

Explaining the Integration of ESG Risks into Investment Decisions

Lessons from Project Finance and the Equator Principles

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Abstract

Investors are increasingly integrating environmental, social, and governance (ESG) issues into investment decisions. A plethora of studies generated by the financial community itself has demonstrated the business case for doing so with increased sophistication. Specialized firms or divisions within financial institutions are developing tools and methodologies for systematically accounting for these risks in investment risk management and analysis. The recognition that ESG risks are increasingly material has led to the development of a host of new products and services. These developments reflect a trend in which the consideration of ESG risks is moving from governing investments in niche (SRI) markets to influencing mainstream investment decisions across an increasing array of financial markets.

But the level and depth of integration differs between financial markets, and across investors operating in the same market. The paper argues that the extent to which investors integrate ESG risks into particular investment decisions is in part a function of the structure of the financial market they are operating in, and in particular, the extent to which these expose investors to reputational risks. With reference to the project finance market, the paper puts forward an argument from an international political economy (IPE) perspective in which reputational risks are central to understanding both the emergence of governance in a particular market and the variations in practice across financial institutions. It concludes by considering the relative role of state authority, favorable institutional conditions and a need for legitimacy in facilitating the integration of ESG risks into the global commercial project finance market.

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Introduction

Project finance is a risk management structure that is used to capitalize the construction and operation of a large share of energy and infrastructure development in both developed and developing countries. Given the sheer scale of projects, this form of financing can be associated with significant adverse environmental and social impacts. In the 1990s, alongside the growing attention to corporate social responsibility in the financial sector, commercial banks were increasingly targets of environmental advocacy campaigns because of their involvement in large-scale infrastructure projects in developing countries.. In 2002, a senior executive at ABN Amro met with IFC's executive vice-president and discussed the growing criticism levied against commercial banks for financing projects in developing countries with significant adverse environmental and social impacts, and later that year, the two financial institutions convened a meeting of leading project finance banks in London to discuss the management of environmental and social issues in projects.

During the ensuing four months, the working group collaborated with a technical advisor from the IFC to consider a set of environmental and social standards for project finance investments that would be suitable for commercial banks. In June 2003, senior executives of ten commercial banks gathered at the IFC's headquarters in Washington D.C alongside its chief executive to officially launch the Equator Principles. In actuality, the formal existence of the framework is limited to a publicly available document that spells out the normative and business rationale for undertaking environmental risk management, and specific operational standards that adopting banks commit to using in their project finance activities. It has no formal organization or secretariat, and communication with stakeholders is done through a website hosted on by one of the adopting banks on a rotating basis.² It is a strictly non-binding framework in which '[financial] institutions are adopting and implementing [the] Principles voluntarily and independently, without reliance on or recourse to IFC or the World Bank.'³ Furthermore, it has no independent monitoring mechanism mandated to verify that projects have been prepared according to the relevant provisions. As is stated, compliance with host country laws and regulations and relevant World Bank and IFC guidelines will be addressed to the satisfaction of the financier.

In 2006, following three years of implementation and dozens of new adopting banks, the Equator Principles were revised. By and large, the differences between the original and the revised version reflect the changes that the IFC made to its own environmental and social policy framework in March 2006. Under both

² www.equator-principles.com.

³ Equator Principles (2006), "The Equator Principles - A Financial Industry Benchmark for Determining, Assessing and Managing Social and Environmental Risk in Project Financing", www.equator-principles.com, July 2006, p.5; Equator Principles (2003), "The Equator Principles – An Industry Approach for Financial Institutions in Determining, Assessing and Managing Environmental and Social Risk in Project Financing.", June 2003, p.4.

versions of the framework, adopting banks pledge to apply an environmental screening process to their project financing, in which project proposals are assigned a category – A, B or C – according to the level of perceived environmental and social risk. In turn, project sponsors borrowing for projects likely to generate significant adverse impacts are required to undertake more rigorous and extensive environmental impact studies and public consultation processes, amongst other things. In addition, both versions require project sponsors of category A and B projects to complete an environmental assessment report which identifies requirements under host country laws and regulations and international treaties and agreements, as well as a wide range of other concerns not necessarily covered in national jurisdictions. Subsequently, they have to complete an environmental management plan that addresses mitigation, actions plans, monitoring, and the management of risk and schedules.

The Equator Principles is yet another manifestation of how firms are increasingly engaged in creating and implementing transnational rules to govern corporate practices, especially those in developing countries. However, there a large variations across financial markets as to whether financial institutions systematically manage environmental, social and governance (ESG) risks. Variations can be found among financial institutions engaged in the same financial markets and even among those financing the same companies or projects. Many financial institutions have not developed systematic environmental and social policies to guide investment decisions. Among those that have, few implement them across all product lines. In many cases, types of debt and equity financing that potentially have severe adverse environmental impacts are excluded. These variations reflect how interventions are products of risk management, rather than a principled commitment to particular environmental and social objectives.

More broadly, private standards with the same level of operational specificity as the Equator Principles have not emerged in other financial markets. But the level and depth of integration differs between financial markets, and across investors operating in the same market. The paper argues that the extent to which investors integrate ESG risks into particular investment decisions is in part a function of institutional features of the financial market they are operating in, and in particular, the extent of public involvement, the opportunities for public scrutiny and the potential for cooperation between firms. By examining the emergence of the Equator Principles, and related, the growth of ESG risk management in the international project finance market, the paper puts forward an argument in which reputational risks are central to understanding both the emergence of governance in a particular market and the variations in practice across financial institutions.

