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Environmental Considerations in Corporate Lending Business of Montenegrin Commercial Banks

Recommendable Environmental Policies and Procedures for Corporate Credit Management: Case Study EBRD

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Abstract

Commercial banks can play an important role in environmental issues. Having a role of an intermediary in an economy, because of their importance for the business sector, commercial banks can influence and contribute to the healthy environment significantly. Still, the banking sector is slowly responding to environmental challenges in comparison to other sectors: banks' direct impacts on the environment arising from their internal processes is relatively low. However, the banking sector's indirect impacts on the environment (i.e. environmental impacts of their clients' operations, can be significant. This fact is not adequately recognized by the commercial banks and even though banks are exposed to risks connected to their clients' environmental performance, they are rather slow in evaluating these risks.

However, among banks there are front-runners in incorporating environmental considerations in business practices. Internationally, there are many voluntary initiatives aiming at involving banks in taking a more active role in environmental issues, such as the United Nations Environmental Programme Finance Initiative (UNEP FI), the Equator Principles (EP), the European Principles for the Environment (EPE), and so on. A bank that is particularly active in evaluating environmental consequences of its operations is European Bank for Reconstruction and Development (EBRD). EBRD operations cover different investments and include project financing for banks, industries and businesses. EBRD has adopted an environmental policy and a set of procedures necessary for assessment of environmental issues, risks and opportunities in connection with its operations.

In this thesis, the author explores Montenegrin commercial banks' corporate lending practices and their environmental practices. EBRD is chosen as a case study because of its environmental mandate. The parallel with the EBRD practices serves as a basis for making recommendations for changes in current corporate lending process. The aim is to raise awareness of decision-making authorities in Montenegrin commercial banks on the necessity to take into account environmental issues in the business practices.

Executive Summary

The purpose of the thesis is to examine environmental policies and procedures of the European Bank for Reconstruction and Development (EBRD), as a front-runner in considering environmental issues in its operations to ensure all its operations are environmentally sound. The examination is undertaken in order to consider possibilities for introducing such policies and procedures in commercial banks in Montenegro and describe how commercial banks can implement them. The author's intention is to raise awareness of the decision-makers in the Montenegrin commercial banks and point out that it is necessary to take into account environmental issues in banking business. Also, the intention is to make recommendations for their future policies and procedures.

The following research questions were defined in order to govern the work on the thesis: 1. What are the global trends in banks' involvement in environmental issues? How can environmental issues influence commercial banks' business operations? 2. What are the environmental policies and procedures EBRD applies in its financing business in order to manage environmental risks and ensure soundness of their financing business? 3. What are the lessons national commercial banks can learn from EBRD as a role model: what environmental considerations should be incorporated in Montenegrin commercial banks' corporate lending business and how should banks address environmental risks arising from corporate lending?

The relevant methodology for the thesis is the qualitative research method and a case study approach. The work on the thesis included: (1) literature review, (2) focus area research, (3) analysis and discussion. The relevant research methods are used for each of the phases, including literature review, case study, and personal interviews.

Relationships between banks and the economy were explained in order to illustrate the importance of banks for the business sector. As well, impacts that banks indirectly can have on the environment were described. The banking sector can have significant indirect impacts on the environment, through their clients operations, primarily by choosing which projects of their corporate clients will be financed. This is not sufficiently recognized by the commercial banks and even though banks are exposed to risks connected to their clients' environmental performance, they are rather slow in evaluating these risks. Banks can positively influence the environment by financing only environmentally sound projects of their clients.

Additionally, in a section of the thesis an overview of the most relevant international voluntary initiatives aiming at banking sector involvement in tackling environmental issues was presented: The United Nations Environmental Programme Finance Initiative, the Equator Principles, and the European Principles for the Environment. The aim was to show global trends in the banking industry in relation to environmental considerations in business practices.

Environmental work within the European Bank for Reconstruction and Development (EBRD) was presented in detail, with the emphasis on the loan management environmental policies and procedures. EBRD environmental policies and procedures were described, particularly procedures in relation to financial intermediaries. These procedures prescribe a set of rules for banks that act as financial intermediaries between EBRD and the business sector: the banks are required to adjust (or adopt and implement) their internal procedures in a way that will enable conformity with the EBRD environmental mandate. The intention is to show on practical level, how taking into consideration environmental questions can help banks have better loan management, primarily reduce risks, and increase quality of the loan portfolio. The EBRD example is especially relevant as the bank operates also in the Montenegrin market,

which is the focus of this thesis, as well as in other neighbouring markets in the South-Eastern European region, and furthermore in Eastern Europe.

Recent developments in the Montenegrin banking sector are described, together with the current market situation, followed by an explanation of corporate credit management processes in local banks. Also, in order to demonstrate possible future challenges in regards to corporate clients, a digest of most significant Montenegrin environmental laws that were adopted in 2005, but entered into force in 2008 is offered, together with explanation of the administrative framework for their implementation. Implementation of these laws can have significant impact on the business of some groups of corporate clients, primarily industry and mining, but also the energy sector, transportation, tourism, agriculture, forestry, projects or activities in protected areas of natural or cultural significance.

Analysis of the lending practices and corporate credit management in Montenegrin commercial banks has shown that there is clear lack of environmental considerations in the business practices today. While environmental issues are implicitly incorporated in the corporate credit management processes (through clients legal compliance checks), banks are not prepared for probable future challenges in relation primarily to new national environmental legislation. As long as environmental issues are not considered properly and environmental risks assessed individually and not only in light of clients' legal compliance, Montenegrin commercial banks are exposed to risks, both financial and reputational, which they don't account for. The recommendations on incorporation of appropriate environmental risk management steps in corporate credit management process are made.

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1 Introduction

1.1 Background Information: Relevance of the Thesis Topic

Banks are important influential players in the economy of a country, as they act as lubrication of the economic system by providing funds for financing of different business activities.

As elaborated in the book “Sustainable Banking: Greening of Finance”¹ (Bouma, Jeucken, Klinkers, 2001, p.29-32), in banks, environmental considerations can be introduced in two ways:

- Tackling internal environmental issues through environmental policies and procedures for banks’ daily business itself, and
- Tackling external environmental issues through environmental requirements banks set for their clients.

This is especially relevant for corporate clients, as primarily companies are banks’ clients that engage in big projects that can have significant influence on the environment, such as for example building a dam, a production facility, and so on .

In other words, banks can target their direct environmental impacts (first point mentioned above), or their indirect environmental impacts (second point mentioned above). Even though introducing environmental policies and procedures which would take into consideration impacts from the banks’ daily activities would have positive impacts through their improved reputation among clients and society as responsible members of the society, commercial banks’ direct environmental impact is significantly lower compared to the indirect environmental impacts arising from projects financed by the banks. By setting environmental criteria and posing environmental requirements on their clients’ operations or projects financed by the banks, commercial banks can positively influence and raise environmental awareness and environmental quality of other businesses and, consequently, the entire economy. It is more beneficial for the environment if commercial banks make their business “greener” by including environmental concerns into the loan business policies and choosing to finance only environmentally sound projects or technologies, or developing new products that would improve customers’ businesses sustainability. In this way, banks can have benefits from new business opportunities and from risk management perspectives. Also, they can show to their stakeholders that they act as responsible corporate citizens.

However, among Montenegrin commercial banks and in general in the business sector there is little awareness on environmental issues, their importance for the banks and the roles the banks can play in that matter. The situation is the same with the local banks and international commercial banks operating in the country. In this situation, banks are exposed to additional risk (both credit and reputation) they don’t account for. From a broader perspective, the potential for positive effects on sustainable developments stays unexploited.

¹ Bouma, Jan Jaap, Jeucken, Marcel, Klinkers, Leon, Deloitte & Touche. (2001). ” Sustainable Banking: The Greening of Finance”. Greenleaf Publishing (2001). http://books.google.com/books?id=Inwps_2fMWgC [12 September 2008]

1.1.1 Relevance of the Case Study

The European Bank for Reconstruction and Development (EBRD) is a bank operating in countries from Central Europe to Central Asia, well-known as a front-runner in incorporating environmental considerations in their business and supporting sustainable development. EBRD works under set of policies and procedures which encompass high accent on environmental protection and sustainable development. EBRD operates in Montenegro since 2002. Until recently, EBRD operations were managed from their offices for Serbia and Montenegro. After Montenegro became independent in 2006 and successfully applied for membership in EBRD, the bank adopted a new strategy for the country in 2007 and opened offices in the capital of Montenegro, Podgorica.

Having in mind that EBRD complies with the market rules as other commercial banks, EBRD may act as a role model for the other banks on how to incorporate environmental considerations in every day business with a positive effect on environment and the banks' business in terms of reduced risks and better reputation and increased quality of the financed projects; environmental policies and procedures developed by EBRD can be used as a guide and show possible ways for other banks.

Using EBRD as an example, Montenegrin commercial banks can discover possible ways of improving business practices while having positive effect on the environment and acting more towards sustainable development of the country.

1.2 Purpose of the Thesis and the Research Question

The purpose of the thesis is to analyze the environmental policies and procedures of EBRD, to consider possibilities for introducing such policies and procedures in commercial banks in Montenegro and to look at consequences of the introduction in relation to banks' financing business: possible benefits and/or drawbacks of taking environmental issues into consideration for their loan business policies and operations and describe how banks can implement them. For this purpose, the work on the thesis will be governed by the following set of research questions:

1. What are the global trends in banks' involvement in environmental issues? How can environmental issues influence commercial banks' business operations?
2. What are the environmental policies and procedures EBRD applies in its financing business in order to manage environmental risks and ensure soundness of their financing business?
3. What are the lessons national commercial banks can learn from EBRD as a role model: what environmental considerations should be incorporated in Montenegrin commercial banks' corporate lending business and how should banks address environmental risks arising from corporate lending?

The author's intention is to raise awareness of the decision-makers in the Montenegrin banking industry of the necessity to take into account environmental issues in business by making recommendations for their future policies and procedures.

1.3 Methodology, Data Collection and Utilization of Data

Information necessary for addressing the research questions will be collected using the following methods:

- Review of literature on:
 - Banking business and financial institutions in general and their relation to the environment,
 - International financial institutions' initiatives in relation to the environment;
 - EBRD's profile, history and current activities; EBRD policy documents;
 - Studies on evaluation of EBRD environmental policies;
 - Montenegrin banking sector development;
 - Montenegrin environmental legislation;
- Interviews with well-informed stakeholders, such as:
 - EBRD representatives;
 - Local commercial banks representatives;
 - Environment protection experts from Montenegro.

The relevant methodology for this report is the qualitative research method and a case study approach. The work on the thesis includes: (1) literature review, (2) focus area research, (3) analysis and discussion. The relevant research methods are used for each of the sections, including literature review, case study, and personal interviews by telephone, email or in person.

The literature review will provide input on general business rules of the banking sector. As well, it will provide an overview of banks' involvement in environmental problems and issues globally.

The proposed case study will give an insight on how environmental considerations can be practically incorporated into day to day business of banks using the example of EBRD. By investigating the Montenegrin banking sector and relevant environmental legislation, a comparison will be drawn and recommendations made on the policies and procedures regarding the environment that local banks should adopt following the EBRD example.

1.4 Hypothesis

By adopting environmental policies and procedures Montenegrin commercial banks could decrease credit and reputation risks and increase quality of their portfolio by investing in environmentally sound and low-risk projects.

Additionally, the banks could influence their clients making them more environmentally aware. By financing sustainable projects the banks could boost sustainable development more efficiently.

This hypothesis will be tested against data collected from the studies evaluating results of EBRD policies and procedures and information gathered from the interviews with EBRD representatives, local environmental protection experts and Montenegrin commercial banks' representatives.

1.5 Scope and Expected Limitations

The environment, as one of three pillars of sustainability is in the scope of the thesis. This is one of the limitations. The other two pillars, economic and social, although mentioned, are not explored in detail. Therefore, it is worth mentioning that terms environment and sustainability will be used interchangeably.

There are different financial institutions that play a role in economic life: central banks, commercial banks, development banks, venture capitalists, etc. However, the focus in the thesis is on commercial banks due to their strong relationship with the business sector and the role they have in the Montenegrin financial market.

In the scope of the thesis are environmental impacts arising from commercial banks' activities regarding corporate lending. Therefore, for EBRD business, the focus will be on its environmental policies in financing business in relation to corporate clients.

The geographic scope of the thesis is Montenegro. EBRD is a regional bank, which operates in a number of countries, including Montenegro and other neighbouring countries in the South-Eastern European region, and further in Eastern Europe and some Asian countries.

Till nowadays, the EBRD operations in Montenegro were of limited scope, especially those related to projects or activities connected with significant environmental impacts. Therefore, it is difficult to assess actual practical implications of its environmental policies and procedures in Montenegro, what is often a critical part for the process of policies' creation and implementation. This is a limitation of the thesis.

Nevertheless, it will be possible to make certain recommendations for the local banks on how to organize their environmental work in credit management and how to include environmental risks management into their overall risk management.

1.6 Structure of the Thesis

The thesis is structured in the following way:

In the introduction, background information is provided and a justification for the thesis topic, as well as research questions, hypothesis, methodology, scope and expected limitations.

In Sections 2 and 3 the role of banks in the economy is explained and the most significant international environmental initiatives are described. These initiatives aiming at mobilising financial institutions to consider environment in their business practices are presented in order to give an overview of global trends.

Section 4 provides an overview of the environmental work within EBRD, with the emphasis on the loan management environmental policies and procedures. The intention is to show a practical example of how taking environmental questions into consideration can help banks manage loans better, primarily by reducing risks, and increasing quality of the loan portfolio. The EBRD example is especially relevant as the bank also operates in the Montenegrin

market, which is in the focus of the thesis, as well as on other neighbouring markets in the South-Eastern European region.

Section 5 gives an insight in recent development of Montenegrin banking sector, a description of the current market situation, followed by an explanation of corporate credit management processes in local banks. Also, in order to demonstrate possible future challenges in regards to corporate clients, a digest of the most significant Montenegrin environmental laws that were adopted in 2005, but entered into force in 2008 is offered, together with explanation of the administrative framework for their implementation. Implementation of these laws can have significant impact on the business of some groups of corporate clients, primarily industry and mining, but also the energy sector, transportation, tourism, agriculture, forestry, projects or activities in protected areas of natural or cultural significance.

Sections 6 and 7 are intended for analysis and discussion of presented information and drawing conclusions, respectively.

