality: medium (2 points)
Financial institution category: S4
Result: Portfolio with low environmental and social sensitivity (3 points)
Proposed ESMS model: once the client has been assessed according to its level of environmental and social categorization, general conditions may be included, covering the country's environmental and social policy and legislation. The financial institution, having low exposure to environmental and social issues, can manage these issues from a specific area (usually risk or commercial), with the appropriate training of its employees in environmental and social issues.



b) **Commercial bank**
Relevance: medium (2 points)
P**roportionality:** medium (2 points)
Financial institution category: S3
Result: portfolio with medium environmental and social sensitivity (4 points)
Proposed ESMS model: Once the client has been evaluated according to its level of environmental and social categorization, an environmental and social rating is assigned separately from the credit rating. In accordance with the environmental and social rating, specific conditions may be defined (e.g. environmental and social action plan), in addition to the general ones. The financial institution, having medium exposure to environmental and social issues, should establish an environmental and social team to lead the ESMS, usually comprised of an environmental and social officer and one or two analysts (depending on the size of the institution). Likewise, the rest of the areas should participate in the process (credit, risk, etc.), with the appropriate training on environmental and social issues.



c) **Development bank**
Relevance: high (3 points)
Proportionality: high (3 points)
Financial institution category: S1
Proposed ESMS model: A more complex model is proposed, in which the client's environmental and social rating is integrated into the credit rating, impacting provisions. Likewise, the conditions may be specifically defined according to the environmental and social assessment, in addition to the general ones. The financial institution, having a high exposure to environmental and social issues, is required to have an environmental and social team leading the ESMS, generally consisting of two or more environmental and social officers and one or two analysts (depending on the size of the institution). Likewise, the other areas will have to participate in the process (credit, risks, etc.), with the appropriate training on environmental and social issues. In some cases, external consultants, specialists in the sector of the project to be financed, must be hired to carry out the evaluation.



6. Challenges and next steps for ESMS development

The implementation of an ESMS can bring about challenges for a financial institution due to resistance to change and learning new concepts. To meet the challenges of implementation, the ESMS must be gradually implemented, allowing the incorporation of changes that do not obstruct the credit process, and avoiding significant delays and costs.

> "There is high interest and profound understanding of the potential benefits that the bank will gain from implementing the right ESMS. We are now setting up a standalone team to ensure that E&S factors are taken into account in all our activities and all our operations."
>
> Nana Yaa Afriyie Ofori-Koree, Head of Partnerships, Sustainability and CSR, Fidelity Bank (Ghana)

Top management commitment is crucial. For an ESMS to be developed and implemented, the institution's senior management must approve and endorse its integration into the credit process. In addition, it is necessary to build an appropriate governance structure for the effective implementation of an environmental and social risk management system, with defined responsibilities.

In addition to top management support, feedback from ESMS implementers is key. Therefore, a team trained and sensitized on environmental and social issues and ESMS is essential to understand and disseminate the importance and benefits of the system. In this regard, the support of the ESMS team on the applicability of processes, procedures, and tools is crucial to ensure users are engaged and the system is effective. In addition, it is desirable to conduct internal ESMS surveys during a pilot implementation to identify opportunities for improvement.

Customers play an essential role in the ESMS design and implementation process. Financial institutions often believe the ESMS will impede the lending process or restrict disbursements. However, when the ESMS is appropriately designed, this presumption is wrong: **it helps to identify and manage risks, supporting the search for solutions not only for the financial institution but also for the client.**

On the other hand, the institution should consider using companies with good environmental and social performance as an example when conducting environmental and social analysis, especially those that are customers of the financial institution. In this way, a "model" can be shown to other clients in the portfolio, and employees can be trained on the subject.

It should be noted that an ESMS can be seen as an opportunity for the financial institution, not only in terms of strengthening compliance with national regulations but also in terms of operations and the market. Environmental and social risks are increasingly evident for financial institutions, and their identification, assessment, and proper management is, in specific cases, mandatory, and in all cases, essential for business continuity. In addition, access to international capital is a crucial issue, and a robust ESMS is a requirement for international development finance institutions.