In identifying fears of reputational damage as central to understanding why financial institutions integrate ESG risks in investment decisions, the paper provides supports extant research on environmental governance in the financial sector. Industry surveys have found a strong link between the emergence of the

Equator Principles and reputational risk management. Freshfields Bruckhaus Deringer (FBD), the international law firm, produced a comprehensive survey of Equator banks and major project sponsors, and found that both returned ‘repeatedly to the value and importance of reputation, the need to protect a good reputation and the difficulty in regaining a good reputation, if tarnished.’⁴ Two dimensions of reputational risk were of concern; protecting and enhancing the public image of the financial institution by carefully selecting and managing projects, and protecting themselves from the negligence or malpractices of project sponsors. Overall, the survey found support for the common contention that reputation is hard won, but can be easily lost as a result of ‘stigma damages’, or controversies that generate a poor image of the corporation among consumers, corporate clients, competitors and governments.⁵

The paper is divided into four sections. The first section identifies three competing theoretical perspectives on why firms may alter their business practices and argues for a synthesis approach to studying private governance formation. The second section introduces project financing and identifies the central role of project risk management in investment decisions. The third section describes the growth of reputational risk in project financing and what determines its materialization. And finally, the concluding section revisits the theoretical perspectives and identifies how a confluence of state power, favorable institutional conditions and a quest for legitimacy encouraged the integration of ESG risks in project financing.

1. Explaining Private Governance Formation

The emergence of the Equator Principles reflects a broader trend in global governance towards the greater inclusion and influence of private actors in transnational rule-making. In the recent decade, much attention has been given to the proliferation of transnational networks and partnerships between and among civil society groups, inter-governmental organizations, business associations and TNCs existing largely independently of the formal treaties,

⁴ FBD (2005), *Banking On Responsibility, Part One of Freshfields Bruckhaus Deringer Equator Principles Survey 2005: The Banks*, July 2005. Similarly, Environmental Resources Management (ERM), the British consulting firm, conducted a survey of 38 Equator banks and non-Equator banks on their environmental risk management practices, and found that 73 percent were ‘paying a great deal more attention’ to what NGOs are saying, following the launch of the Equator Principles. (ERM (2006), “Credit Risk Management – Banking Industry Integrating Environmental and Social Issues: How Much and How Fast?“, survey prepared by John Ganzi, Reed Huppman, and Carlo Alberto Marcoaldi, Environmental Resources Management, July 2006, see also BMU (2002), “Green Finance – Environmental Management in Banks, Savings Banks and Insurance Companies”, report by the German Federal Ministry for Environmental Protection, Conservation and Nuclear Reactor Safety (BMU); EIRIS (2006), “Project Finance – A Sustainable Future?“, *Social, Ethical and Environmental Risk Briefing*, Ethical Investment research Briefing (EIRIS), July 2006; ISIS (2002), ‘A Benchmarking Study - Environmental Credit Risk Factors in the Pan-European Banking Sector’, ISIS Asset Management (now F&C Asset Management), September 2002)

⁵ Frye, R, (1998), ‘The Role of Private Banks in Promoting Sustainable Development, From Outside Counsel’s Perspective’, 29 *Law & Policy in International Business*, 481.

conventions and agreements that are typically associated with inter-state relations. This trend is best captured by the phrase 'governance without government', which refers to the role that social institutions, rather than organizations or material entities, play in solving collective-action problems that pervade social relations under conditions of interdependence.⁶ These initiatives often take the form of voluntary codes of conduct, industry standards and guidelines that define norms for corporate behavior in relation to a wide variety of public interest concerns, such as human and civil rights, environmental issues, corruption, and labor.⁷

In the study of global environmental politics in particular, but also international political economy more broadly, the growing role and influence of private governance is becoming an important aspect of the evolution of international organization and institutions.⁸ In many areas of environmental governance, TNCs no longer hold subordinate positions to states in the drafting of institutional arrangements, but acquire positions of authority by virtue of their financial resources and technical knowledge. With their growing influence, the profit motive has become increasingly accepted as a legitimate, and in some cases, vital aspect of environmental governance, leading to institutional arrangements centered on addressing the environmental and social cost of business within the parameters set by the commercial interests of private enterprise.

Since most of these new forms of private governance are not rooted in a formal or legal authority with sanctioning power, there is much uncertainty as to how and why they emerge. In the field of international political economy, governance formation has been traditionally studied with reference to one of three analytical concepts; power, interests and knowledge. In a power-based theory, governance formation reflects the power and authority of particular actors. For example, perspectives in the realist tradition of IPE hold that dominant states provide the conditions for processes of institutionalization to emerge and evolve, and are assumed to possess the capability and instrumental power to bring them to an end.⁹ As such, corporate strategy and behavior is a function of state power, in the

⁶ Young (1994), p.16. The central point of emerging literature on 'governance' is that the absence of world government does not mean that governance is impossible beyond the level of individual states. (Koenig-Archibugi 2006, p. 4)

⁷ For overviews, see Bendell (2004), pp.25-28, Drahos and Braithwaite (2000), Lipchutz and Fogel (2002), pp. 125-129, Newell (2001), pp.91-95, and Utting (2005), pp.2-3. For example, the Coalition for Environmentally Responsible Economies (CERES) emerged out of discussions between companies, environmentalists and churches, calling on the private sector to reduce pollution, conserve non-renewable resources, and use sustainable energy as evaluation criteria for selecting Board members. Similar voluntary regulation is facilitated by the World Business Council on Sustainable Development (WBCSD), the International Chamber of Commerce (ICC), and the U.S Climate Action Partnership (USCAP).

⁸ As per Falkner (2003), private governance 'emerges at the global level where the interactions among private actors, or between private actors on the one hand and civil society and state actors on the other, give rise to institutional arrangements that structure and direct actors' behavior in an issue-specific area.' (p.72)

⁹ See for example Gilpin (1971) and Lipson (1984). As Haufler (1999) has noted, the literature attributing regime emergence and persistence to hegemonic power integrated hegemonic stability theory to the study of international institutions, and embedded it within a liberal concern for institutional cooperation.

sense that firms are continuously forced to adapt their market behavior according to the rules and regulations created and enforced by states. This means private governance reinforces, rather than undermine, existing systems of state-based rules and regulations.