2 The Banking Sector in the Economy and in the Environment: the Role of Banks

2.1 The Role of Banks

A financial institution can be defined as a "commercial or investment bank, trust company, brokerage house, insurance company, or other institution that participates in financial transactions involving cash or financial products. The primary role of such an institution is to facilitate the financing of investments, from home mortgages to the raising of funds via the issue of debt or equity for mega-projects. It may also provide insurance, take on fiduciary responsibilities, store cash and securities for safekeeping, etc."² Generally, financial institutions are organisations that support the movement of available funds through an economic system by collecting surplus money from savers (companies and individuals) and supplying the money to borrowers. In other words, any organisation whose business includes dealing with money moving, lending or investing, or other financial instruments or providing financial services is a financial institution. They include central banks, development banks, commercial banks, trust companies, insurance companies, investment funds and other.

Banks are financial institutions which traditionally engage in depositing of clients' funds and lending money to the customers. Banks' products include savings, lending, investments, advisory services, payments, guarantees, and other. Nowadays modern banks engage in many other financial and non-financial services and have broadened their business scope: the banks engage in operations with securities, investment banking, assets management and other. Banks have two main sources of income, and these are interest income and income from provisions: in first case banks work on their own behalf and risk, while in the other case banks work on behalf and at the risk of their clients³. For example, when approving a loan, banks work at their own risk: the client pays interest for the borrowed funds, but the bank is at risk that the client will not be able to repay the loan. On the other hand, for transferring a payment according to a client's payment order, a bank charges provision from a client. However, since the funds transferred are the client's funds, the client is at risk. Banks make profit for their shareholders based on the difference between the interest and provisions they collect from clients and interest and provisions they pay to other banks and clients that deposit their funds in the bank. Banks have three main roles: "as the repository of liquidity, as the core payment mechanism, and as the principal source of finance to at least a large part of the economy"⁴. The third role of banks as a key source of funds for the economy, and consequently for the business sector is especially significant for the purpose of the thesis and will be highlighted and explained more in detail.

The scope of the thesis are commercial banks because of their strong relationship with the business sector as an intermediary between funds owners and enterprises needing funds, i.e. as a supplier of funds necessary for the functioning of the businesses. In market economies,

² Financial Consumer Agency of Canada. (2008). "Glossary". <http://www.fcac-acfc.gc.ca/eng/glossary.asp#F> [12 September 2008]

³ Bouma, Jan Jaap, Jeucken, Marcel, Klinkers, Leon, Deloitte & Touche. (2001). "Sustainable Banking: The Greening of Finance". Greenleaf Publishing (2001). http://books.google.com/books?id=Inwps_2fMWgC [12 September 2008]

⁴ Liu, Victory (Shengli). (2004). Environmental Considerations and Business Operations of Commercial Banks in China - A case Study of the Project Loan Appraisal Policy of ICBC. Lund, Sweden. IIIIEE
Original source: George, E.A.J. (1997). Are Banks Still Special? In Enoch, Charles, & Green, John, H., Banking Soundness and Monetary Policy: Issues and Experiences in the Global Economy. Washington, D. C.: International Monetary Fund, pp.251-270

commercial banks as well as businesses operate under market rules. On the other hand, for example central banks' relations with businesses are not direct nor of same type as the relations of commercial banks and business. Therefore, the emphasis will be given only to commercial banks.

Commercial banks are “institutions which use the funds entrusted to them by their customers to extend loans to consumers and business customers and distribute profits to the banks shareholders”⁵.

2.2 Commercial Banks and Businesses

There are many different players in economic life: companies (domestic, multinational, international), individuals and households, banks and other financial institutions, governments, stock markets (domestic and international), and so on. It is already stressed that banks can play different roles in business life and engage in security markets, investment banking, assets management, advisory services, apart from their traditional roles as depositories of funds and lenders. However, lending is still a great part of the banks business. Since banks as lenders are in the scope of this paper, the process of collecting funds and lending will be described in the following part.

There are two main groups of banks' clients: individuals/households and companies. Households and companies deposit their surplus of money in commercial banks. On the other hand, the banks use this money to finance companies and households which need funds through lending. A source of funding for commercial banks can also be loans from other banks.

The individuals and companies that have surplus of money can decide to put it in a bank instead of investing it in a stock market for example. Generally, by depositing money in a bank, they gain less (the returns are lower) than by investing it in other ways, but at the same time the risk they take is much lower. The banks lend funds to clients on their own behalf and their own risk. In other words, deposits of banks' clients have to be safe and guaranteed by the banks, and for that purpose numerous standards for limits in regards to relation between banks' liabilities towards depositors and banks' claims against borrowers are established: up to a certain limit banks have to finance their activities out of their own funds (mainly their shareholders initial investments). These standards can be internationally or nationally agreed, and usually they are prescribed by the law. Also, there are independent funds established for deposits' protection, in which banks have to participate by the law.

The companies that borrow funds from banks use these funds for financing their investments, projects or as working capital for financing their regular activities and overcome temporary gaps in their cash flows.

Evidently, commercial banks play a role of an intermediary which brings together money excesses and deficits, i.e. a role as liaison between borrowers and lenders. In the process, it is important that the scale, time and place match: to balance the supply and demand of money. For commercial banks it is important that risks they take by lending the money to different clients are at least acceptable. Commercial banks work towards minimizing risks and

⁵ Liu, Victory (Shengli). (2004). *Environmental Considerations and Business Operations of Commercial Banks in China - A case Study of the Project Loan Appraisal Policy of ICBC*. Lund, Sweden. IIIIEE
Original source: Jeucken, Marcel. (2001). *Sustainable Financing and Banking: The Financial Sector and the Future of the Planet*. London: Earthscan Publication Ltd.

maximizing returns on their investments, and can spread risks and reduce transaction costs by using large scale of business advantages⁶.

In order to protect themselves from risks and maximize returns, commercial banks develop different tools such as credit management policies and procedures (e.g. loan appraisal policies), customer assessment systems, monitoring systems, and similar. In short, before approving loans, commercial banks assess potential risks in connection to clients (“screen” clients), and later on monitor loans.

Relations between commercial banks and companies are important for both sides. Companies are profit oriented organizations. In order to generate profit, they have to expand their business or innovate (for example, production of new products, modernisation of processes, management and information systems). The result can be improved cost efficiency, increase in capacity, improved product quality and similar. Companies usually don't have enough liquidity (funds) to finance expansion of their business. Generally, cash flows generated by companies' regular activities are enough for covering operating expenses. Surplus of generated money is not always enough for relatively large investments such as for example purchase of new equipment to expand the production in present or new markets or to replace the old equipment. In that case, companies can get funds from their shareholders (increase of capital) or more commonly they turn to commercial banks in order to take loans and ensure funds for planned projects. Cash flows generated from these new business activities are *inter alia* intended for repayment of loans and interests to banks.

As loan repayments depend on cash flows generated in companies, banks' clients, for banks it is very important that they give loans for good projects and investments. It is the risk banks take, and that risk has to be acceptable for the banks. In order to determine the risks, banks screen the customers, i.e. make sure that they are capable to return loans and pay interest and commissions to the banks.

2.3 Commercial Banks and the Environment

As presented in the paper “Banking and sustainability: Slow starters are gaining pace” (Jeucken, 2003, p.1), the banking sector was rather slow in recognising the need to respond to sustainability challenges, and consequently the environmental challenges, compared to other sectors. Banks' direct influence on the environment arising from internal processes is relatively low in terms of emissions and pollution. “The environmental burden of their energy, water and paper use is not comparable to many sectors in the economy.”⁷ However, when it comes to their indirect influence, i.e. environmental impacts of their clients, the situation is different: the influence can be high.

Banks are exposed to risks connected to their clients' environmental performance. Experience has shown, however, that banks were slow in evaluating these risks. Having a role of an intermediary in an economy, banks can contribute to sustainable development significantly, and in line with that the healthy environment. In Figure no 1, banks' direct and indirect influence on the environment and sustainability is presented.

⁶ Guo, Hao. (2005). Pathways to Sustainable Banking in China: From Environmental Risk Management to Green Financing - An Explorative Case Study of the Financing System for Corporate Customers in the Industrial and Commercial Bank of China. Lund, Sweden. IIIIEE

⁷ Bouma, Jan Jaap, Jeucken, Marcel, Klinkers, Leon, Deloitte & Touche. (2001). ” Sustainable Banking: The Greening of Finance”. Greenleaf Publishing (2001). http://books.google.com/books?id=Inwps_2fMWgC [12 September 2008]

As far as the economic dimension of sustainability is concerned, “banks transform money in terms of duration, scale, spatial location and risk and have an important impact on the economic development of nations. This influence is of a quantitative, but also of a qualitative, nature, because banks can influence the pace and direction of economic growth”⁸

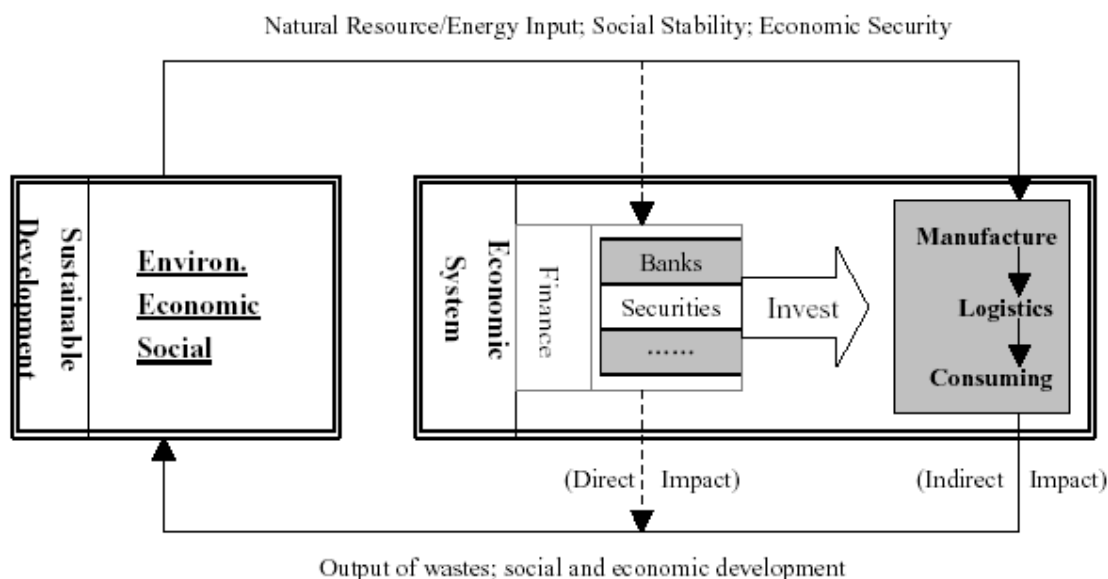


Figure 1 Financial sectors in sustainable development⁹

The credit risk management process can be divided into five phases, as shown in Figure no. 2 (Weber, Fenchel, Scholz, 2008, p.4). In the rating phase, banks determine borrower default risk: creditworthiness is evaluated together with personal credibility in order to determine probability of default, i.e. probability that borrower will not be able to repay the loan. In the costing phase, banks quantify expected losses based on identified probability of default and some other factors. In the pricing phase, the identified costs (expected losses) are incorporated in the loan conditions: the borrowers are charged based on their expected losses in order to compensate for lending losses. Credit risks can change in loans life span. Therefore, it is essential to monitor credit risks and take corrective measures if borrowers’ expected loss increases. In work-out phase, so-called bad loans (loans that can not be paid back fully) are managed with the aim to reduce the losses or work on getting borrowers to remedy their financial situation. An empirical study on banks in Europe showed that environmental risks were significantly more considered in the rating phase (Weber, Fenchel, Scholz, 2008, p.1).

⁸ Jeucken, Marcel. (2003). Banking and sustainability: Slow starters are gaining pace. Corporate Social Responsibility - Concept and Cases, Vol. I, pp103-112. <http://www.sustainability-in-finance.com/ec-web.pdf> [07 August 2008]

⁹ Guo, Hao. (2005). Pathways to Sustainable Banking in China: From Environmental Risk Management to Green Financing - An Explorative Case Study of the Financing System for Corporate Customers in the Industrial and Commercial Bank of China. Lund, Sweden. IIIIEE

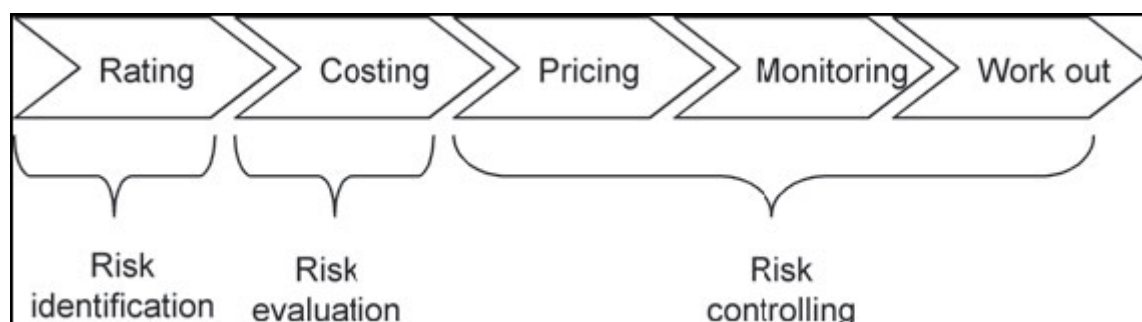


Figure 2 Phases of credit risk management¹⁰

The banks included in the study explained this fact by following reasons: “a lack of suitable instruments in the phases after the rating, the opinion that environmental risks are not relevant to the other phases and the belief that it is impossible to integrate environmental risks into all phases of the credit risk management process”¹¹. The authors point out that these findings illustrate the facts that up to date, mainly new credit rating systems were developed in order to consider environmental risks in the credit rating, but instruments for dealing with environmental risks in the other phases are needed as well. There is also lack of experience and know-how in dealing with environmental risks. The study shows that the costing phase is the most critical, as mostly banks are not fully aware of credit defaults that are due to environmental risks, i.e. they are not aware of importance of environmental risks in their loan portfolio. Overall conclusion of the study is that even if environmental risks are generally part of overall credit risk management, systematic and quantitative approach to include these risks in the process is still lacking.