From developing to fully implementing an ESMS, including diagnostic, design, development, training, pilot (test) implementation, and full integration into the credit process, normally takes between 9 and 14 months, a timeline that may vary according to the needs and capabilities of the institution. ***Table 15*** shows an illustrative timeline of the activities and respective deadlines for the implementation of an ESMS, averaging 12 months, for a financial institution that utilizes external consultants or specific persons responsible for the internal implementation.

Table 15 – Model timeline for ESMS diagnosis

Activity / Month	1	2	3	4	5	6	7	8	9	10	11	12
1.a. Sensitivity diagnostic												
1.b. Gap analysis of the country's social and legal legislation												
1.c. Practices diagnostic												
1.d. Action plan												
2.a. ESMS model development												
2.b. Development of ESMS guidelines and tools												
2.c. Actions and training plan for ESMS												
3.a. Implementation of ESMS Pilot and monitoring of results												
3.b. Evaluation of the ESMS Pilot results												
3.c. ESMS review and start of full implementation												

The support of a team specialized in the subject can be of significant help. The experience obtained from the ESMS diagnostic, design, training, and implementation processes enables external experts to have a greater capacity to identify the needs of the financial institution - against regulatory and market demands - and how to implement them.

Consulting services may be required for one or more phases of ESMS development, but it is recommended that the institution's staff are involved in all phases of ESMS development. In this way, the support of an expert team ensures that each stage is carried out properly.

"Consultants can help broaden your perspective and think outside the box. It's not just about following regulations but staying ahead of the competition. They can bring valuable insights and assist with implementing new ideas."

Angeline Mwangi, Senior Manager, ESG & Climate Risk at Family Bank (Kenya).

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Glossary

ESG: Acronyms to refer to environmental, social, and governance issues.

Gap analysis: Analysis of the environmental and social legislation of the financial institution's country of operation against international best practices (such as the Performance Standards of the International Finance Corporation - IFC).

Practices diagnostic: Analysis of the formal and informal practices of the financial institution in relation to E&S risk management: initial screening or exclusion list, environmental and social categorization, environmental and social assessment, environmental and social management, monitoring and review/audit.

Sensitivity diagnosis: Analysis of the environmental and social exposure of the portfolio, considering the principles of proportionality and relevance.

International Finance Corporation Performance Standards (IFC): Eight Performance Standards within a sustainability framework along with other strategies, policies, and initiatives aimed at achieving social and environmental development objectives.

Proportionality: Degree of exposure to environmental and social risks of the institution's operations, i.e., types of products offered, loan amounts, tenors, and guarantees required.

Relevance: The level of environmental and social risk of the economic sectors supported by the financial institution, as well as the contexts of legal security, fragility of biomes, and climate risks in the regions of operation.

ESMS: Financial institution's environmental and social risk management system.

Credits

About eco.business Fund

eco.business Fund is an impact investment fund that aims to promote business and consumption practices that contribute to biodiversity conservation, to the sustainable use of natural resources, and to mitigate climate change and adapt to its impacts in Latin America, the Caribbean, and Sub-Saharan Africa.
The eco.business Fund pursues its mission by providing dedicated financing and technical assistance to financial institutions and businesses committed to environmental practices in unique ecological landscapes. The fund focuses on sustainability in four priority economic sectors: agriculture and agri-processing, fishery and aquaculture, forestry, and tourism.

In its effort to maximize and deepen the fund's impact, the Development Facility provides support to the fund's partner financial institutions and end borrowers, while strengthening the four priority sectors. The technical assistance provided by the Facility responds directly to stakeholder needs. They can range from implementing environmental and social and social risk management systems to sponsoring events and funding training and research opportunities.

About ERM

Founded in 1971, ERM (Environmental Resources Management) is the world's largest specialist sustainability consultancy, dedicated solely to sustainability. With over 50 years of experience, we partner with leading global organizations to address critical sustainability challenges, guided by our purpose to create a better future. Recognized as the market leader in sustainability services, we build trusted partnerships, with most of our work being sole-sourced. Our approach involves active collaboration and co-creation with clients and changemakers, aligning our efforts with the Sustainable Development Goals (SDGs).

We continuously innovate and invest in our capabilities to support our clients' needs, driven by our core values of accountability, client focus, collaboration, empowerment, care for our people, and transparency. Our global reach, facilitated by our Partnership model, mobilizes experts across 40 countries, ensuring we remain at the forefront of sustainability consulting. As pioneers in the field, we strive to make a positive impact on our clients, society, and the planet.

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