Interest-based theories of governance formation point us to the positive and negative incentives that actors face in cooperating with each other, and the institutional conditions that encourage cooperation. In this perspective, governance formation is a product of rational bargaining processes between actors, and is not simply an expression of state power. However, states are assumed to produce the institutional structures within which private actors operate. However, this view would consider the proliferation of private governance as a product of particular institutional changes which have caused firms to pursue certain courses of action and favor cooperation with other actors over unilateral behavior, giving rise to private governance.¹⁰

In contrast to the rational ontologies of these perspectives, constructivist approaches assume the identities and interests of actors are not fixed, but are constituted by particular ideas about the material world and norms that define standards of behavior.¹¹ In turn, changes in corporate strategy and behavior are attributed to the diffusion of norms and ideas, rather than material factors, that attribute meaning and social purpose to different forms of behavior. By implication, the growth in ethical business practices, and related, the emergence of private standards that define boundaries for responsible corporate conduct, reflect a deeper transformation in corporate identities towards a self-conception of being “corporate citizens” with broader ethical responsibilities in society. Thus, rather than responding to state power or strategically amending practices according to new institutional conditions, firms engage in ethical business practices because they consider it legitimate and appropriate. More broadly, this perspective attributes governance formation to a shift in norms.

The Case for a Synthesis Approach

In understanding the emergence of environmental governance within a particular market, that paper argues that a synthesis approach that draws on all three perspectives and recognizes the complexity of governance formation is called for. An emphasis on state power recognizes that the proliferation of private governance cannot be disassociated from public policy and regulation. While standard-setting processes initiated and dominated by private actors and interests may in some cases marginalize governments and international

¹⁰ For example, global economic integration has increased interactions between states and interdependencies between them. To illuminate the distinction between institutionalist and structural realist accounts of international relations, using the analogy of a poker game, Keohane and Nye (1989) argue that ‘at the process level, analysts are interested in how the players play the hands they have been dealt.’ (p.21)

¹¹ For brief overviews of constructivism in international relations, see for example Wendt (1995), Checkel (2001) and Finnemore (1996).

organizations, their eventual outcome do not necessarily undermine national and international law, regimes and institutions. For example, in some cases, informal, voluntary and discretionary rules often harden over time into formal regulation enforced by states, which suggests that private governance may give rise to, rather than prevent, state regulation.

At the same time, global integration of financial markets has increased the value of the knowledge and expertise that financial institutions possess. As states are unable to regulate much of transnational financial activity, they often delegate, or are forced to concede, authority to firms in the formation and implementation of governance. Moreover, private forms of governance are distinct from those developed in the public sector, as they conform to the commercial logic of markets and are constrained by the rules and practices that govern investment decisions, including respect for client confidentiality. In this regard, they express the growing role and influence that firms are able to exert in an increasingly integrated global economy.

An institutional approach, while commonly failing to adequately account for the underlying power structures that shape institutional conditions, can illuminate why there are variations in corporate strategy and behavior across markets, and the extent to which negative and positive incentives inform business decisions. An often neglected aspect of private governance formation is the fact that business interests are often deeply fragmented and conflicted, with regional, sectoral and cultural differences between firms. However, in some cases interest conflicts between firms are not obstacles to institutionalized cooperation, but an important precondition, as they provide an impetus for firms to engage in coalition-building in an attempt to defend their interests and market share. Interest-based approaches are therefore instructive to illuminate intra-industry dynamics between firms, and how these are shaped by changes in institutional conditions.

And finally, constructivist approaches to understanding corporate behavior have been criticized for undermining the overarching significance of profit motives in the private sector. Arguing that the rise of corporate social responsibility simply reflects a broader transformation of corporate identities deemphasizes the extent to which voluntary environmental and social practices are strategically developed and implemented as an aspect of broader corporate strategy. Yet, the emergence and diffusion of norms have a significant bearing on decision-making under conditions of uncertainty, such as risk management. As a result, while constructivists may overemphasize the power of ideas in explaining the emergence of voluntary business regulation, it is hard to disregard the extent to which new self-understandings of legitimate corporate conduct is changing the way firms define and pursue their interests in global markets fraught with risk.

The next section introduces project finance and the significance of risk management to investment decisions.

2. Project Finance as Risk Management

Financial institutions have become central to the capitalization of infrastructure development in many developing countries. Since the early 1990s, market reforms in many developing countries have resulted in the widespread privatization of traditional public sector industries, harmonization of tax regimes, and lower restrictions on foreign capital all contributed to the growth in long-term private capital flows to infrastructure projects, including power plants, roads, ports and telecommunication.¹² Between 1991 and 1997, long-term official capital flows to developing countries declined nearly 40 percent and the World Bank withdrew almost entirely from large-scale public infrastructure lending. However, during the same period, multilateral- and bilateral financing to private entities in developing countries nearly tripled, growing from US\$ 9 billion to US\$25 billion.¹³ And reflecting the increasingly favorable conditions for private investment in developing countries, commercial bank financing for infrastructure in developing countries increased nine-fold, and the annual volume of project finance deals exploded from less than \$5 billion to over \$50 billion.¹⁴

These investment rates reflect the increasingly favorable investment conditions in developing countries, and the attractive features of project financing as a means to capitalize infrastructure development. Project finance is a specialized form of financing that is predominately used to finance projects that require large amounts of capital investments, and are expected to generate significant revenues over an extended period of time once the project is in operation.¹⁵ A common characteristic of project financing is a long initial 'search' phase, in which government and project sponsors explore a variety of project proposals through extended negotiations.¹⁶ While project finance is theoretically appropriate for financing any economic activity that can be legally separated from project sponsors, it is predominately used for projects in capital-intensive economic sectors, such as extractive industries, or energy, transportation, and communications infrastructure. And as these sectors are often heavily regulated due to their centrality to national economic development objectives, private companies often undertake projects in the context of concession arrangements with governments, in which private ownership, investment and operation is predicated on a set of limited financial, economic and legal conditions.