According to empirical research in 1990s, which is mentioned in the article “Banking and sustainability: Slow starters are gaining pace”¹², banks’ interest in the environmental impact of their business activities or their clients’ business activities was rather low. The situation changed over time in terms of growing awareness on environmental issues, both risks and opportunities connected with them. Later research shows that in Europe, banks started developing environmental policies in mid-1990s, focusing more on internal environmental issues (direct impacts) and development of environmental products (e.g. environmental investment funds), while risk assessment got less attention. Today, banks incorporate both risks and opportunities in their policies regarding the environment. The author points out that there is an indication that sustainability issues are broadly accepted as important in financial sector: the launch of “Dow Jones Sustainability Group Index”¹³ in 1999 and the “FTSE4Good Index”¹⁴ in 2001. The author’s recent research covered 34 international banks from Europe, North America, Japan and Australia, which are among the 80 top-banks in the world regarding total assets. The results show that while many proactive banks work on

¹⁰ Weber, O., Fenchel, M., & Scholz, R. W. (2008). Empirical analysis of the integration of environmental risks into the credit risk management process of European banks. *Business Strategy and the Environment*, 17(3), 149-159.

¹¹ Weber, O., Fenchel, M., & Scholz, R. W. (2008). Empirical analysis of the integration of environmental risks into the credit risk management process of European banks. *Business Strategy and the Environment*, 17(3), 149-159.

¹² Jeucken, Marcel. (2003). Banking and sustainability: Slow starters are gaining pace. *Corporate Social Responsibility - Concept and Cases*, Vol. I, pp103-112. <http://www.sustainability-in-finance.com/ec-web.pdf> [07 August 2008]

¹³ The Dow Jones Sustainability Indexes are global indexes measuring the financial performance of the leading sustainability-driven companies all over the world. Source: website <http://www.sustainability-indexes.com/>

¹⁴ The FTSE4Good Index Series is used for measuring the performance of companies that meet globally recognised corporate responsibility standards, and facilitating investment in those companies. Source: FTSE Group (FTSE) website, http://www.ftse.com/Indices/FTSE4Good_Index_Series/index.jsp

reducing direct environmental impacts of their operations, environmental reporting is a characteristic of European banks. In regards to environmental risks, 63% of the European banks included in the research perform environmental risk assessment in financing business decisions. Also, environmental loans are often included in loan portfolios offered to clients, as well as investments in environmental funds. The author however concludes that while it seems that there are many banks that are active in environmental issues (30% of banks are very proactive, 18% can be considered as “followers”, and 53% as “stragglers”), there is still a large group of banks unaware of the role they can play in sustainability and environmental issues.

3 Environmental Considerations in the Banking Sector Globally: International Financial Institutions Initiatives

Internationally, there are different initiatives aiming at moving forward engagement of financial institutions in general in environmental issues. In this section, important international or regional initiatives will be presented in order to illustrate the efforts in this matter that are undertaken by banks and other financial institutions worldwide. These initiatives include:

- United Nations Environment Programme Finance Initiative (UNEP FI),
- The Equator Principles (EP),
- The European Principles for the Environment (EPE).

The information presented in this section is mainly from materials published on the official websites of respective initiatives and the European Investment Bank (information regarding the EPE), from research papers and other materials published on websites of the World Bank, the International Finance Corporation (IFC), the United Nations Environment Programme (UNEP) and from other separately mentioned sources as well.

There are other international or regional initiatives targeting financial institutions, such as for example Global Reporting Initiative,¹⁵ UN Principles for Responsible Investments¹⁶ and Project Preparation Committee¹⁷, or the Collevocchio Declaration¹⁸, an alternative voluntary code of conduct initiated by NGOs. However, in the author's opinion, the initiatives chosen to be presented here are most informative for the purpose of the paper as they present well global trends in financial institutions' involvement (and consequently banks' involvement) in environmental issues.

3.1 United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP was established at the United Nations (UN) Conference on the Human Environment in Stockholm in 1972. Its mission is to “provide leadership and encourage partnership in caring for the environment by inspiring, informing, and enabling nations and peoples to improve their quality of life without compromising that of future generations”¹⁹. Its main task is to encourage economic growth that goes in line with the protection of the environment.

At the beginning of 1990s UNEP started its work with financial organizations. In 1991, a group of commercial banks (such as Deutsche Bank, HSBC Holdings, Natwest, Royal Bank of Canada, and Westpac) started working with UNEP on the topic of banking industry involvement in environmental issues. The result was “UNEP Statement by Banks on the

¹⁵ More information available at the Global Reporting Initiative website: <http://www.globalreporting.org/Home>

¹⁶ More information available at the Principles for Responsible Investment website: <http://www.unpri.org/about/>

¹⁷ More information available at the “Environment for Europe” website: <http://www.environmentforeurope.org/institutions/ppc.html>

¹⁸ More information available at the Friends of the Earth website: <http://www.foe.org/camps/intl/declaration.html>

¹⁹ UNEP website: <http://www.unep.org/Documents.Multilingual/Default.asp?DocumentID=43>

Environment and Sustainable Development”, which was a start of the Banking Initiative. Different financial institutions including commercial banks, investment banks, multi-lateral development banks and other, joined the initiative. Integration of environmental considerations in all aspects of banks’ operations was in focus of the initiative. A secondary aim was to foster investments in environmentally sound technologies and services of the private sector, i.e. banks’ clients.

Later, in 1995, leading insurance and reinsurance companies and pension funds joined UNEP in forming the “UNEP Statement of Environmental Commitment by the Insurance Industry.” In the statement, the emphasis is on sustainable development and the precautionary principle and, similar to the banks’ statement, on incorporation of environmental considerations into on the whole business practice. The Insurance Industry Initiative (III) was formed in 1997 with the main intention to provide funding for research, meetings and workshops.

At the same time, in 1997, the banks’ UNEP statement was changed and broadened in its scope, and consequently, the Banking Initiative became the Financial Institutions Initiative (FII). Finally, after working more closely on issues interesting for both parties through work programmes and regional activities, in 2003 the two initiatives formed a single initiative “the UNEP Finance Initiative” (UNEP FI). At the moment, the initiative has more than 160 signatories from over 40 countries.

A Steering Committee, involving a UNEP representative and representatives of signatory institutions, is governing the initiative. Annual working programme and regional activities are decided in consultation with the Steering Committee.

The UNEP FI includes the two above mentioned statements and financial institutions wanting to join the initiative need to sign one of them depending on their main business:

- UNEP Statement by Financial Institutions on the Environment and Sustainable Development,
- UNEP Statement of Environmental Commitment for the Insurance Industry.

As banks are the scope of the thesis, only the financial institutions statement will be presented here and as well only its environmental dimension, although the statements cover all three pillars of sustainability (economic, social and environmental).

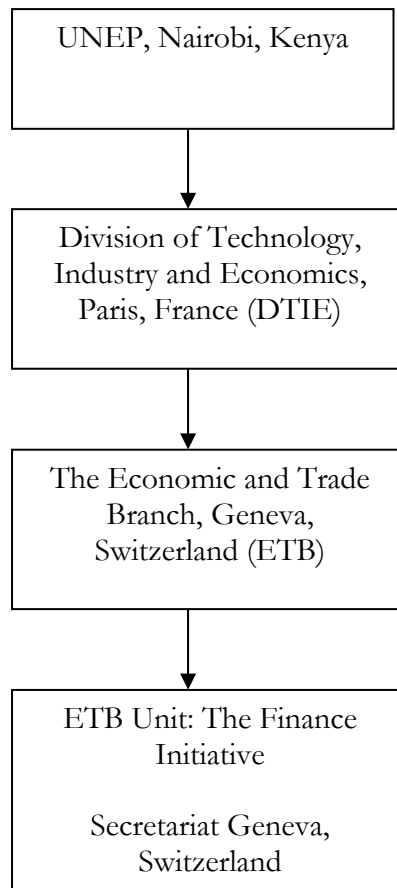


Figure 3 Organisational structure: UNEP and UNEP FI²⁰

The statement consists of three main parts: commitment to sustainable development, financial institutions' relation to environmental management, and public awareness and communication. According to the stipulations, the financial sector can contribute greatly to sustainable development in association with other economic sectors. The precautionary principle is accepted in relation to environmental management. Signatories commit to complying with applicable environmental regulations overall (local, national and international) and to incorporating environmental considerations in business operations and practices and business decisions as well. Signatories also recognize that environmental risks should be included in regular processes or risk assessment and management. Customers' compliance with applicable environmental regulations and environmentally sound practices are recognized as important for good corporate management of financial institutions. Emphasis is also put on internal environmental management and applying best practices in this regard, particularly in energy efficiency, recycling and waste reduction. Development of environmental products and services is also encouraged. In conclusion, the signatories should commit to the integration of environmental considerations into overall business practice, from internal environmental management and cooperation with suppliers that have better environmental performance, offering environmental products, to business engagement with customers that have sustainable, environmentally sound businesses.

²⁰ Based on the information presented at the UNEP FI website: <http://www.unepfi.org/about/structure/index.html>

Signatories of the statements also accept the “Recommendations from the UNEP Finance Initiative Presented to the World Summit for Sustainable Development” (2002). The Recommendations are proposed by the UNEP FI for adoption by the UN World Summit for Sustainable Development²¹, “so that banks, insurers and funds managers can better implement...shared goals for sustainable development”²². Inter alia, in the Recommendations it is stated that the UNEP FI will encourage usage of sustainability criteria in investing and lending business so companies which business operations are more sustainable (consequently, environmentally sound) are supported more. Also, it is stipulated that the UNEP FI and its members will work on raising awareness of participants in financial markets on financial risks that arise from unsustainable behavior of companies, so these risks can be included in the evaluations: investments or lending connected to high financial risks are not attractive for investors. The anticipated results are investments in sustainable companies. The recommendations also include suggestions for social and economic development enhancement, but these dimensions are not in the scope of this paper.

The UNEP FI Statements are declarations of intent, voluntary and not legally binding for the signatories. The breach of the commitments by a financial institution can result in a jeopardized reputation, but there are no legal consequences attached to it.

Requirements from the signatories are not many:

- To pay an annual contribution fee,
- To participate in annual meetings,
- To report annually on achievements (policies and practical actions) towards advancing the commitments made.

3.1.1 Practical Outcomes of UNEP FI

As presented on the UNEP FI website, there are benefits from joining the initiative. Firstly, in recent time financial institutions’ corporate governance is much more examined by investors and regulators in order to check environmental and social impacts of their operations. By joining the UNEP FI, the financial institutions (FIs) have opportunity to get to know best practices and learn best ways to answer to their shareholders’ concerns. Secondly, signatories can use advantages of networking.

In the paper “Empirical Analysis of the Integration of Environmental Risks into the Credit Risk Management Process of European Banks” (Weber, Fenchel, Scholz, 2008), results show that there are significant differences in treating environmental issues between banks that are signatories of the UNEP FI banks’ statement and banks that are not signatories to the statement. The difference is in the level of integrating environmental risks into credit risk management, as presented in Figure no 4.

21 The World Summit for Sustainable Development (WSSD), held in Johannesburg in 2002, is(was? a UN conference on sustainable development with the official aim to review what was achieved worldly since the first UN conference on sustainability, Rio Summit held in 1992. It gathered representatives of governments, UN agencies, NGOs, multilateral financial institutions and business.

22 UNEP Finance Initiative. (2002). Recommendations from the UNEP Finance Initiatives (FI) Rio Roundtable, 14-15, March, 2002 Presented to the World Summit for Sustainable Development (WSSD), Johannesburg, South Africa.
http://www.unepfi.org/fileadmin/statements/wssd_unepfi_recomendations.pdf [15 August 2008]

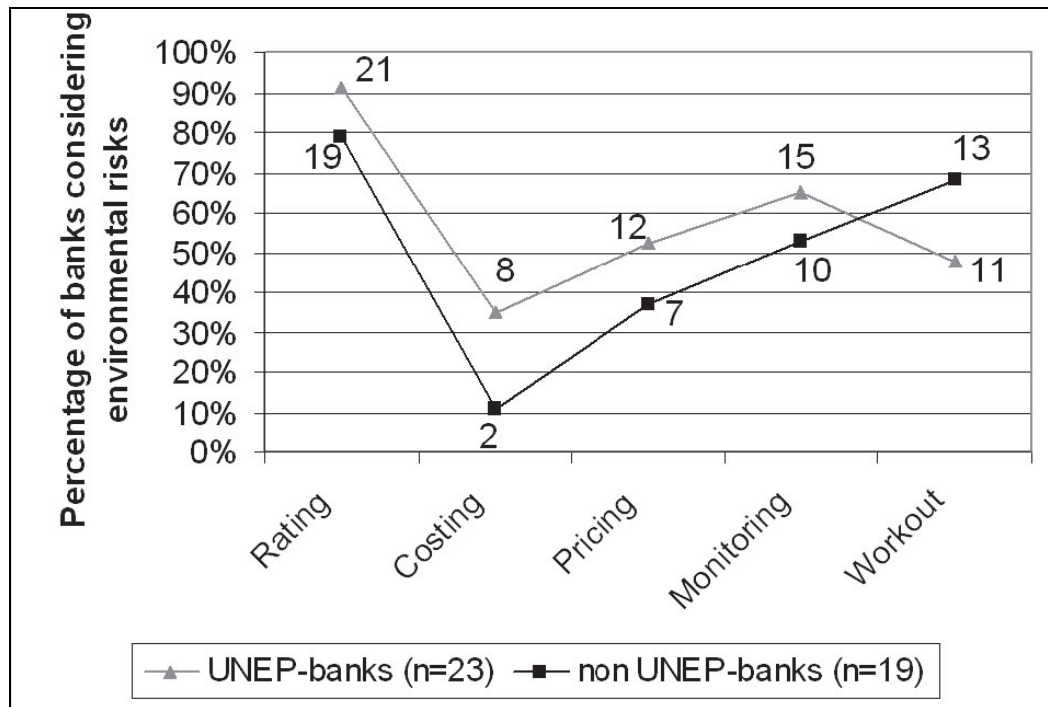


Figure 4 Consideration of environmental risks in European banks: UNEP FI statement’s signatories vs non-signatories²³

It is obvious that joining the UNEP Finance Initiative has helped the signatories in the management of environmental risks, i.e. influenced credit management strategies and operations. However, it doesn’t mean that signatories’ practices fully match commitments from the statement, or that environmental risks are included in all sections of credit management process.

