ORANGUTAN CONSERVATION SERVICES PROGRAM

SCREENING PROTOCOL FOR FINANCIERS

Mitigating Risk into Rainforests that are Orangutan Habitat

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Mitigating Risk into Rainforests that are Orangutan Habitat

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PURPOSE

This Screening Protocol is a risk assessment tool designed to assist financial institutions mitigate risk prior to committing to invest in or supply credit to natural resource extraction companies operating or planning to operate in rainforests that are orangutan habitat.

BACKGROUND

In the early 1990's, several private sector international financial institutions worked with the United Nations Environment Programme (UNEP) to establish ground rules for financial institutions to follow when making investments, offering credit and underwriting insurance risk related to environmental and other issues concerning the sustainable use of natural resources. These efforts resulted in The Sustainable Banking Principles, which were signed by 20 banks prior to the 1992 UN conference in Rio de Janeiro on sustainability. Some 200 banks, investment firms, insurance companies, asset managers and pension funds have since signed onto the Principles. These financial institutions are now discussing a holistic approach to environmental, social and corporate governance issues, integrating non-traditional and intangible risks, and seeking new funding opportunities.

More than ten years later, in spring 2003, the International Finance Corporation and four leading international financial institutions established the *"Equator Principles."* The Equator Principles (EP) are a financial industry best practice approach for determining, assessing and managing social and environmental risk when considering infrastructure project finance transactions in developing countries (i.e., excluding other types of investment and credit extensions). Between 2003 and 2008, an additional 50 financial institutions adopted the Equator Principles, increasing the likelihood that their infrastructure project financing in developing countries will become more socially responsible and reflect sound environmental management practices. The negative impacts of these projects on ecosystems and communities can, where possible, be avoided. Where such impacts are unavoidable, they can be reduced, mitigated and/or compensated for appropriately. An important additional benefit is that the financial institutions involved can protect or enhance their reputation and brand value.

These two international protocols have catalyzed investment firms and commercial banks to consider and review sustainability risks in a wide range of financial transactions. For example, Citigroup's (formerly known as Citibank) policy now covers critical habitats, illegal logging, climate change and ecologically sound development. Citigroup specifies not only what it does not want to finance, but also highlights that it wants to finance certified forestry and renewable energy.[1] Further, the *Equator Principles* only apply to project finance with a minimum capital cost of US$ 50 million. JP Morgan Chase has formally stated that it will use a lower threshold, namely US$ 10 million. In practice, other signatories to the *Equator Principles* are also applying these principles to project finance activities below the US$ 50 million threshold.[2]

In Indonesia, major financial institutions have embarked on key reforms to improve their corporate governance. As a result, a number of them (including BI, BAPEPAM, BNI, BRI, BCA, Mandiri, Danareska BII, Danamon) are now developing programs to improve their

[1] Citibank's New Environmental Initiatives with UNEP, Citibank, New York, January 2001.

[2] JP Morgan Chase Infrastructure and Environmental Policy Framework, JP Morgan Chase, New York, November 2007.

understanding and management of non-traditional financial risks. In Indonesia, the focus has been on social/community risks; little headway has been made so far in tackling environmental risks.

SCOPE

USAID's Orangutan Conservation Services Program (OCSP) has developed a screening protocol ("protocol") to assist local and international financial institutions operating in Indonesia ("financiers") to better understand the environmental and financial risks of investing in or providing credit ("funding") to natural resource companies as their clients or potential clients. This protocol will help guide financiers to ensure that the business practices of their clients are not highly destructive to orangutan habitat or orangutans. Financiers can use the protocol before and during engagement in the financial review process to help them better understand, manage, and mitigate the financial impacts and risks associated with their funding decisions.

The protocol only covers potential funding for clients operating in Borneo and Sumatra, Indonesia, and with a transaction value of at least US$5 million.

THE PROTOCOL

The protocol has five parts:

1. **Guiding principles:** Strategic rationale on why financiers should assess the impacts of extending credit to or investing in natural resource companies operating in Sumatra and Borneo in orangutan habitats.
2. **Initial assessment of broad risk factors:** Analysis that will assist financiers to appreciate specific areas of risk that may require detailed evaluation, and to determine whether they can obtain the information they need to perform an adequate due diligence of the prospective transaction and client.
3. **Site, client and project assessment scorecard:** The gathering, evaluation, and rating of specific information on the site, the client and the project by the financier related to the risks associated with the particular credit extension or investment.
4. **Conditionalities and contractual covenants:** Legal and contractually binding obligations of the client that must be followed.
5. **Monitoring system:** An independently-operated third party process designed to monitor how well the client is following the agreed to conditionalities and contractual covenants.

1. Guiding principles

a) Financiers have a role in contributing to the short- and long-term survival prospects of orangutans and the protection of their habitat in Borneo and Sumatra.
b) Financiers should be undertaking reasonable evaluations to ensure that they are contributing to the survival of orangutans and the protection of their habitat.
c) Financiers should abstain from funding potential clients or, if engaged already, at least minimize their funding of clients that have been identified to materially (i) reduce the survival chances of orangutans, or (ii) have a destructive impact on orangutan habitat.

2. Initial assessment of broad risk factors

When a potential client applies for funding, the financier will, as part of the due diligence process, evaluate the broad nature of the transaction's financial risks and risks to orangutan habitat and orangutans. This review covers four areas:

a) Industry management analysis reports, if available, for the relevant industry that will help facilitate benchmarking.
b) Orangutan density survey both within and on adjacent land to the potential client's land and operation.
c) Based on written documentation, the extent to which the potential client has previously complied with OCSP best management practices.3 (Appendix A).
d) Client agreement to provide answers to the checklist of questions and to cooperate in further on-site investigations, if necessary.