In contrast to corporate finance, debt and equity in this form of financing are provided to a self-liquidating single purpose company, commonly a joint venture

¹² World Bank (2004), *Global Development Finance 2004*, World Bank: Washington D.C.

¹³ IFC (2002), *Developing Value – The Business Case for Sustainability in Emerging Markets*, International Finance Corporation, SustainAbility and the Ethos Institute, 2003.

¹⁴ Esty, B.C (2004), 'Why Study Large Projects? An Introduction to Research on Project Finance', *European Financial Management*, Vol. 10, No. 2, 2004, 213–224; World Bank (2004), *Global Development Finance 2004*, World Bank: Washington D.C.

¹⁵ Pollio (1999), and Smith and Walter (2003), pp.125-146.

¹⁶ Miller and Hobbs (2005).

between a domestic- and a foreign TNC. This project company owns and operates the project, and controls its physical assets and underlying contracts.¹⁷ The capitalization of the project company is typically a lot less than the financial needs of the project, and the difference is typically made up of debt or issuing bonds.¹⁸ The assets of the project, the contracts associated with its construction and operation, and the cash flow generated by it, are all legally separated from balance sheets of project sponsors.¹⁹ As part of this legal arrangement, project sponsors are barred from redeploying any resources raised through the project for any other purposes.²⁰

Debt financing is commonly provided by multiple lenders organized in loan syndications, often exceeding dozens of public and private financial institutions. Such arrangements allow individual banks to provide debt to multiple projects in small amounts, rather than single projects in large amounts, thereby diversifying their financing and reducing their overall risk exposure.²¹ Financing projects through syndications also provides individual banks with greater access to collective information and expertise, and the ability to engage in loan trading and derivatives sales.²² In addition, many syndicates include multilateral- and bilateral development agencies that bring significant risk management resources to bear and have close relationships with both project sponsors and host governments, which provides additional security to participating commercial lenders.

The exact financing structure of individual projects varies, but a shared characteristic is a high debt-equity ratio, making them highly leveraged transactions.²³ Typically, equity provided by project sponsors represents no more than 20 to 40 percent of total financing, with the remainder of capital raised through a combination of bank loans and bond issues.²⁴ Once financing has been committed, creditors cannot seek compensation from the operators of the project or the host government in the event that the project is unable to generate sufficient cash flow to service debt obligations. Therefore, project finance is commonly referred to as either non- or limited recourse, since creditors fully or mainly depend on future revenue streams for loan repayment. Non-recourse project finance refers to a financing structure in which lenders and creditors have no direct recourse to the sponsor beyond the assets being financed. In contrast, limited recourse project finance, which is common for projects in developing countries, does provide lenders and creditors with some limited security, usually in the form of pre-completion guarantees during the construction phase.

¹⁷ IFC (1999)

¹⁸ Smith and Walter (2003).

¹⁹ IFC (1999).

²⁰ Pollio (1999).

²¹ Donaldson (1988).

²² Smith and Walter (2003).

²³ Pollio (1999).

²⁴ Dailami and Leipziger (1997).

These features of project financing means that the market is unlike most other financial markets. Given the scale of investment, both in terms of financing volume and project size, project financing is time-intensive for all parties involved, requires considerable risk management expertise and involves significant involvement of the public sector. And the financing modality is only used for large, complex projects likely to generate significant revenue streams, thus naturally constraining the size of the market. In 2004-05, only 216 projects were financed worldwide, totaling £38 billion, with 61 percent of projects in either power or infrastructure.²⁵ However, this year was part of a longer recovery after the credit crisis of 2000. Current growth is primarily driven by continuing deregulation and privatization in the power, telecommunications, and transportation sectors, and by the globalization of project financing products, particularly project bonds.

The concept of ‘project risk’ significantly informs how environmental and social issues are governed in project finance transactions. Project risk is crudely defined as the probability of project failure, and ultimately, the aversion of risk among lenders is driven by a desire to avoid financial misadventures. In the context of project finance, project risk can be defined as ‘the possibility that the project will be unable to produce output in the quantity or quality or at a cost that ensures sufficient cash flow generation to repay the original indebtedness.’²⁶ The nature of risk associated with individual projects will in large part determine its exact financing structure.²⁷ Generally, the higher the level of perceived project risk, the more risk mitigation measures are needed. For example, projects in countries with significant political and financial volatility would require more government assurances and support schemes to be able to attract risk-averse private creditors and investors.

As such, project finance principally functions as a risk management structure chosen by lenders, sponsors and governments for its risk sharing attributes and associated financial advantages over other forms of financing.²⁸ In managing risk, decision-makers choose one of four possibilities depending on the significance of the risk; prevention, mitigation, transfer, or acceptance. The choice of strategy is primarily driven by the overarching objectives, namely the protection of project revenue streams, and more broadly, shareholder value. But generally, decisions about the level of risk mitigation are based on what is financially acceptable to those exposed to the risk, rather than an absolute concern for eliminating the risk entirely.²⁹ As a result, the expectation is that a project proposal would only be rejected in the most extreme cases.³⁰

²⁵ EIRIS (2006).

²⁶ Pollio (1999), p.4

²⁷ IFC (1999).

²⁸ See Hainz and Kleimeier (2003), and Pollio (1999).

²⁹ Pollio (1999).

³⁰ IFC (1999).

To manage risk, lenders must identify and evaluate a variety of project risks that could derail the revenue predictions presented by the project sponsor. The literature typically distinguishes between two types of project-related risks.³¹ Commercial risks are those related to the development and construction of the project, the maintenance of assets and the identification of a target market for the project output. This category also includes broader risks bearing on the project economics, such as interest rate changes, inflation, currency risk, and price fluctuations associated with raw materials and energy. Non-commercial risks relate to the policy environment of the project, and include unfavorable legislative and regulatory changes that disrupt construction or operation, including expropriation of assets and the failure of the host government or public enterprises to meet contractual obligations. It also includes political and civil disturbances, including the likelihood of armed conflict.