3.2 The Equator Principles

The Equator Principles is an international code of conduct for financial institutions, primarily private, commercial banks, created with an aim to promote sustainable development through financing sustainable projects by incorporating management of social and environmental issues in project financing, and consequently strengthening the banks’ social and environmental risk management. The Equator banks are “largely concentrated in institutional environments shaped by targeted advocacy campaigns organized by civil society groups and strong regulatory systems. In addition, they typically operate transnationally, and as lead arrangers, are more likely to have a visible role in high-risk project finance deals, which increases the likelihood that environmental malpractice may be exposed by stakeholders and cause damages to corporate reputation.”²⁴ Today, the Equator Principles financial institutions (EPFIs) mount up to around 60 institutions.

As defined by the Basel Committee on Banking Supervision, project finance is “a method of funding in which the lender looks primarily to the revenues generated by a single project, both

23 Weber, O., Fenchel, M., & Scholz, R. W. (2008). Empirical analysis of the integration of environmental risks into the credit risk management process of European banks. *Business Strategy and the Environment*, 17(3), 149-159.

24 Wright Christopher, & Rwabizambuga Alexis. (2006). Institutional Pressures, Corporate Reputation, and Voluntary Codes of Conduct: An Examination of the Equator Principles. *Business and Society Review*, 111(1), 89-117.

as the source of repayment and as security for the exposure. This type of financing is usually for large, complex and expensive installations that might include, for example, power plants, chemical processing plants, mines, transportation infrastructure, environment, and telecommunications infrastructure. Project finance may take the form of financing of the construction of a new capital installation, or refinancing of an existing installation, with or without improvements. In such transactions, the lender is usually paid solely or almost exclusively out of the money generated by the contracts for the facility's output, such as the electricity sold by a power plant. The borrower is usually an SPE (Special Purpose Entity) that is not permitted to perform any function other than developing, owning, and operating the installation. The consequence is that repayment depends primarily on the project's cash flow and on the collateral value of the project's assets."²⁵ Project financing plays an important role in financing development, especially in developing countries and growing markets: "Main provisions are directed primarily to private, commercial lending in developing countries and emerging economies where borrowers rely more heavily on external project finance than is the case for businesses and governments in OECD countries"²⁶.

The Equator Principles were adopted in 2003 by a group of ten top banks (such as Citigroup, ABN AMRO, Barclays) from seven countries in order to tackle social and environmental issues in regards to the financing of development projects. The principles were developed with support in advice and guidance from the International Finance Corporation (IFC), a member of the World Bank Group which is established with the purpose to support private sector investments in developing countries and therefore to foster sustainable growth in the developing countries. The principles are based upon the IFC's social and environmental performance standards, and were revised in 2006 to reflect changes in the IFC performance standards which were changed in 2006 as well, with the aim of creating consistent standards for private sector project financing. The new revised standards also reflect "lessons learnt" from the first three years of implementation and feedback from stakeholders such as clients, non-governmental organizations (NGOs), and some official agencies. Also, the revision has brought a broadened scope of the principles (the principles now include advisory services for project finance, and also improvements or expansion of existing projects) and setting lower limits from the projects' capital costs: from 50 million USD to 10 million USD. The EPFIs now apply the principles to all loans for projects which have capital costs equal or more than 10 million USD.

The EPFIs commit to complying with the following nine principles in financing of projects while the additional tenth principle refers to the EPFI reporting:

1. Review and Categorisation

The EPFI commits to reviewing and categorization of the projects proposed for financing by using internal systems based on the IFC environmental and social screening criteria. The projects are categorized in three groups depending on their potential impacts and risks connected with them:

- group A – projects with potential significant irreversible negative social and environmental impacts;

²⁵ Basel Committee on Banking Supervision. (2005). International Convergence of Capital Measurement and Capital Standards ("Basel II"). Bank for International Settlement. <http://www.bis.org/publ/bcbs118.pdf>. [19 August 2008]

²⁶ Richardson, B. J. (2005). The Equator Principles: The Voluntary Approach to Environmentally Sustainable Finance. *European environmental law review*, 14(11), 280-290.

- group B – projects with limited potential negative impacts which are site-specific, reversible, and possible to address by mitigation measures; and
- group C – projects with insignificant or no negative environmental and social impacts.

2. Social and Environmental Assessments

For projects in the A or B category, it is the borrower's responsibility to provide social and / or environmental assessments in order to evaluate relevant impacts and risks associated with the project and where applicable propose mitigation and management measures. In this context, the needed assessment can be a full-scale social and environmental impact assessment, a limited assessment such as an audit, or simply application of pollution standards, construction standards, and similar. The documents can be prepared by the borrower, or by independent external experts. The projects must comply with relevant host country laws and regulations as well.

3. Applicable Social and Environmental Standards

The difference is made between High Income OECD Countries, as defined by the World Bank²⁷, and other countries: in High Income OECD countries the regulatory requirements are usually at the same level or above requirements of the IFC Performance Standards on Social and Environmental Sustainability and the IFC Industry-Specific Environmental, Health and Safety (EHS) Guidelines²⁸. Therefore, for projects in these countries compliance with local and national legislation is considered as acceptable alternative for compliance with the above mentioned IFC standards and guidelines, and as well with requirements in the principles 4, 5 and 6.

4. Action Plan and Management System

For all A and B category projects in non-OECD countries and not the High-Income OECD countries, the borrower has to prepare an action plan with a list of mitigation measures, corrective actions and monitoring measures in order to address risks identified in the assessment of the project. As well, the borrower has to establish or build up a social and environmental management system to be able to manage the identified impacts and risks, and corrective actions. For projects in High-Income OECD countries, it may be required from the borrower to create an action plan based on regulations and permitting requirements in the host country.

5. Consultation and Disclosure

In case of all A category and where appropriate B category projects, in non-OECD countries and not the High-Income OECD countries, local communities affected by the project activities have to be consulted. The consultation has to be free, prior and informed, in order to ensure that the local communities concerns are incorporated in the project.

6. Grievance Mechanism

Depending on the assessed impacts of the project, the borrower has to establish a borrower will, scaled to the risks and adverse impacts of the project, establish a mechanism for complaints by individuals and groups from affected local community as a part of the management system, and inform local communities about it.

²⁷ More information available at the World Bank website: <http://web.worldbank.org/>

²⁸ Available online at the IFC website:

<http://www.ifc.org/ifcext/sustainability.nsf/Content/PerformanceStandards> and
<http://www.ifc.org/ifcext/sustainability.nsf/Content/EnvironmentalGuidelines>

7. Independent Review

An independent expert's review of the assessment, the action plan and consultation process is needed for all A and B category projects, where appropriate.

8. Covenants

For all A and B category projects, the borrowers agree in the project financing documents to comply with all relevant environmental and social legislation and regulation including permitting, to comply with the action plan where it exists, to report periodically to the EPFI, to decommission the facilities according to the agreed plan.

9. Independent Monitoring and Reporting

For all A and where appropriate B category projects, an independent environmental and / or social expert's review of the borrower's monitoring information is required on regular basis, to ensure monitoring and reporting over the life span of the loan.

10. EPFI Reporting

The EPFIs commit to report publicly about the Equator Principle implementation in their organization. The EPFIs should report at least annually.

In short, for "A and B projects (high and medium risk), the borrower completes an environmental assessment addressing the environmental and social issues identified in the categorization process. After appropriate consultation with affected local stakeholders, category A projects, and category B projects where appropriate, will prepare Environmental Management Plans that address mitigation and monitoring of environmental and social risks"²⁹.

As the Equator Principles are a voluntary code of conduct and a framework, it is the banks responsibility to put in place internal policies and procedures to ensure that the principles are put into practice. The EPFIs consent to approve loans only for financing of projects that are environmentally sound and in a socially responsible manner. However, the principles are not solely a declaration of intent, as they incorporate the above mentioned IFC procedures and standards. It is important that the borrowers demonstrate ability and willingness to comply with the EPFI requirements and develop such projects, i.e. that the projects comply with relevant host country laws and the IFC Performance Standards and the IFC Industry-Specific EHS Guidelines.

3.2.1 Practical Outcomes of the Equator Principles

As stated in the Equator Principles official website³⁰, adoption and implementation of the principles didn't have negative consequences on business volume of the EPFIs in the first three years of implementation. On the contrary, according to the information published, representatives of the EPFIs claim that the principles are good for the business as they help the banks in terms of greater learning about social and environmental issues in project financing and therefore the banks will be able to better advise their clients and control risks.

²⁹ The World Bank - News and Broadcast. (2005). IFC: The Equator Principles. <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20193065~menuPK:34480~pagePK:34370~theSitePK:4607,00.html> [17 August 2008]

³⁰ Equator Principles, <http://www.equator-principles.com>

In the article “Banking on the Equator: Are Banks that Adopted the Equator Principles Different from Non-Adopters?”³¹, the authors provide an analysis of differences in performance of banks that adopted the principles and non-adopters, and conclude that adoption of the principles signals responsible conduct of the banks. The EPFIs have developed social, ethical and environmental policies, which is not always the case with the other banks, while the other characteristics are not significantly different. The EPFIs are typically significantly larger than other banks, and usually in the focus of public attention. According to the article, NGOs were accusing the banks that adopted the principles for “greenwashing” because of alleged nontransparency of the projects and because the principles would not contribute enough sustainable development. However, the principles are an example of self-regulation which has stricter requirements than the legal ones. The authors notice that there are some indirect indications that adoption of the principles is associated with higher operational costs for the adopter. However, benefits of adopting the principles – reduced risks are higher than these additional costs, although reduced risks are not always possible to show in financial reports. As well, shareholders’ reaction to the adoption of the principles is not negative, and there are two possible reasons for that: project finance is small part of the overall banks’ business, so implementation of the principles will not significantly influence profits, or no direct trade-offs between shareholders’ earnings and corporate social responsibility. The authors conclude that the banks adopting the principles value highly corporate social responsibility, and even though the adoption is associated with additional costs, it also improves the risk profile of the adopter, i.e. improves its reputation.

In the work of Wright and Rwabizambuga³² it is stated that by adopting the principles, banks reduce the potential market for project finance, which means that there can be opportunity costs. In other words, it can mean loss of potential customers and probably market share as well. In addition, not only will screening and monitoring lead to increase in costs, but operational costs of the project can be significantly higher in order to operate in environmentally sound and socially responsible manner. The authors point out a possibility of “free-riders” occurrence, i.e. financial institutions that adopt the principles and get some reputational benefits, while their practices stay the same, because they are not forced to change by any formal mechanism for monitoring of the actual members’ practices. This is also in focus of the civil society organisations’ network Banktrack³³ through which large part of civil society reactions to the principles is directed. On the other hand, banks that may strongly consider environment and social issues in their business practices may choose to be independent from these schemes that are partly under control of external stakeholders and their competition. This is the main concern in considering broadening the scope of the Equator Principles to other areas.

Richardson in his article “The Equator Principles: The Voluntary Approach to Environmentally Sustainable Finance”³⁴ examines the Equator Principles as a voluntary code of conduct intended for banks. The author points out that until today, very few policy interventions targeting finance sector were made. In the absence of stricter regulations, the achievements in making the financial world working towards sustainable development will

³¹ Scholtens Bert, & Dam Lammertjan. (2007). Banking on the Equator. Are Banks that Adopted the Equator Principles Different from Non-Adopters? *World Development*, 35(8), 1307.

³² Wright Christopher, & Rwabizambuga Alexis. (2006). Institutional Pressures, Corporate Reputation, and Voluntary Codes of Conduct: An Examination of the Equator Principles. *Business and Society Review*, 111(1), 89-117.

³³ For more information go to: <http://www.banktrack.org>

³⁴ Richardson, B. J. (2005). The Equator Principles: The Voluntary Approach to Environmentally Sustainable Finance. *European environmental law review*, 14(11), 280-290.

greatly depend on voluntary schemes, such as the Equator Principles. The Equator Principles are seen as a move in the right direction, however, not as strong enough to ensure banks' environmentally responsible financing decisions. The principles provide a process of incorporating environmental issues in the decision making process, while what happens in reality, i.e. how principles are translated into procedures depends on the public accountability and transparency of the decision making process. In other words, without transparent decision making processes it is hard to expect real results of the implementation of the principles. In the EU, which is a leader in environmental reforms, information disclosure is seen as the main challenge: the financial sector has the power to decide which companies and business activities get financing, and therefore significant indirect impact – information disclosure from the financial sector on their financing and investing activities would give incentives to act more environmentally sound. Different proposals were made on how to strengthen the EP, such as a proposal to establish an independent commission to investigate all complaints in regards to both social and environmental issues (e.g. human rights abuse, or environmental damage), or setting up an independent Environmental Bank, which would assist in carrying out environmental assessments and monitoring. These proposals are made in the Freshfields study³⁵.

The already mentioned network BankTrack has made a series of recommendations on how to improve the EP such as: banks should get the status of EPFIs after going through a certain assessment and verification process for their lending policies, the EPFIs should create an “independent accountability mechanism” to control implementation and ensure improvement of the principles, etc.

There are also many other unsolved practical issues, such as need for lenders to be involved much earlier in the project cycle in order to have greater influence on the project plan. There is also a lack of sector policies that would give the EPFIs more detailed policy framework than now is the case. For example, ABN Amro Bank has developed a number of policies for forestry, mining, tobacco and other industry sectors. There is also a question of extending the principles from project financing to other banking activities and financial markets. The EPFIs are not totally welcoming such proposals: it seems more feasible to incorporate environmental considerations into project financing than other banking activities³⁶.

Richardson concludes that there is no enough empirical data on voluntary schemes such as the EP and the UNEP FI achievements in order to determine whether such codes are appropriate mechanism to support sustainable development or they are just “green-washing”. However, the voluntary codes are only one mechanism, and there are many other, economic instruments, such as tax incentives, direct regulation or information requirements (mandatory reporting), which have to be considered as it seems the EP are not strong enough to succeed independently.

3.3 European Principles for the Environment Declaration

The European Principles for the Environment Declaration (EPE Declaration) is briefly presented in this section, it is an initiative of a group of European banks operating internationally and publicly owned, to promote the European Union (EU) environmental

³⁵ Richardson, B. J. (2005). The Equator Principles: The Voluntary Approach to Environmentally Sustainable Finance. *European environmental law review*, 14(11), 280-290.

³⁶ Richardson, B. J. (2005). The Equator Principles: The Voluntary Approach to Environmentally Sustainable Finance. *European environmental law review*, 14(11), 280-290.

regulation, principles and practices in the countries of their operation and ensure harmonized approach to the environmental management of project financing.

In the Sixth EU Environment Action Programme it is specified that one of the strategic approaches to meet the EU environmental objectives will be the support of integration of environmental issues in the financial sector by:

- considering a voluntary initiative within the financial sector,
- asking for strengthening integration of environmental considerations into lending activities of the European Investment Bank and promoting integration of environmental issues into the activities of other financial institutions (e.g. the European Bank for Reconstruction and Development)³⁷.