3. Site, client and project assessment scorecard

This scorecard helps financiers to determine the type and magnitude of risks related to a potential funding transaction and how it might affect both the client and their own financial performance. The higher the number, the greater the risk, as detailed below:

a) Score of 0-12: Potential client poses no or minimal risk to the conservation of orangutans and their habitat.
b) Score of 13-34: Potential client poses specific risk to the conservation of orangutans and their habitat. Funding will require contractual covenants and conditionalities in order to mitigate financial risk and protect orangutans and their habitat through specific actions.
c) Score of 35-44: Potential client poses a high financial risk because of the high probability of impacting orangutan habitat or orangutans.
    - Project should be revised.
    - Additional information is needed.
    - Strong conditionalities and contractual covenants are needed.

In some instances, justification for the score will depend on evidence from a third party audit report.

Criteria	**Scoring (higher number represents greater risk)**	
The Site	**Scoring Range**	**Score**
Are orangutans known to be in the project site or within a range of 1000 meters from the project site?	Resident high density/don't know = 7 Known to be resident occasionally/ Moderate density = 5 Reported but not seen regularly/ Low density = 3 Not present = 0	
Is the site located in or adjacent to peat swamp forest? *Peat swamp forests have very high densities of orangutans and are extremely sensitive to environmental degradation.*	Yes/don't know (within) = 6 Yes (adjacent) = 5 Yes (close by) = 3 No = 0	

[3] Natural resources industries – natural forests, industrial timber plantations, oil palm plantations, and mining

Does access to the site negatively impact orangutan populations or their habitat? *Access roads tend to greatly fragment orangutan forests and create significant barriers to orangutan movement.*	Heavy impact/don't know = 4 Moderate impact = 3 Light impact =2 No impact = 0	
Are there potential habitat corridors connecting the project site to a surrounding landscape of natural forest? *Most sites are too small to have a viable resident population of orangutans; orangutans' ability to move to the greater landscape via forest corridors is important to their survival.*	No corridors/don't know = 3 Moderate corridors = 2 Poor corridors = 1 Good corridors = 0	
Sub-total site score	0 to 20	
The Client & Subcontractors	**Scoring Range**	**Score**
Has environmental damage occurred at the site (caused by the client or a sub-contractor) or has there been an investigation of environmental damage at the site in the last 5 years? *The definition of "environmental damage" should follow the legal definition in local environmental laws.*	Significant/Don't know = 5 Moderate = 3 Light = 1 No damage = 0	
Is the client cooperative in disclosing information on the nature of any environmental investigations conducted against it, and on any risks that its operations may pose to orangutans?	No/Don't know = 2 Yes = 0	
Do the client and its sub-contractors show a positive performance record regarding environmental issues, as evidenced by environmental awards, management system certificates or other documents or endorsements?	No/Don't know = 2 Yes = 0	
Sub-total client & subcontractors score	0 to 9	
Project Management Process	**Scoring Range**	**Score**
Will project development have an indirect or direct impact on orangutans and their habitat?	Heavy impact/ Don't know = 5 Moderate impact = 3 Light impact = 1 No impact = 0	
Does the project have a conservation management plan (CMP) in place that meets key elements of OCSP's Best Management Practices (BMP)?	No CMP = 4 Early stage development =3 Draft CMP being prepared = 2 CMP in place = 0	
Does the project have sufficient staff (in terms of both quality and quantity) to manage the risks to orangutan habitat?	Insufficient /Don't know = 3 Some but too few = 2 Sufficient = 0	
Has the client allocated adequate financial resources to this project to address its impact on orangutans and their habitat?	Inadequate/Don't know = 3 Barely adequate = 2 Adequate = 0	
Sub-total project management process score	0 to 15	
Total Score	0 to 44	

4. Conditionalities and contractual covenants

The financial institution needs to draft, present and explain to the potential client the proposed contractual covenants and conditionalities that the client will need to agree to in order to comply with the protocol. Some of these will be preconditions for funding, while others will be covenants during the financing period.

These contractual covenants and conditionalities will be established based on the scorecard results and the extent to which the client has in the past met a key set of performance indicators on management processes and improvement programs that satisfy OCSP best management practices for orangutan and their habitat for the client's particular industry.

5. Monitoring system

A third party should monitor fulfillment of contractual covenants and conditionalities on an annual basis. This will require a monitoring and evaluation program designed to demonstrate the client's performance of its contractual covenants and conditionalities. If the client is found not to be in full compliance with the contractual covenants and conditionalities, the third party will provide a report to both the client and the financier and arrange a meeting of the parties to evaluate how the condition can be corrected to prevent the client defaulting on the contract.

This annual monitoring will be part of a three-year monitoring and evaluation plan, preferably developed in consultation with key stakeholders, including regional and local government, local community and NGO representatives. The plan will need to establish clear, practical and measurable indicators of implementation success. Where success is not achieved, the plan will need to be adapted to allow alternative approaches to be developed, discussed and agreed on by the stakeholders in order to ensure successful implementation.

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Appendix

OCSP Best Management Practices for Conservation of Orangutan in four industry sectors (natural forests, industrial timber plantations, oil palm plantations, and mining).