3. Reputational Risk and the Emergence of the Equator Principles

In the 1990s, TNCs and their financial bankers increasingly presided over the construction and implementation of projects that not only contributed to the economic transformation of entire sub-national regions and industry sectors, but also had a profound impact on the environment and local communities. The growth in commercial project lending was led by commercial banks from OECD countries - principally Japan, the United States, France, Germany, the Netherlands, and the United Kingdom -which accounted for roughly three-quarters of all commercial infrastructure finance in developing countries. In many cases, their involvement was facilitated by multilateral lenders and official export credit agencies, which arranged syndications and provided risk guarantees for projects in industrial sectors and regions fraught with political, financial and economic risks.³²

Alongside the expansion and integration of global financial markets, resentment against the unaccountable nature of financial flows sparked a public debate over the costs and benefits of foreign direct investment to developing countries, particularly in relation to environmental protection and labor conditions. In cases where large-scale privatizations transferred critical public services to the private sector, projects were often criticized for reducing social protections and introducing cost recovery in public services. Furthermore, financial institutions and their corporate borrowers were driving the rapid expansion of environmentally-sensitive sectors, including mining, forestry and transportation, placing them at the center of public policy debates over sustainable development.

The materialization of reputational risk in project financing is closely linked to the emergence of information and communications technologies increased public

³¹ IFC (1999).

³² World Bank (2004), *Global Development Finance 2004*, World Bank: Washington

scrutiny of project financing in a number of ways.³³ First, it has allowed geographically disparate groups to form transnational advocacy networks, share information and build political alliances, which has both produced a convergence around particular norms and ideas, and increased the mobilization of resources. While such networks had emerged already in the 1980s during the World Bank campaigns, the scale and pace of political organization increased considerably. Secondly, it has increased the availability of independent information (and disinformation) about corporate practices, as the internet as allowed media outlets and ‘watchdog’ groups to effortlessly disseminate viewpoints and assessments. And third, alongside the transnational mobilization of civil society and the greater access to information, public awareness of the development impact of corporate practices increased considerably, particularly in developed countries. In combination, these developments attached a considerable reputational risk to project financing in developing countries by increasing the likelihood that the adverse environmental and social impacts associated with project they financed could be exposed, scrutinized and criticized, and ultimately damage their corporate reputation.³⁴

Explaining Reputational Risk Exposure

Exposure to reputational risks varies significantly across financial institutions active in the project finance market. Three inter-related factors are central to determining the level of reputational risk associated with project financing that is likely to generate significant adverse environmental and social impacts in a developing country. First, the pressure against a development project in the country in which the project takes place (host country) significantly determines the extent of negative local and international media coverage that is produced. In many cases, a controversy erupts when a local community organizing a protest or court actions against a project sponsor over negligence or deliberate injustices, generating publicity around the adverse environmental and social impacts generated by a project. While the severity of ecological damages and social injustices is a factor in determining the level of local opposition, the political rights and capacity of local community groups to organize a response and be heard is also a crucial factor.

³³ Bendell, J. (2000), ‘*Barricades and Boardrooms: A Contemporary History of the Corporate Accountability Movement*’, UNRISD, 2000; Newell, P. (2001), ‘Managing Multinationals: the Governance of Investment for the Environment’ 13 *Journal of International Development* (2001) 907.

³⁴ This growing scrutiny of commercial project financing in the late 1990s mirrored a growing trend in transnational business; that large TNCs could no longer ignore the impact of their activities on the environment with impunity (see Jenkins, R. (2001), “Corporate Codes of Conduct – Self-Regulation in a Global Economy”, United Nations Research Institute for Social Development (UNRISD), *Technology, Business and Society Programme Paper*, Number 2, April 2001.; Newell, P. (2001), ‘Managing Multinationals: the Governance of Investment for the Environment’ 13 *Journal of International Development* (2001) 907; Sethi, S. (2002), “Standards for Corporate Conduct in the International Arena: Challenges and Opportunities for Multinational Corporations.”, *Business and Society Review* 107(1)(2002):20–40)

The extent to which national environmental laws and regulations are well developed and comprehensively enforced also contributes to the level of pressure in host countries. For example, requirements associated with the provision of operating permits and licenses can put legal pressure on financial institutions to undertake more rigorous environmental and social risk studies. This explains why the most controversy have occurred in connection with large-scale development projects that require widespread government approvals, and undertaken in developed countries with generally mature democratic institutions and well-organized civil society groups, that collectively are able to mobilize political support behind the concerns of project-affected communities.³⁵

Secondly, while the local contestation of a project may induce project lenders to confront the project operator and demand changes to project design or operations, it is unlikely to trigger wholesale changes to project lending practices. Overall, the higher the public pressure in the home country of the financial institution to consider environmental and social issues in investments, the greater likelihood that a controversial project in a developing country will translate into a reputational liability. With recent advances in information and communications technologies, the potential that corporate malpractice in one country affects public perceptions of that company in another country has grown exponentially.³⁶

Environmental NGOs have been instrumental in transmitting and amplifying information by gathering, organizing and diffusing information about development projects that runs counter to the corporate reporting of financial institutions. Apart from the growth in information flows, their influence stems from a capacity to politically mobilize consumers and citizens, and wage influential media campaigns against corporations that question the legitimacy of their business activity. Such ‘naming and shaming’, which differentiates corporate leaders from laggards, is central to the enforcement of environmental norms.³⁷ For example, narratives of a destructive project can produce a broader public backlash in which policy-makers, bank customers, and the media demand that project lenders pressure their borrowers to meet the demands of local community groups.