Apart from voluntary initiatives, the programme considers strengthening environmental practices of publicly owned development and other banks.

In May 2006, five European-based Multilateral Financing Institutions³⁸ (MFIs) adopted the European Principles for the Environment (EPE) and signed the EPE Declaration as their joint approach to environmental management in project financing, “based on the particular EU approach to the environment, which is as strong as any that exists”³⁹. Signatory MFIs are following:

- The Council of Europe Development Bank (CEB),
- The European Bank for Reconstruction and Development (EBRD),
- The European Investment Bank (EIB),
- The Nordic Environment Finance Corporation (NEFCO) and
- The Nordic Investment Bank (NIB).

The MFIs aimed at addressing environmental issues in the project financing together with project sponsors (persons responsible for project management, administration, monitoring, and the overall project delivery on behalf of an organization⁴⁰) and better management of their credit and project related risks in regards to the environment. “The EPE promotes the EU approach to environmental sustainability, and commits the signatories to applying EU principles, practices and standards to all projects financed by the Signatory institutions.”⁴¹

³⁷ Official Journal of the European Communities L 242/1. (2002). “Decision No 1600/2002/EC of the European Parliament and of the Council of 22 July 2002 laying down the Sixth Community Environment Action Programme”. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:242:0001:0015:EN:PDF> [23 August 2008]

³⁸ A multilateral financing institution is a financial institution which operates in more than one country and usually is founded by a group of countries

³⁹ The European Investment Bank. (2006). European Principles for the Environment Declaration. <http://www.eib.org/infocentre/epe/declaration/index.htm> [13 August 2008]

⁴⁰ Crawford, Lynn and Brett, Christine. (2006). “Exploring the Role of the Project Sponsor”. Project Management Program, University of Technology, Sydney. <http://www.projects.uts.edu.au/resources/pdfs/PMINZ2001CrawfordBrett.pdf> [13 September 2008]

⁴¹ The European Bank for Reconstruction and Development. (2008). “International cooperation: environmental enhancement” <http://www.ebrd.com/enviro/partners/enhance.htm> [23 August 2008]

“The EPE recognise that the IFIs will ensure the respect and promotion of the *acquis communautaire* and international commitments made by the European countries concerning the protection and management of the environment.”⁴² *Acquis communautaire* refers to the entire body of legislation of the European Communities and Union, which applicant countries must accept before they can join the EU⁴³.

The EPE is based on environmental principles that are incorporated in the EC Treaty, standards from the European environmental legislation and the project-specific practices in the EU. The guiding principles regarding the environment incorporated in the EC Treaty in its article 174 (2) are the following:

- High level of protection principle (taking into account differences between regions in the EU),
- The precautionary principle,
- The polluter pay principle,
- Principle of prevention rather than remediation
- The proximity principle
- The integration principle.⁴⁴

The EPE is applicable on projects in countries of operation of the signatories: not only for projects within the territory of the EU, but also the territory of the European Economic Area (EEA), the EU Acceding, Candidate and potential Candidate countries and other neighboring countries covered by specific agreements with EU.

In the region that includes the EU member states, the EEA countries, the EU Acceding, Candidate and potential Candidate Countries, all publicly and privately sponsored projects financed by the EPE signatories should comply with the EPE and the relevant secondary EU environmental legislation:

- The EU *acquis communautaire* in regards to environmental assessment,
- The EU directives in regards to industrial production, water and waste management, air and soil pollution, occupational health and safety, and the protection of nature.⁴⁵

⁴² The Council of Europe Development Bank (CEB). (2007). “The CEB and the management of the environment”. <http://www.coebank.org/en/autres/frrecherche.htm> [23 August 2008]

⁴³ Definition from the European Commission Justice and Home Affairs Glossary, http://ec.europa.eu/justice_home/glossary/glossary_a_en.htm [13 September 2008]

⁴⁴ The European Investment Bank. (2006). European Principles for the Environment Declaration. <http://www.eib.org/infocentre/epe/documentation/objectives-and-principles/index.htm> [13 August 2008] Also, Official Journal of the European Union C 115/47. (2008). “Consolidated Version of the Treaty on the Functioning of the European Union”. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:115:0047:0199:EN:PDF> [23 August 2008]

⁴⁵ The European Investment Bank. (2006). European Principles for the Environment Declaration. <http://www.eib.org/infocentre/epe/declaration/index.htm> [13 August 2008]

As well, projects in this region have to comply with provisions of relevant Multilateral Environmental Agreements ratified by the EU, according to applicable EU laws. The EPE implementation in other countries depends on the feasibility because of local conditions, costs of application, as well as the time frame needed for implementation of EPE. In case of co-financing a common approach is to be agreed, which is consistent to or based on the EPE.

The initiative is endorsed by the Environment Directorate-General of the European Commission⁴⁶. It is seen as a basis for harmonized approach to the environmental management and an impetus for additional signatories. However, the author did not succeed in obtaining more detailed information in regards to the practical implications of the initiative.

⁴⁶ “The main role of the European Commission's Environment Directorate-General (DG) is to initiate and define new environmental legislation and to ensure that agreed measures are put into practice in the EU Member States” Source: The European Commission website http://ec.europa.eu/dgs/environment/index_en.htm[13 August 2008]

4 Environmental Considerations in European Bank for Reconstruction and Development (EBRD) Business Operations with Focus on Credit Management

Information provided in this section is gathered from the European Bank for Reconstruction and Development (EBRD) website and documents published on the website, including such as the agreement establishing EBRD, EBRD policies and procedures, annual reports, sustainability reports, studies evaluating EBRD operations and similar sources of information, as well as from interviews with the EBRD Montenegro country office representatives.

4.1 EBRD History and Profile

Following an initiative of the President of France Mr. Mitterrand which was supported by the European Council and the European Community, the agreement establishing EBRD was signed in 1990 and it entered into force in 1991. Countries participating in the negotiations were all 24 members of the Organization for Economic Cooperation and Development; Malta and Cyprus; 8 Central and Eastern European countries; the European Economic Community and the European Investment Bank, and in later phases Egypt, Israel, the Republic of Korea, Liechtenstein, Morocco and Mexico. It is stipulated that membership in the EBRD is open for European countries, non-European countries which are members to the International Monetary Fund, the European Community (EC) and the European Investment Bank (EIB). Currently, the EBRD is in the ownership of 61 countries and 2 intergovernmental institutions: the EC and the EIB. The complete list of members is in Appendix no 1.

The EBRD is established with the primary purpose to help process the transition of so called “recipient countries”, Central and Eastern European countries and ex-soviet countries’ economies to market economies, after the communism collapse. In fulfilling its purpose, the EBRD assists recipient countries in making shift towards full market economies (“the transition impact”) by making investments that:

- support structural and sectoral reforms such as demonopolisation, decentralization and privatization,
- promote market competition and development of the private sector, especially entrepreneurship and small and medium sized enterprises,
- develop infrastructure necessary to support private sector initiatives,
- foster development of financial institutions and service sector, as well as capital markets and employment of domestic and foreign capital in private sector.

The idea behind the EBRD is to raise productive investments and consequently the overall economic and to some point social situation. The EBRD provides technical assistance for preparation and implementation of projects for which financing the bank provides funds, where necessary and in line with specific investment programmes. The EBRD invests in diverse business sectors, i.e. different kinds of enterprises and financial organizations, mainly in the form of loans or equity investments.

The EBRD is committed to cooperation with all its members, but also in line with its purpose with international financial organizations, e.g. the International Monetary Fund, the

International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the Organization for Economic Co-operation and Development, the United Nations and its agencies, and other organizations which work is in relation to the economic development of Central and Eastern European countries.

Today, the EBRD has operations in 29 countries, mainly Central and Eastern European countries, but also some central Asian countries, ex-Soviet republics. The complete list of the countries in which the EBRD operates is in Appendix no 2.

According to the information published on its website, the EBRD is the largest single investor in the Central and Eastern European region, but apart from that it also mobilizes considerable direct foreign investments in the region, which is significant for the economic development of these countries.

The EBRD is very active on the international capital markets with a broad range of activities such as funding, investments (credits), balance sheet management, and client risk management. In order to balance credit risks to which it is exposed in transition economies and other countries where it operates, the bank has established conservative procedures for lending and other operations and due to that it is rated as a top bank – it maintains its top credit rating. The rating is amongst other things based on conservative policies regarding risk management which ensures secure investments of the shareholders assets. As well, capital adequacy requirements established by the bank are high, i.e. capital levels are prudent: the total amount of outstanding loans, guaranties and share investments is up to 100% of the bank's subscribed capital, reserves and net income (i.e. gearing ratio, which generally compares owner's funds or capital to borrowed funds is 1:1). This is a sign for investors that the investments made by and consequently in the EBRD are reliable.

In all its activities, the EBRD is committed not only to applying sound banking principles, but also promoting environmentally sensitive development. From the Agreement founding the EBRD it is clear that the understanding is that sound business management is not possible without considering sustainable development, i.e. that economic growth is inseparable from keeping the environment healthy and taking into account social issues. Incorporation of environmental considerations and sustainable development requirements as well are high on the list of priorities in the EBRD activities.

According to the EBRD sustainability report for 2007, the bank is operating in line with its commitments regarding the environment: out of 5.6 billion EUR, 1.35 billion EUR was invested in financing environmental improvements in the projects. Out of this amount, 1 billion EUR was invested in projects with a specific focus on the environment (an increase of 17% compared to 0.87 billion EUR in 2006), for example through sustainable energy and municipal infrastructure, and 329 million EUR was invested in environmental improvements in other projects (increase of 214% compared to 105 million EUR in 2006). In overall, 24% of the total amount invested in the projects in 2007, was invested in direct environmental improvements. Apart from this, simultaneously with 5.6 billion EUR of EBRD funds invested, additional funds of 8.6 billion EUR are mobilized from other investors, and the total project value in 2007 was 13.8 billion EUR (increase of 15% in comparison to 2006). Total net profit of the bank in 2007 was 1.9 billion EUR. As indicated in the bank's annual report for 2007⁴⁷, the net profit in 2006 was 2.4 billion EUR, and the decrease in 2007 was a result of decreased realized gains from sale of shares from the bank's portfolio.

⁴⁷ EBRD. (2008). Annual Report 2007 Financial Statements. <http://www.ebrd.com/pubs/general/fr07.pdf> [07 August 2008]

According to the information from the 2007 annual report⁴⁸, the total provisions for impaired loans for the bank's loan portfolio in 2007 were 124 million EUR (341 million EUR in 2006), or compared to the bank's operating assets 0.25% of sovereign loans or 1.69% of nonsovereign loans (0.70% and 5.16% in 2006 respectively)⁴⁹. The model based on incurred loss was used for the calculation of provisions. During 2007, the model for calculation is adjusted according to up to date available historical data on losses (the bank's experience) and it resulted in an updated Risk Capital Model. This was the main reason for decrease in provisions, which reflect credit risks related to the bank lending business. It can be concluded that the bank's experience has shown that the bank is exposed to lower risks because of its loan portfolio then originally calculated. The information on provisions is very indicative for the investors as it shows level of risks to which banks expose themselves in lending operations.

The EBRD policy rule is that at least 60% of all completed projects are evaluated. The evaluation is made one or two years after all funds are disbursed, and the criteria for the evaluation is consistency with the EBRD's mandate, sound banking principles and the effectiveness of the project implementation, as illustrated in Figure no 5.

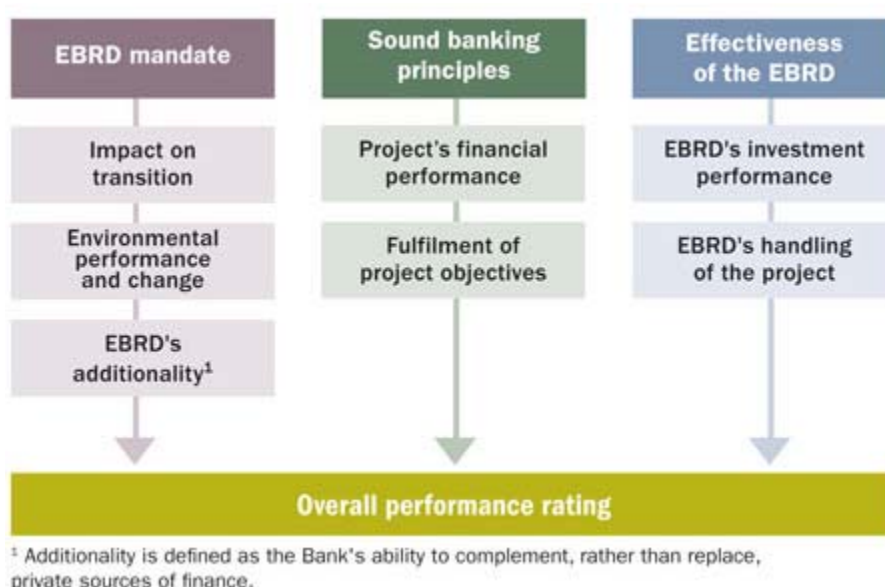


Figure 5 Factors considered in the evaluation of the performance of EBRD operations⁵⁰

Out of all projects evaluated for the overall performance between 1996 and 2005, 14% were unsuccessful, 28% were partly successful, 48% were successful and 10% were highly successful⁵¹.

⁴⁸ EBRD. (2008). Annual Report 2007 Financial Statements. <http://www.ebrd.com/pubs/general/fr07.pdf> [07 August 2008]

⁴⁹ A loan is impaired when it is probable that the borrower will not be able to repay all amounts due according to the contract with the lender (i.e.principal amount and interest); sovereign loan is a loan to a government, usually overseas.

⁵⁰ EBRD. (2008). Methodology and Ratings. <http://www.ebrd.com/projects/eval/method.htm> [07 August 2008]

⁵¹ EBRD. (2008). Methodology and Ratings. <http://www.ebrd.com/projects/eval/method.htm> [07 August 2008]

4.2 How is Environmental Work Organized within EBRD?

Information presented in this section is gathered from publicly available material published on the EBRD website, such as the Environmental Policies (from 2003 and 2008), the Environmental Risk Management Manual for Financial Intermediaries, as well as from interviews with the EBRD Montenegro country office representative (information related to the Environment Department, project approval procedures and environmental appraisal).