Other sources of pressure in the home country can also be significant and help legitimize and boost the influence of environmental NGOs. Progressive firms, such as socially responsible investment funds or environmental technology firms, are often advocates of corporate responsibility and give legitimacy to claims

³⁵ Examples include large-scale colonization projects in Brazil and Indonesia, and several hydropower projects in India, which have involved large-scale land conversion, infrastructure development and the resettlement of local communities. Many of these are referenced in later chapters.

³⁶ Frye, R. (1998), ‘The Role of Private Banks in Promoting Sustainable Development, From Outside Counsel’s Perspective’, 29 *Law & Policy in International Business*, 481.

³⁷ Haufler, V. (1999), “Self-Regulation and Business Norm: Political Risk and Political Activism”, in Cutler, A.C., Haufler, V. and Porter, T. (eds.) (1999), *Private Authority and International Affairs*, Albany: SUNY Press.

within the financial sector that certain corporate practices are inappropriate and irresponsible. In addition, government regulations and guidelines can call attention to the negative consequences that can be generated by the activities of TNCs in developing countries, and force financial institutions to publicly disclose their corporate practices. More broadly, both public and firms can contribute to creating an institutional environment in which financial institutions feel pressured to demonstrate their commitments and contributions to sustainable development.

And third, the vulnerability of a financial institution to a public backlash also depends on the structure of the financial institution. Project finance banks differ widely in the geographical and sectoral distribution of their portfolio, which has a bearing on the overall level of environmental risk they are exposed to. Since systems of governance and environmental management differ widely between developed and developing countries, an industrial accident is much less likely to happen in developed countries, and if it does happen, will have much greater adverse impact on the environment or local people in developing countries. In terms of sectors, projects in industries associated with significant adverse environmental impacts, such as oil, gas, mining and hydropower, are more likely to generate adverse environmental and social impacts than those in more service-oriented industries, such as health, education and telecommunications. In the latter case, larger projects are also more likely to attract public attention than smaller projects.

Furthermore, apart from the composition of the project finance portfolio, the level of reputational risk that stems from adverse environmental or social impacts increases if the financial institution has a large consumer banking network. If citizens in the home country have banking relationships with the financial institution, they are in position to directly punish its commercial standing by withdrawing funds and moving accounts to a competitor. As a result, deposit-taking financial institutions that allow consumers to make their preferences known in the marketplace enhances the leverage of environmental NGOs, and makes it much more likely that public revelations of irresponsible financing practices will result in financial costs.³⁸ If the financial institution has a retail presence in the developing country in which the project is located, the same dynamic pertains. Conversely, if the financial institution does not take deposits, or if retail banking only represents a very marginal share of its overall revenue streams, a public backlash is less damaging. This can explain why two financial institutions involved in the same controversial development project may not be exposed to the same level of reputational risk.

In summary, the materialization of reputational risk depends on the confluence of institutional pressures in geographically disparate places, producing information about the impacts of development projects that challenges the

³⁸ Newell, P. (2001), 'Managing Multinationals: the Governance of Investment for the Environment' 13 *Journal of International Development* (2001) 907.

accounts put forth by financial institutions. For this to generate a reputational threat to the financial institution, the disclosure of irresponsible financing needs to induce an adverse market reaction that directly impacts the financial institution's profitability. For commercial banks, this means project risk management is no longer confined to simply identifying the risks and opportunities geographically or operationally located near the project. It adds considerable uncertainty to project risk management, especially in the context of large projects where responsibility for environmental and social management is fragmented.

4. Lessons Learned: Why ESG Governance Emerges

The analysis has identified exposure to reputational risk as the most critical factor in explaining the growing integration of Esg risks in project financing, and the emergence of the Equator Principles. ten financial institutions that originally adopted the Equator Principles were amongst the largest financial TNCs in the world, and many were headquartered in financial centers within the OECD. As many of these commercial banks were frequently involved in financing oil and gas pipelines, hydropower projects and mining operations in developing countries, reputational risk emerged as a significant strategic concern for the commercial project finance business. In 2003, in the so-called 'league tables' released by the financial press, all but three of the financial institutions were among the top ten global mandated arrangers of project finance loans by financing volume or number of projects.³⁹ This reflected the fact that many of them specialize in arranging project finance loans, a function which generally entails a higher level of public visibility than others, such as providers, bookrunners, managers, financial advisers, or legal advisers.⁴⁰ By extension, they were more likely than smaller commercial banks to attract media attention in cases where projects were found to cause significant adverse environmental or social impacts.

So what explains the materialization of reputational risk in the commercial project finance market? In answering this question, it is worth revisiting the theoretical perspectives on governance formation alluded to in first section. It identified how changes in corporate behavior can be explained using three

³⁹ For the period July 01, 2003 – June 30, 2004 (Euromoney (2004), Project Finance Yearbook 2004-05, Euromoney International Plc.). Financial institutions are ranked by project financing loan volume. The six regions and the respective top ranked financial institutions are: Europe (RBS), Middle East and Africa (HSBC), North America (CSFB), Latin America (WestLB), Asia (Bank of China) and Austral-Asia (Westpac Banking Corporation). HSBC adopted the Equator Principles on September 4, 2003, three months after the framework was launched.

⁴⁰ To illuminate, among financial institutions that make the list of the top twenty Global Mandated Arrangers of project finance loans, 60 percent are Equator banks. The corresponding figures for other services or functions are; Global Providers (55 percent), Global Bookrunners (45 percent), Global Managers (35 percent), Global Financial Advisers (30 percent), and Global Legal Advisers (none). (Euromoney (2004), Project Finance Yearbook 2004-05, Euromoney International Plc, pp.67-70). Only two banks had very small project finance portfolios, Rabobank and Hypovereinsbank (HVB).

paradigms; response to coercion (power), response to new incentives (interests), and a quest for legitimacy (knowledge). The materialization of reputational risk in project financing lends some support to all of these at different stages.

The Role of State Authority

Multilateral development banks, and in particular those that serve the private sector, have contributed to the institutionalization of environmental and social norms in global finance. The IFC, as the largest multilateral lender to the private sector in developing countries, not only encourages the harmonization of practices across national jurisdictions, but also act as norm entrepreneur in its own right, favoring technocratic solutions to environmental and social problems that give the private sector a central role in implementation. The World Bank has formally recognized and embraced this discursive role by seeking to project itself as a 'knowledge bank', whereas the IFC is increasingly promoting itself as a depository of knowledge and technical expertise in environmental and social risk management, producing research reports, surveys and guidelines, in addition to providing training for financial institutions.⁴¹ As a result, the IFC has become a significant discursive force in financial markets in developing countries, articulating ideas and norms that define how and why financial institutions should further sustainable development in their investment practices.⁴²

The presence of public financial institutions in the project finance market is much greater than in most other transnational financial markets. State authority is reflected in the Equator Principles primarily in the selection of standards. To understand the IFC's 'soft power' and the appeal of its environmental and social risk management policies among leading commercial banks, it is necessary to consider their characteristics from the commercial vantage point of financial institutions in position to decide whether or not to apply them to their project finance lending.

First, choosing to base the common industry standards on the IFC's environmental and social policy framework guaranteed that they would draw a certain amount of immediate and unconditional recognition and legitimacy. As the IFC's Board of Directors, representing over 170 governments, formally approves changes or additions to the IFC's operational policies and procedures, the *Safeguard Policies* enjoyed a multilateral endorsement, albeit perhaps not equally supported by all governments. And as they give affirmation to well-recognized norms and rules in the international system, such as human rights, protection of sensitive ecosystems and public access to decision-making, they also enjoy relatively strong support among environmental NGOs campaigning for better protections for the environment and local communities.

⁴¹ See Stone and Wright (2006), pp.9-16.

⁴² See Wright (2006), pp.70-76. For similar arguments about the World Bank and the IMF, see Woods (2006).

Secondly, the fact that many commercial banks were quite familiar with the IFC's environmental and social policy framework provided a strong rationale for aligning industry standards with it. Although the IFC has less financial strength than many commercial banks, it enjoys unique privileges as a multilateral institution that allow it to significantly influence how environmental and social issues are managed in large-scale infrastructure projects in developing countries. By determining the financing conditions attached to its own loans, and in the context of syndications, to commercial bank loans as well, the IFC can influence the standardization of contracting practices and commercial legal obligations in developing countries, particularly those that lack access to private financing. By implication, frequent borrowers in environmentally-sensitive industries, such as oil, gas, mining and infrastructure, and commercial banks participating in loan syndications, have become familiar with the IFC's environmental and social policies and the World Bank's environmental standards and guidelines.

And finally, given the global reach of the project finance market, there was a purely functional argument for commercial banks to choose a policy framework that could be applied to project investments in all industry sectors globally. In fact, gaining the support of a significant share of market participants was as important for the working group as the selection of standards. In contrast to those of regional development banks, the IFC's operational policies and procedures were not designed to respond to the institutional conditions of particular geographic regions, but meant to be applicable and equally effective in all of its countries of operation. In turn, this universal logic was well suited for a globally integrated industry, in which the project finance portfolios of commercial banks differed widely in their geographic and sectoral concentrations. In this context, drawing on the IFC's framework would be meant to ensure the widest possible participation in the Equator Principles, as it would not in principle discriminate against financial institutions from any region.

The Significance of Market Structures

Yet, the preexistence of the state-sanctioned policies for managing environmental and social risks did not guarantee that commercial banks felt obligated to integrate them into their project finance operations, or were able to collectively organize around a common standard. Section three identified the centrality of reputational risks of providing commercial banks with stronger incentives to integrate ESG impacts into their investment decisions. Yet, there are several preconditions for reputational risks to materialize and 'civic regulation' to perform effectively. Klein and Harford (2004) identify four requirements for the reputational mechanism to be effective. First, companies must have long time horizons, and not be driven by short-term greed, as the benefits of a positive reputation may not materialize until after the project is operational. Second, consumer boycotts and other disruptions to business activities must be easy to inflict. Third, companies that fail to comply must be identifiable, so that they will suffer reputational damages. And fourth, the cost of obedience must be moderate

compared to the cost of reputational damages. Overall, the generation, collection, management and diffusion of information between parties become central to the effectiveness of the framework.

The reason that the reputational mechanism was effective in this case can be attributed to the structure of the project finance market. Relative to Klein and Harford's criteria, the project finance market satisfies all of them. In contrast to other forms of lending, project financing typically has long time-horizons with long loan maturities, requiring commercial banks to consider risks oftentimes decades into the future. More broadly, as a result of bank mergers and brand consolidations, the corporate brands of many commercial banks have become more powerful and vulnerable, leading many to pay closer attention to investment practices that may undermine their corporate reputation. Secondly, the public visibility of large projects and the ease with which environmental NGOs could identify financial institutions involved with particular projects made 'naming and shaming' possible and effective. Third, because of the increasing information available about the impacts of corporate practices in developing countries, failures to comply with well-recognized international standards were easily uncovered. And fourth, the Equator Principles, despite being based on public standards developed by and for public financial institutions, were appealing to commercial banks because the cost of doing so was much less than suffering reputational damages from irresponsible project investments.

Explaining Norm Diffusion: The Role of Environmental NGOs

The preexistence of environmental and social risk management standards sanctioned by states provided commercial banks with a strong starting point for developing common standards of their own. Furthermore, the institutional features of the project finance market proved favorable for enabling cooperation between banks. However, the diffusion of norms across institutional contexts, in this case between multilateral and commercial project financing, does not take place automatically and is closely associated with particular actors and actions.