Environmental components are integrated in all projects financed by EBRD. Additionally, some projects are specifically developed for environmental improvements. Project sponsors are required to implement the environmental standards the EBRD is committed to and to set up appropriate environmental management systems. In the cases where projects are financed through financial intermediaries (e.g. local banks or leasing companies), a set of requirements is put on the intermediaries in order to ensure that the financed projects comply with the EBRD's environmental mandate and policies.

While the Operation Leader has the overall responsibility for environmental aspects of an activity on behalf of the Bank, the EBRD has established an Environment Department, which is responsible for different specific environmental issues, such as identification of potential environmental concerns and opportunities in connection to an operation and advising on necessary environmental investigations and public consultations, and preparing and/or reviewing documentation in relation to environmental aspects of the project and other activities.

EBRD is active in different international initiatives and organizations working on environmental enhancement:

- The Global Environment Facility, a financial organization providing environment improving projects in developing countries where EBRD is one of its executing agencies,
- The UNESCO World Heritage Convention and Ramsar, aimed at protecting and enhancing natural biodiversity and cultural heritage,
- The European Principles for the Environment, and other⁵².

4.2.1 Environmental Policy and Procedures

At the Board of Director meeting in 1991 the EBRD adopted its first environmental policy. The policy was revised twice, and the revised version from April 2003 is still valid⁵³. It will be replaced in November 2008 by new Environmental and Social Policy and Performance Requirements which were adopted in May 2008. The new policy is a comprehensive document that covers both the environmental and social dimensions of sustainable development, together with performance requirements for environmental and social appraisal and management, labour related requirements, cultural heritage, pollution prevention and abatement, stakeholder engagement and other. However, the emphasis in this section will be given to the parts of the policy related to environmental issues, as that is in the thesis scope.

⁵² More information at the EBRD website: <http://www.ebrd.com/enviro/partners/enhance.htm>

⁵³ EBRD. (2003). "EBRD Environmental Policy". <http://www.ebrd.org/about/policies/enviro/policy/policy.pdf> [24 August 2008]

As stated in the document, the “EBRD will seek to ensure through its environmental and social appraisal and monitoring processes that the projects it finances:

- are socially and environmentally sustainable;
- respect the rights of affected workers and communities;
- and are designed and operated in compliance with applicable regulatory requirements and good international practice”⁵⁴.

As a part of the policy document, the bank has developed a set of Performance Requirements (PR) as guidelines for transformation of the objectives into practice. The Performance Requirements regarding the environment are following:

- PR1: Environmental and Social Appraisal and Management
- PR3: Pollution Prevention and Abatement
- PR6: Biodiversity Conservation and Sustainable Management of Living Natural Resources, and indirectly:
- PR9: Financial Intermediaries.

In PR 1, the importance of a systematic approach to social and environmental management by companies receiving funding from the EBRD is highlighted. “Effective management systems, appropriate to the size and nature of the business activity, allow companies to better manage risks, take advantage of opportunities, enhance their social and environmental performance and reputation and often lead to improved financial performance.”⁵⁵ The responsibility for appraisal, management and monitoring of environmental and social issues related to proposed projects, along with stakeholders’ engagement is generally on the clients. Depending on the results of the environmental and social appraisal and consultation with stakeholders, the client should develop a plan including mitigation and performance improvement measures addressing identified environmental and social issues. It is called ESAP, the Environmental and Social Action Plan.

In PR 3, EBRD principles such as the precautionary principle, the prevention principle, the principle that environmental damage should as a priority be rectified at source, and the polluter pays principle are pointed out, together with requirements for compliance with EU standards, especially in regards to industrial production, water and waste management, air and soil pollution, occupational health and safety, and protection of the nature. Therefore, the objectives are: to avoid or minimize pollution related directly from the projects, to help clients to identify opportunities for increased energy and resource efficiency and reduction of waste, as well as reduction of green-house gas emissions.

⁵⁴ EBRD. (2008). “EBRD Environmental and Social Policy Approved by the Board of Directors 12 May 2008”.
<http://www.ebrd.com/about/policies/enviro/policy/2008policy.pdf> [24 August 2008]

⁵⁵ EBRD. (2008). “EBRD Environmental and Social Policy Approved by the Board of Directors 12 May 2008”.
<http://www.ebrd.com/about/policies/enviro/policy/2008policy.pdf> [24 August 2008]

In PR 6, EBRD points out the support to the implementation of relevant international law and conventions on biodiversity and relevant EU directives. Again, a support to a precautionary principle for sustainable use, management and conservation of natural resources and biodiversity is stated. The biodiversity mitigation hierarchy is as follows: avoid – minimize – mitigate – offset.

PR 9 is developed to define EBRD relations with Financial Intermediaries (FIs) and environmental requirements from the FIs. EBRD delegates responsibility for the overall portfolio management including loan appraisal and monitoring to FIs, as well as the environmental and social risk management. However, EBRD continues to oversee the FI, by assessing and monitoring if environmental and social risks are addresses by the FI in an appropriate manner. In line with objectives of PR 9, FIs are encouraged to consider joining international initiatives that promote best environmental practices such as the Equator Principles, the UNEP Finance Initiative, and the Principles for Responsible Investment (PRI).

4.2.2 The Role of the Environment Department (ED)

According to the information presented during the interview with the EBRD Montenegro office representative Mr Ralevic and relevant parts of the EBRD Operations Manual, the bank has formed the Environment Department (ED) which has the following responsibilities:

- identification of both environmental concerns and opportunities connected to an activity or project;
- advising on necessary environmental investigations and public consultation where needed;
- preparing documents needed for different stages of the project appraisal, such as: an Environmental Screening Memoranda in the initial phase Concept/Structure Review and Environmental Review Memoranda for the final approval of an operation (Final Review);
- review of environmental investigations' results and bringing significant findings to attention of the responsible persons (Operations Committee and / or senior management)
- review and agree on environmental covenants and other related documentation;
- assisting in monitoring of the activity or project.

An Operation Leader, appointed by EBRD and responsible for an operation, however, has the overall responsibility for the environmental aspects of an operation, i.e. a project or activity. The Operation Leader's responsibilities include: establishing communication between clients and the ED where necessary, informing clients on the bank's environmental requirements and obtaining environmental information from clients, incorporating environmental findings in relevant documents for operations' appraisal as well as in legal agreements, and finally monitoring if the environmental requirements are implemented. The bank's clients are responsible for commissioning or conducting necessary environmental investigations required by the bank and ensuring the bank's environmental requirements are met.

In the operation appraisal, the ED is involved in different stages. In the operation identification phase, clients are required to provide environmental information along with other initial information. The information includes recent environmental assessments or audits

of a specific site and environmental concerns related to a site, compliance with environmental regulations, clients environmental policies, and similar. Environmental specialist from ED assigned for the operation cooperate with the Operations Leader and use this information for an Environmental Screening. The ED specialists prepare the Environmental Screening Memorandum, a document incorporating information on the environmental category of the operations:

- “A” category: operations for which an Environmental Impact Assessment is required;
- “B” category: operations for which and Environmental Analysis is required;
- “C 1” category: operations for which an Environmental Audit is required;
- “C 0” category: operations for which neither of the above is required.

The Memorandum includes information on environmental issues and opportunities and public consultation requirements. The format of the document differs in from the case when the financing is direct to the case when it is through a financial intermediary.

The Operation Leader is responsible for undertaking actions set in the Environmental Screening Review and providing adequate information for the ED. Environmental investigations are the basis for an Environmental Action Plan for specific activities. Furthermore, the ED requires a confirmation from the Operations Leader that the client can finance the environmental protection costs. Based on the findings of the environmental investigations, site visits where needed and public consultation results, the ED prepares the Environmental Review Memorandum, as a document containing environmental information relevant for the operation approval, while a summary of environmental objectives and risks is a part of Final Review document.

Monitoring of the operations confirms that clients’ environmental commitments are adequately met. Usually, clients are required to report on environmental issues regularly and the environmental performance monitoring is included in the credit monitoring.

The ED has the role of a specialized service department, responsible for assessing, analyzing important environmental information in connection to operations and bringing it to attention of the relevant decision-makers within the EBRD.

4.2.3 Environmental Appraisal

The information provided in this section is obtained from the EBRD Operations Manual and presented in the interview with an EBRD Montenegro office representative Mr. Ralevic. However, the version of the Operations Manual is from 1994 and is to be updated in the near future.

The purpose of environmental appraisal of EBRD operations is improved decision making in the following ways: giving valuable inputs in order to decide if an activity should be financed, and if yes, defining how environmental issues should be incorporated in the activity and/or how the activity should be designed to provide environmental benefits.

The environmental appraisal begins with identification of the national environmental laws and other regulations that are applicable to a planned activity and relevant international agreements as well. This is very important for assessment and mitigation of the financial risks of the

operation. For example, if the costs for compliance with environmental legislation are not taken into account, they may significantly increase operating costs, or in case of non-compliance, charges or fines would have to be paid and also lead to increased costs which would on the other hand compromise the borrower's ability to repay the loan in time. Also, there could be financial risks connected with liabilities for historical pollution. All these elements have to be considered in early phases of a project in order to make proper decisions.

- According to the manual, the environmental due diligence process includes:
- environmental screening to decide on the nature of environmental investigation needed for an operation;
- reviewing the results of the environmental investigation;
- incorporation of the outcomes of the environmental investigation in the preparation of the operation, and in legal documents (covenants in the agreements with clients);
- monitoring of the environmental performance of the operation and evaluation of the performance after completion of disbursement.

Environmental investigations conducted for the bank's operations are mainly environmental impact assessments (EIAs), environmental analyses and environmental audits.

Operations classified in "A" category by the EBRD's Environmental Appraisal Unit (EAU) require EIA. Environmental analyses, required for "B" category projects are similar to EIA in terms of content, however, in the scope are more limited. Operations classified as "C 1" require environmental audit. Environmental audits recognize environmental concerns in relation to existing or past activities and identify environmental risks and potential liabilities in connection to an operation.

EBRD gives great attention to public consultation and disclosure of information. All national requirements in regards to public consultation must be met and specific EBRD rules set in the EBRD environmental policy.

4.2.4 Environmental Requirements from Clients

The EBRD environmental requirements from clients differ in the way they are shaped to ensure implementation of EBRD environmental commitments depending on the nature of the cooperation with clients: funding through financial intermediaries, investments in equity, or lending activities (project financing). However, all requirements put on clients aim at ensuring the EBRD environmental mandate is taken into account. In the next section, EBRD environmental requirements from financial intermediaries (e.g. banks and leasing companies) will be presented to illustrate how banks can introduce environmental issues in their corporate lending business.

4.2.5 Assessment of the Projects – Financial Intermediaries

The information presented in this section is primarily collected from the EBRD Environmental Risk Management Manual⁵⁶, which is a part of material published on the

⁵⁶ EBRD. (2008). "Environmental Risk Management Manual". <http://www.ebrd.com/enviro/tools/fi.htm> [07 August 2008]

EBRD website as supporting tools for the EBRD partners as guidance on environmental issues. Environmental risk management is connected to the assessment of environmental risks and opportunities associated with funds lent to the banks clients. In the loan appraisal process, the EBRD performs four main steps connected to the assessing of environmental risk and environmental risk management process. These steps are presented in the Figure no 6.

In the first step, the environmental screening, an initial environmental risk rating is performed and environmental risks associated with the activity are roughly estimated as high, medium or low risks. The methodology is very simple and the main criterion for the rating is the business activity. For the purpose of this initial assessment a Business Activity Risk List is prepared by the EBRD and it consists of a list of business activities ranked according to the official EU statistical classification codes and the estimation of the risk associated with the activities. Apart from business activity, other criteria are: size of loan, terms of loan and nature of the collateral (a security or guarantee for repayment of a loan). The environmental screening form for corporate lending which is used for assessing of the Initial Environmental Risk Rating by the credit officers is presented in Appendix no 3.

Some activities are a priori excluded or restricted from EBRD financing:

1. activities that are illegal under national (i.e. host country) or international law are excluded,
2. activities which have serious environmental consequences are excluded and listed in the Exclusion List⁵⁷; such as for example production and trade in ozone depleting substances that are subject to international bans and phase-outs.
3. activities that may be hazardous are included in the Referral list⁵⁸ and can not be financed without referral to the EBRD's Environmental Department and the prior written approval by the EBRD; examples are production of energy using nuclear fuel, activities within, adjacent to or upstream of protected areas, etc.

⁵⁷ EBRD. (2004). „EBRD Environmental Exclusion and Referral List for FIs“. <http://www.ebrd.com/enviro/tools/procedur/exclude.pdf>
[24 August 2008]

⁵⁸ EBRD. (2004). „EBRD Environmental Exclusion and Referral List for FIs“. <http://www.ebrd.com/enviro/tools/procedur/exclude.pdf>
[24 August 2008]

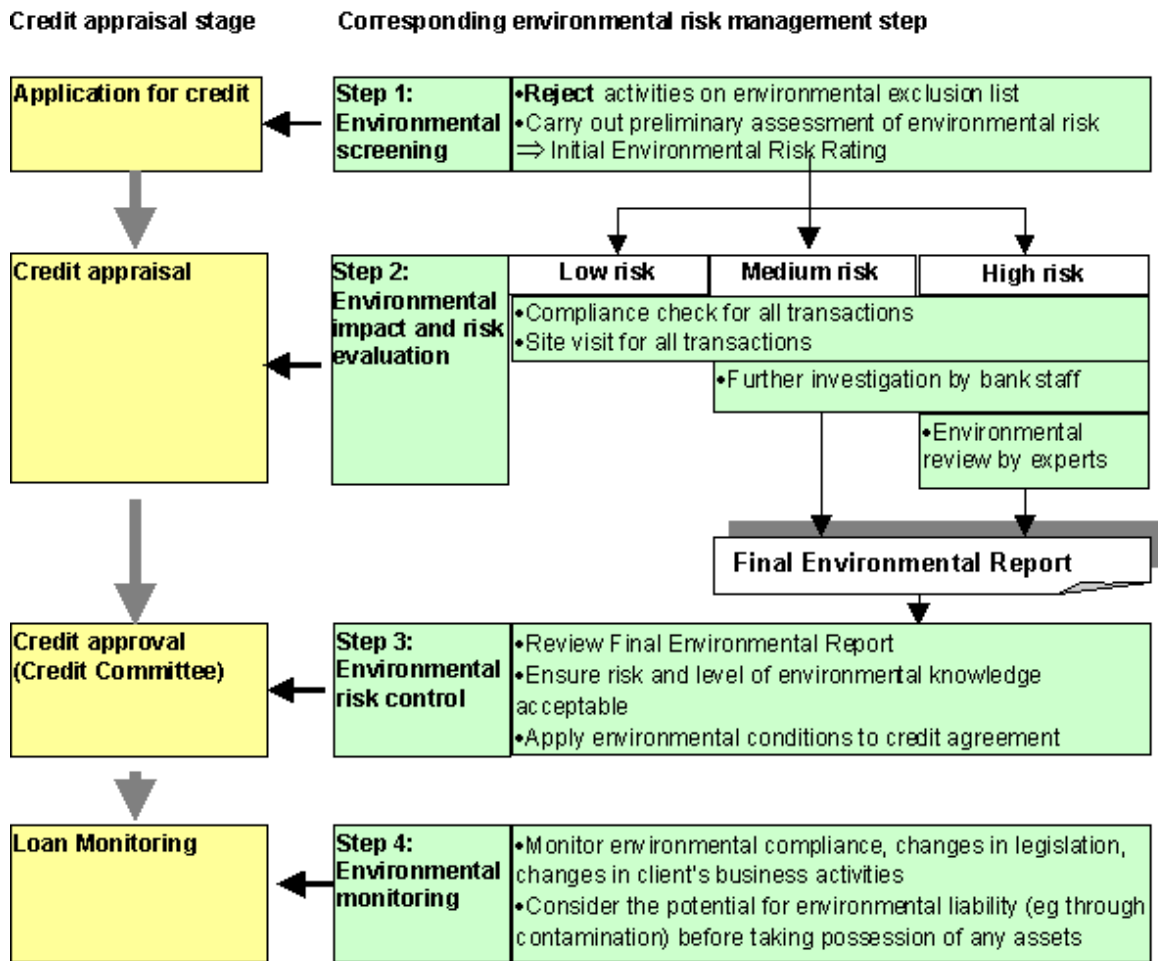


Figure 6 The EBRD credit appraisal process overview⁵⁹

This is identified in the first step of credit appraisal – the environmental screening. In this first step the activities are ranked in three groups: activities connected with high, medium or low risks.