Prior to the emergence of the Equator Principle, environmental NGOs were very prolific in generating research on the environmental and social costs of commercial project financing in developing countries, and blending this in with specific policy recommendations. In many cases, the World Bank standards and procedures were held up as a benchmark for responsible project financing. In most cases, reports singled out specific projects or industries and brought to light examples of environmental and social injustices in remote areas that have not generated any media attention in the home countries of the respective commercial banks.⁴³ As an example, in 2000, Milieudefensie and Greenpeace in the Netherlands, with input from an Indonesian network of local NGOs working

⁴³ In a survey of commercial banks, events such as 'polluting incidences' that generate significant media coverage were associated with a considerable risk to corporate reputation. (ISIS 2002, p.10)

against palm oil plantations, released a report, *Funding Forest Destruction*, which catalogued the impacts of the government program on Indonesia's forests and the people that depended on them.⁴⁴ The same year, the CIFOR and WWF released a report – *Profits and Paper* - that documented how up to £7.5 billion in foreign investment into the Indonesian pulp and paper industry was significantly contributing to deforestation.

A central premise of this research and advocacy was that public and private lenders should be held to the same environmental and social standards, even though their project financing is organized around different mandates. There is a strong recognition among leading commercial banks that published research by Banktrack members was important in raising awareness about the negative impacts that project financing could have on local communities and the environment. This research was integrated into specific advocacy campaigns directed at commercial banks and their stakeholders, which became central to broadening public expectations about the roles and responsibilities of commercial banks in promoting sustainable development.⁴⁵ It was also presented in bilateral discussions with commercial banks, alongside calls for complying with the World Bank's environmental and social policies. Many of the advocacy groups that would later form the network Banktrack, including FOE (numerous chapters), WWF, and Campagna per la Riforma della Banca Mondiale (CRBM), had experience staging campaigns against multilateral lenders, and drew lessons from those successes when confronting the commercial banking industry.

Yet, in order to generate adverse media publicity, it was also necessary for transnational advocacy groups to demonstrate that commercial banks could have intervened to prevent the damages, or alternatively, should have avoided financing the project in the first place. Commonly, advocacy groups would present evidence of environmental and social harm and attribute blame to commercial banks, which in response countered such claims with statements of innocence. To build pressure, advocacy groups would creatively mobilize market actors that for either financial or ethical reasons objected to the actions of financial institutions.. To come across as more persuasive, advocacy groups cushioned their moral claims within well-recognized international norms, such as the precautionary principles, human rights, and transparency, whereas commercial banks stressed the limited responsibility, as well as leverage and opportunity, they had for addressing these concerns, given the financial and legal structure of project financing. They also frequently claimed their mandates barred them from addressing non-financial project impacts and disclosing information on the specifics of financial transactions. But the existence of public standards for managing environmental and social risks, and the growing

⁴⁴ Milieudefensie (2000). The report recommended that Dutch banks refrain from financing plantations unless guarantees were given that the borrower would not clear more land to make way for new plantations, or violate the rights of local people and Indonesian law.

⁴⁵ For the role of NGOs in the 'greening' of the World Bank, see Bramble and Porter (1992), pp.325-336), Keck and Sikkink (1998), O'Brien et.al (2000), pp.115-134, Park (2006), Rich (1993), and Wade (1997).

recognition that complying with these did not necessarily undermine commercial interests, made it difficult for some commercial banks to argue against them.

Conclusion

Private standards with the same level of operational specificity as the Equator Principles have not emerged in other financial markets. But the level and depth of integration differs between financial markets, and across investors operating in the same market. The paper has argued that the extent to which investors integrate ESG risks into particular investment decisions is in part a function of institutional features of the financial market they are operating in, and in particular, the extent of public involvement, the opportunities for public scrutiny and the potential for cooperation between firms. By examining the emergence of the Equator Principles, and related, the growth of ESG risk management in the international project finance market, the paper put forward an argument in which reputational risks are deemed central to understanding both the emergence of governance in a particular market and the variations in practice across financial institutions.

Advances in risk management are at the center of the expansion of the global project finance market, and the capitalization of large projects in countries with weak governance and economic, financial and political instability. To hedge against the higher levels of investment risk in developing countries, commercial banks continued to diversify the range financial products they offered. Project structures became increasingly complex, reflecting the risk-aversion of participants and complicated governing structures of projects financed as part of privatization schemes. Whereas the success of infrastructure projects in previous years was dependent on sound civil engineering, the growth of the project finance market in the 1980s and beyond was based on advances in financial engineering in light of the higher levels of investment risk in developing countries. In particular, a variety of developments enabled major corporations and public-sector enterprises to access financing in equity markets, often at more favorable terms than bank loans.⁴⁶

With regards to expanding the integration of ESG risks in financial markets, the Equator Principles was a path-breaking initiative and its impact has already eclipsed that of other voluntary initiatives in the financial sector. In contrast to several preceding initiatives, such as the United Nations Environment Program's Finance Initiative (UNEP FI) and the London Principles, the Equator Principles goes beyond aspirational goals and principles to specifically define how environmental and social issues should be identified, assessed and mitigated in project financing, and stipulate procedures that can be directly integrated into existing credit risk processes. As a result, adopting banks have invested in environmental risk management training for staff, reorganized credit risk

⁴⁶ Smith and Walter (2003).

processes and in some cases, publicly announced a withdrawal of interest in a project because it violated the principles.

Despite its specificity, the lack of transparency and an independent resource mechanism for project-affected communities continues to generate criticism of the framework. Environmental NGOs, organized through the transnational network BankTrack, frequently accuse banks of violating the Equator Principles. They have strategically used the framework to compare the environmental performance of banks, mobilize public opinion, and hold them more accountable to the impact of their financing.⁴⁷ The framework has not only provided a basis for regular consultations among commercial banks, but also led to a structured dialogue with environmental NGOs, international organizations and business professionals active in the project finance market. As a result, there is now a process in place, however insufficient it may be, that puts pressure on financial institutions to better manage non-financial risks and report on how they are doing it.

⁴⁷ see Banktrack (2006), *Shaping the Future of Sustainable Finance – Moving From Paper Promises to Performance*, Banktrack; Amsterdam.

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