High activity risk are activities that potentially can cause significant and/or long term environmental impacts or can have significant environmental liabilities connected with them. Also, these activities can involve reputational risk for the EBRD or the financial intermediary.

The activities in the first step of credit appraisal are divided in three groups: the Exclusion list activities, the Referral list activities and Category A activities, for which an Environmental Impact Assessment (EIA) is required, and it has to be made publicly available for potentially affected parties. In addition to the EIA which can be legally required, an Environmental Due Diligence Report is required. It should include information on permits/licences, environmental impact assessment if required by national regulations, site visit, inspection report, health, safety and environmental (HSE) regulatory compliance, accidents, risks monitoring and mitigation, as well as environmental opportunities; furthermore, an environmental audit or other input from independent environmental experts can be required.

59 EBRD. (2008). "Environmental Risk Management Procedures – Corporate Lending Overview: Credit appraisal process overview". Environmental Risk Management Manua. <http://www.ebrd.com/enviro/tools/fi.htm>. [07 August 2008]

All this information is collected and activities undertaken in Step 2: the environmental impact and risk evaluation.

Medium activity risk are activities that have environmental impacts associated with for which the borrower has capacities to predict, prevent and mitigate them. For these activities usually the Environmental Due Diligence Report is required and information in connection with it.

Low activity risks are activities that have insignificant environmental impacts and require minimum Environmental Due Diligence (a regulatory compliance check and site visit).

In the next, third step, environmental risks, connected to the specific activity for which a loan is requested, are reviewed. The overall credit decision includes judging if the risks are acceptable or not. In addition, adoption of appropriate measures for environmental risk control can be required and environmental clauses can be added to the transaction agreement.

The fourth step includes environmental monitoring and reporting during the lifetime of the transaction. It implies systematic collection of information related to the specific financed project. Monitoring has to be focused on the client's regulatory compliance and compliance with environmental requirements in relation to the loan agreement, as well as changes in environmental regulation, and the client's business activities.

4.2.6 EBRD Operations in Montenegro

EBRD activities in Montenegro have not been intensive up to date reflecting the fact Montenegro is a small country. According to the information published on the bank's website, the EBRD has been involved mainly in financing major projects for transport and infrastructure, as well as investments in local banks and micro finance institutions (e.g. equity and lending for supporting small and medium sized enterprises (SMEs)) and investments in private companies.

Projects that are especially significant for the country are investment in a water supply system in Southern part of the country, investment in modernization of the country's rail infrastructure, and modernization of the airport. The water supply system for coastal municipalities is a joint investment with the World Bank. That region, very important for tourism development, has been experiencing water shortages during summer. Having in mind that tourism is one of the main industries for country's economy, normal water supply is essential for both tourism and local people quality of life. The railway and airport modernization are important as they are key transport links with the rest of the region.

In the coming period, the EBRD operational priorities in Montenegro will be:

- Private corporate sector, especially Montenegrin tourism and property sector, supporting for example construction of low-density tourism facilities, as well as supporting private corporate clients' investments in new technology and environmental improvements;
- Infrastructure projects in connection to tourism or regional development, financed jointly with the World Bank and the EIB;
- Cooperation with financial sector, through support to local banks in form of lending, or cooperation with local banks looking for opportunities to increase market share.

Having in mind the thesis scope, the EBRD activities involving Montenegrin local banks and microfinance institutions are especially relevant. In 2004, the EBRD provided a loan in the amount of 3 million euro for financing micro, small and medium sized businesses in Montenegro through its financial intermediary, the Opportunity Bank⁶⁰. Also in 2004, Alter Modus, a former NGO financially supporting micro businesses and entrepreneurs in Montenegro, and now a microfinance institution, received a 1 million EUR loan from a facility set up by the US government and the EBRD. A year after, in 2005, Alter Modus received an additional 2 million EUR loan for further support of entrepreneurs⁶¹.

Additionally, the EBRD has had successful cooperation with the Euromarket Bank⁶², now merged with NLB Montenegro Bank, in means of equity investment and lending investment. The contract with Euromarket Bank was signed in 2002 and involved two components:

- equity investment up to 1,5 million EUR, making the EBRD a shareholder with up to 20% share in the region;
- revolving lending line up to 3 million EUR, intended for support to small and medium sized enterprises through mid-term loans and stimulate the SME sector growth⁶³.

In terms of environmental requirements, the Euromarket Bank was required to comply with the EBRD requirements, i.e. adopt and implement the EBRD's environmental procedures for local banks, comply with the EBRD exclusion list and report regularly on the environmental issues in connection to its activities, for subloans the requirements remained in realms of national EHS requirements⁶⁴.

Detailed information on the EBRD projects success in Montenegro is not obtainable, so it is difficult to evaluate how the environmental procedures established by the EBRD are proven to be in practice in Montenegrin market. Some general information regarding EBRD's cooperation with the Euromarket Bank were obtained in a phone interview with Mrs Mira Lakovic, who worked as a chief of the department for financing small and medium sized enterprises in Euromarket Bank and was directly involved in work with the EBRD representatives in relation to the EBRD financing line for SMEs which was directed through the Euromarket Bank⁶⁵.

Mrs Lakovic explained that the EBRD was a shareholder of the Euromarket Bank, with an investment of 1 million EUR, or approximately 8% of the capital. As well, the EBRD provided 3 million EUR revolving the financing line for SMEs, with maximal loans in the amount of 250 thousand EUR. At the moment 12 SMEs are financed. After the Euromarket

⁶⁰ EBRD. (2004). "EBRD supports micro and small businesses in Montenegro". EBRD Press Releases. <http://www.ebrd.com/new/pressrel/2004/38march10.htm> [06 September 2008]

⁶¹ EBRD. (2005). "EBRD lends Alter Modus €2 million". EBRD Press Releases. <http://www.ebrd.com/new/pressrel/2005/185dec21.htm> [06 September 2008]

⁶² Euromarket Bank was established in 2000 with 100% foreign capital. In the beginning of 2006 the bank was bought by NLB Bank, and merged with Montenegro Banka (also with NLB as a main shareholder), forming NLB Montenegro Banka.

⁶³ EBRD. (2003). „Project Summary Documents: NLB Montenegrobanka“. <http://www.ebrd.com/projects/psd/psd2002/21042.htm> [07 September 2008]

⁶⁴ EBRD. (2003). „Project Summary Documents: NLB Montenegrobanka“. <http://www.ebrd.com/projects/psd/psd2002/21042.htm> [07 September 2008]

⁶⁵ At the moment Mrs Lakovic works in NLB Montenegrobanka as Chief of Bank's cabinet, which is legal successor of Euromarket Bank, and is responsible for reporting to EBRD regarding the mentioned lending line

Bank was merged with a Montenegro bank, NLB Montenegro Bank became legal successor of Euromarket Bank and the mentioned lending line. EBRD kept its equity investment and increased capital to reach ownership of 8% in NLB Montenegro Bank. Asked to comment on the environmental requirements of the EBRD, Mrs Lakovic pointed out that great attention was given to environmental issues from the EBRD side. However, implementation of the EBRD environmental requirements was not complicated for the bank, as they had well trained staff working on corporate loans, while EBRD consultants were working with the bank's loan officers on identifying potentially important environmental issues in proposed projects (projects for which SMEs applied for lending). However, as SMEs were the target group, the projects were of small scale and there were no projects with significant environmental impacts attached to. Greater attention was given only to one of the financed projects, and that included the production of water based paint. EBRD representatives went to site visits to this facility to make sure waste and waste water are managed properly. On the whole, Mrs Lakovic thinks that the cooperation with EBRD was a valuable experience for the bank, mainly because of the fact that the bank's employees had opportunity to learn from the EBRD experts. NLB Montenegro Bank is managing the lending line today; however, EBRD environmental requirements are applicable only for loans from the EBRD financing line.

Having in mind the total corporate loans of the banks in Montenegro, the share of these EBRD loans is relatively insignificant. Total loan portfolio of EBRD in Montenegro disbursed through its financial intermediaries (NLB Montenegrobanka, Opportunity Bank and Alter Modus) amounts to 9 million EUR (3 million EUR in 2002). On the other hand, according to the information from the Central Bank of Montenegro Chief Economist's reports⁶⁶, already in 2002 total corporate loans approved by national banks were over 99 million EUR. During years the corporate loans have been growing significantly, so in 2006 the total corporate loans were 470 million EUR, and in 2007 1,364 million EUR.

⁶⁶ Available at the Central Bank of Montenegro website:
http://www.cb-cg.org/Publikacije/Publikacije_pdf/GodIzvGIEkonom2003_Monetarni.pdf
http://www.cb-cg.org/Publikacije/Publikacije_pdf/GLEK2007_MONETARNA_KRETANJA.pdf

5 The Montenegrin Commercial Banking

In this section, the Montenegrin banking sector will be described. An overview of the current situation in the sector will be presented, and corporate loans appraisal processes of local banks will be explained more in detail. Information in this section is collected from publicly available materials and studies on the banking sector prepared mainly by the Central Bank of Montenegro, but also from other separately mentioned sources. Information is also gathered by a desktop research of the commercial banks' websites and from interviews conducted with bank representatives, and by reviewing Montenegrin legislation regarding banking sector. Interviews conducted included interviews with professionals from the banking sector, but also economic analysts and local independent environmental experts.

5.1 Montenegrin Banking Sector Characteristics

Montenegro is a small country with an area of about 14,000 km² and approximately 700,000 inhabitants, and consequently it is a small market. Even so, at the end of 2007, 11 banks were operating in Montenegro, which is quite a big number having in mind the market size. All Montenegrin banks are privately owned, and only 5% of the total bank capital was participation of state-owned companies⁶⁷. This is proof of a successful privatization process which was a part of the reforms of the sector in the last years.

The reform of the banking sector started in 2000 with the establishment of the Central Bank of Montenegro (CBOM), with main tasks to establish a healthy banking system, efficient payment systems and to be in charge of the country's monetary policy⁶⁸. The privatization was part of the reforms as well, resulting in the above mentioned 'banks' ownership structure.

In interview with Mrs Krsmanovic, an economic analyst, the overall situation and recent developments in the Montenegrin banking sector were discussed. It was stressed that today banking business in Montenegro is highly competitive with 11 banks operating in the market, but the banking sector is also characterized with modern regulation greatly adjusted to the European and international standards and fast development. During last years, development of the Montenegrin banking sector was noticeable and answered to the needs of the business sector and the whole economy. As an illustration, in the year 2007 in comparison to 2006, rapid growth of the core banking operations volume occurred: total loans rose by around 165% (corporate loans by almost 190%) and the deposits by 94% (corporate deposits by approximately 107%)⁶⁹.

The complete list of banks operating in the country is the following:

⁶⁷ EBRD. (2008). Montenegro Country Factsheet. <http://www.ebrd.com/> [05 July 2008]

⁶⁸ Official Gazette "Sl.list RCG" no 47/01.(2001). Law on the Central Bank of Montenegro. <http://www.cb-cg.org/> [08 August 2008]

⁶⁹ Attained from the source: The Central Bank of Montenegro. (2008). Overview of Banks in Montenegro. http://www.cb-cg.org/Publikacije/Publikacije_pdf/GLEK2007_MONETARNA_KRETANJA.pdf [09 August 2008]

Table 1 List of banks operating in Montenegro⁷⁰

Name of the bank	Ownership / main capital source	Market share by loans (in %) end of 2007	Market share by deposits (in %) end of 2007
Crnogorska komercijalna banka AD	Private / foreign	32%	40%
Prva banka Crne Gore	Private / domestic	18%	20%
Hypo Alpe-Adria Bank	Private / foreign	16%	5%
NLB Montenegro banka	Private / foreign	14%	13%
Podgoricka banka	Private / foreign	6%	6%
Opportunity Bank	Private / foreign	4%	6%
Atlasmont bank	Private / foreign	4%	5%
Hipotekarna banka	Private / foreign	3%	2%
Komercijalna banka AD Budva	Private / foreign	2%	3%
Invest banka Montenegro	Private / foreign	0%	0%
First Financial Bank	Private / foreign	0%	0%

As presented in the list, only one bank is for the most part in the ownership of domestic shareholders (Prva banka Crne Gore). The other banks have foreign capital, and the owners are mainly banks groups from developed countries, for example EU countries Hungary (Crnogorska komercijalna banka, a part of OTP Group), Slovenia (NLB Montenegro banka, part of Nova Ljubljanska Banka), and France (Podgoricka banka, part of Societe General Group), etc.

The banks from more developed countries brought in new capital, new modern business rules and fostered development of the financial sector in Montenegro. Furthermore, the Central Bank of Montenegro legislation is significantly harmonized with the legislative trends in developed countries, particularly EU. These two factors together with the raising demand from the business side enhanced the development of Montenegrin banking sector in recent years. However, not all modern trends are accepted in Montenegrin banking: the importance of environmental issues for the society as a whole, and consequently business and citizens as

⁷⁰ The list is from the source: The Central Bank of Montenegro. (2008). Overview of Banks in Montenegro. <http://www.cb-cg.org/> [09 August 2008]; The information on market shares and ownership structure is a result of a desktop analysis of relevant banks' websites.

banks' clients don't include environmental issues as well as roles the banks can play in this matter. This will be elaborated more in detail in the following parts of the section.

Even though two stock markets operate in the country, "the overall contribution of equity markets to economic development remains small"⁷¹. Therefore, Montenegrin commercial banks are especially significant for the country's economy: the capital market is not considerably developed. Although there are some leasing companies operating in the country, there are no noteworthy investments in investment funds, social security funds or other financial institutions.

5.2 Credit Management in Montenegrin Commercial Banks

In order to find out about loan appraisal practices and procedures in local banks, a series of interviews was conducted with professionals involved in Corporate Banking business and dealing with Risk Management.

During the interview with Mrs Mitrovic, whose working experience is within Corporate Banking business, the loan appraisal process in local banks was explained in detail. The Corporate Banking department has a role of a front-office for corporate clients (enterprises and organizations): communication and negotiations with the clients, and preparation of the documentation needed for the loan application and assessment of the client. The documentation necessary for the application is mainly consisting of annual and interim reports (balance sheets, profit/loss reports, cash flow reports, reports on changes in equity, and similar) and business plans for activities for which the loans are requested. The business plans consist of descriptions of planned activities, time frames, expected turnover and profit and expected cash flows. The assessment is usually done by conducting financial analyses in respective departments (typically the Market Support department). The assessments are based on financial results achieved in previous years and corresponding data from the business plans, primarily future cash flows in order to evaluate the client's ability to pay its liabilities to the bank on time. The final decision on the approval of the loan is done by the Credit Committee consisting of Corporate Banking representative, Market Support representatives and the bank's senior management representatives if necessary (depending on the amount of the loan requested). The final decision is influenced by the banks' main strategic direction: if the emphasis is put on the growth in business volumes and number of customers, the taken risks limits will be lower and loans could be approved even to clients with potential solvency problems. However, if focus is primarily on profitability, only high rated clients will get financing from banks. The risks determined in connection to a loan are reflected in prices charged from clients, i.e. higher risks imply higher interest rate to compensate for potentially higher losses banks can have. Monitoring is basically conducted for loans related to specific projects, and rarely for working capital loans. In latter case, monitoring consist of for example reviewing invoices of clients suppliers (when loan is used for paying suppliers). In case of bad or non-performing loans (loans that are not repaid on time and usually are over due 150 days or longer), banks can call in collaterals, given by clients as a guarantee for loan repayment. By selling collaterals (usually assets such as real estate or shares of another company) banks can compensate for non-repaid loans.

According to the Central Bank of Montenegro regulations, minimal standards for credit risk management of banks are prescribed. In the CBOM's Decision on classification of banks

⁷¹ EBRD. (2008). Montenegro Country Factsheet. <http://www.ebrd.com/> [05 July 2008]

assets, provisions and reserves for credit losses⁷², rules for classification of clients in categories according to credit risks to which banks are exposed when approving loans or similar products to these clients are fixed. Every loan is classified according to the following set of criteria:

- Ability of the client to pay its debts to the bank on time, which is assessed by analysis of the following indicators for the period of at least 3 years before the loan is approved and during the period till the loan is matured / repayed:
 - Profitability and cost effectiveness,
 - Liquidity,
 - Debts,
 - Past and future cash flows,
 - If the client was regularly paying its debts to the bank and other creditors in past,
- Assessment of the collaterals' quality, having in mind the collaterals net value (the amount of money the bank can get by selling the collateral or realising it on some other way less the costs of the realisation on the market) and time needed for the realization;
- Other relevant factors, especially:
 - Information on overall economic situation, and information on the situation in the business sector of the client,
 - Information on debt concentration in certain business sectors and certain group of loan users (as there are legal limits in terms of the banks' exposures to certain business sectors, i.e. share of loans approved to certain sectors compared to total loans),
 - The client's market position, ownership structure and status changes,
 - Ability of the client's management to accomplish programmes for which loans are requested,
 - Compatibility of purpose of the loan and industry in which the client operates;
 - Consistency of the loan approval with policies and procedures of the bank.

Depending on the the probability to realize losses, assessments are based on the above mentioned criteria, the banks categorize loans in one of five groups: A-E, where in A group are loans to top clients for which the bank expects total repayment, and in E group are loans to clients for which the bank expects 100% loss. Groups B and C are divided to subgroups B1-B2, and C1-C4, accordingly. The classification has to be done every month, so loans at the beginning classified for example as B or C, can be reclassified as D or E, depending on the

⁷² Official Gazette of Republic of Montenegro no.59/07. (2007)' Central Bank of Montenegro Decision on classification of banks assets, provisions and reserves for credit losses". 5 October 2007.

ability of the client to repay the loan in timely manner and in total according to the agreed repayment plan.

According to the classification of the loans from their portfolio, banks have to make reserves for potential credit losses arising from the loans and other receivables for which banks are exposed to credit risk:

Table 2 Classification groups for credit risk provisions calculation⁷³

Classification Group	Risk Provisions (per cent of the loan or receivable)
A	1%
B1	3%
B2	8%
C1	20%
C2	30%
C3	40%
C4	50%
D	75%
E	100%

In the calculation of the risk provisions, banks are allowed to deduct the amount of cash collaterals and the amount of receivables unconditionally guaranteed by the countries or central banks from OECD countries, or top rated banks from loans on which they calculate the provisions for potential losses.

After classifying the loan portfolio and deducting allowed items from the loans, banks calculate the provisions for potential losses by multiplying the prescribed percentage with the amount of the loan and show in their reports as expenditures on one hand and reduction in total loans on the other hand. So, even if the loss has not occurred as yet and there is a possibility that the loss will never occur, the banks are obliged to show it in their reports and the provisions affect their profits immediately. For investors and shareholders, it is an indication of how risky the investments made by the bank are. It is the responsibility of the management of the bank to make sure that only loans with which the bank is not exposed to high risks are approved.

⁷³ Official Gazette of Republic of Montenegro no.59/07. (2007)“ Central Bank of Montenegro Decision on classification of banks assets, provisions and reserves for credit losses”. 5 October 2007

This decision prescribes minimum criteria for credit risk exposure and credit risk provisions. However, compared to other countries, especially within the EU, and international standards in regards to risk provisions (namely International Financial Reporting Standards, IFRS), the rules are quite strict.

Issues included in the interview with Mrs Ljumovic, whose expertise is within banking risk management, were internal local banks' risk management systems, the Central Bank of Montenegro regulation in this respect, and the overall market situation in the country, as well as environmental risks attached to loan business of local banks. According to Mrs Ljumovic, local banks, especially banks that are part of multinational banking groups, have established internal credit risk management systems that are based on sound banking principles and good banking business practices of the mother banks. The assessment of corporate clients' loan applications and potential risks associated with the loans is based not only on so-called "hard facts" (financial indicators, such as result from previous years, balance sheet and profit&loss statement analyses, and other financial indicators), but it includes a whole range of "soft facts" - all additional information on a client that is relevant for the risk assessment. Soft facts include personal assessment of banks' responsible personnel on a potential client's solvency based on its business plan, projected future cash flows, market share, management structure and management team, its reputation on the market, presentation of the business plan etc. Loan officers are responsible for collecting all necessary information on clients in order to enable credit committees to come up with informed decisions. Primarily in accordance to the regulation adopted by the CBOM (e.g. the decision on risk provisions for banks' assets, which include loans), but also good banking practice and international standards, the Montenegrin commercial banks assess financial risks associated with their clients' businesses and their ability to repay the loans. Based on the assessment, banks create reserves for potential losses from the loans given to clients. These reserves are shown in the banks' books and financial statements and directly influence their financial results. The investments that assume more risks demand higher reserves and consequently the profits are lower. According to the CBOM's decision, the risk assessment has to be based on number of factors, such as clients' financial performance ("hard facts") but also other factors, for example the overall market situation, the clients' market share and similar. However, in practice the regulatory assessment is based predominantly on hard facts, i.e. financial data. In addition, the provisions on potential credit losses are quite strict and anticipated risk much higher than it is proposed by relevant international standards. In this respect the view of the Central Bank of Montenegro is quite different from the view of local commercial banks.

Mrs Ljumovic also commented on the corporate portfolio of local commercial banks. Certain loans are intended to be used as working capital, however mainly corporate loans are connected to specific projects. In each individual case, banks have to know the purpose of the funds and establish appropriate monitoring. For example, if a loan is approved for construction of a building, the funding will be provided in tranches, i.e. the client will receive first tranche to finance land buying and other activities necessary to get required permits, however, future tranches will depend on the presentation of the permits to the bank. Clients usually get a certain time limit in which they are required to ensure necessary permits. As well, tranches are approved separately for different phases in the construction, so the bank makes sure the funds are used for the purpose for which the loan is approved. Monitoring includes site visits by banks' personnel as well as reviewing financial reports that clients are obliged to submit periodically in the loan life span.

Asked to comment on EBRD credit management policies and procedures, specifically in relation to environmental risks management, Mrs Ljumovic pointed out that EBRD operates in significantly different conditions. Namely, even if EBRD operates on the same market, it is

a development bank and its operations usually include cooperation with local governments, i.e. for its operations EBRD usually has certain guarantees from governments of the countries in which it operates. Practically it means significantly lower level of risks associated with its operations. On the contrary, local banks don't have these kinds of arrangements and have to secure their investments with other collaterals. Even though the market is the same, the business conditions for EBRD and commercial banks are significantly different. In regards to environmental risks to which local commercial banks are exposed, the interviewee thinks that at the moment there are no significant environmental risks arising from loan business of local commercial banks. Based on banks' clients' profiles, new businesses developing in Montenegro are mainly connected to not highly significant environmental impacts, such as tourism, construction (buildings and tourism facilities), small scale production, and similar. These companies are mainly clients of the local commercial banks. Major polluters in Montenegro are a few old large industrial facilities (such as an aluminium plant, a thermal power plant, and a steel mill) , and according to the law these companies have a time limit within which they have to bring up their environmental performance to a higher level and modernize their facilities. Local commercial banks operate in highly competitive market and don't have enough power to influence their corporate clients to perform better than required by the legislation. However, having in mind that Montenegrin laws are greatly harmonized with corresponding EU legislation, bringing corporate clients' environmental performance to a high level is a matter of good implementation of laws, i.e. it depends on efficiency of responsible governmental organs and agencies.

5.3 Environmental Legislation in Montenegro

In this section, a brief overview of the Montenegrin environmental legislation will be given. The aim is to illustrate whether local banks' corporate clients will be exposed to increased pressure and requirements arising from stricter legislation and regulation in regards to the environment, and therefore indirectly influence risks exposures of the banks.

On September 20, 1991 the Parliament of Montenegro adopted the Declaration on Montenegro Ecological State which defines its ecological nature. A year after that, on October 1, 1992 Article I of the Constitution of Montenegro stipulated "Montenegro is an ecological state". Unfortunately, in the following years the work on the appliance of the principles of sustainable development was put aside due to different happenings from recent country's history such as the 1990s war, an economic crisis, the international community sanctions, and a political crisis. In recent years, work on a national strategy on sustainable development took place and a whole set of laws and bylaws regarding the environment protection were adopted. However, probably due to lack of institutional capacities, the implementation of the laws is planned for 2008.

An interview with Mrs Markovic, an independent environmental expert from Montenegro, gave insights in the legal and administrative framework in which Montenegrin governmental environmental policy is implemented. As Mrs Markovic explained, the Ministry of Tourism and Environment (MTE) has a main role in formulating and implementing Montenegrin environmental policy. The Ministry supervises institutions that are involved in environmental monitoring: Hydro-meteorological Institute and Centre for Eco-Toxicological Research, and nature protection: the National Parks of Montenegro. Furthermore the Ministry will perform administrative supervision over the soon to be established Environmental Protection Agency (EPA). EPA will have executive power and be responsible for environmental management and will perform monitoring and reporting, environmental permitting and inspection and communication. On the other hand, the Nature Protection Institute, an authority responsible for designation of natural objects and protected areas and biodiversity monitoring is under the

administrative supervision of the Ministry of Culture, Sports and Media. Water management and forestry are under the competence of Ministry of Agriculture, Forestry and Water Management, while chemicals are under the competence of Ministry of Health, Labor and Social Affairs. Finally, physical planning, construction and energy are the responsibility of the Ministry of Economic Development. Clearly, environmental issues are divided within the competences of different ministries. In addition, the competences are not always clearly defined, coordination is insufficient and there is lack of capacities. All these factors have a negative effect on the implementation of the country's policy.

Mrs Markovic pointed out that the environmental legislation developed and adopted during the last few years was harmonized with the relevant EU legislation to a great extent, in particular with horizontal legislation⁷⁴ (covered by Law on Environment, Law on Strategic Environmental Impact Assessment and the Law on Environmental Impact Assessment and the set of relevant secondary regulations)⁷⁵, air quality, water quality and chemicals legislation. Efforts have been made to integrate environmental considerations in other policies. Strategic master plans on water supply, waste and wastewater have been adopted in 2004 and 2005. In 2007 the National Strategy on Sustainable Development was adopted. A national Waste Management Plan is adopted in 2008. Formulation of strategies on biodiversity and climate change (under relevant UN Conventions: Rio Convention on Biological Diversity and the UN Framework Convention on Climate Change (UNFCCC)) is in process. A National Programme for Integration of Montenegro into the EU 2008 – 2012⁷⁶, considering inter alia environmental issues has been finalized and adopted in June 2008.

The list of Montenegrin laws regulating environmental issues is quite extensive and among others includes the following:

- The Law on Environment (2008),
- The Law on Strategic Environmental Assessment (SEA) (2005),
- The Law on Environmental Impact Assessment (EIA) (2005),
- The Law on Integrated Prevention and Pollution Control (IPPC) (2005),
- The Law on Nature Protection (1989; outdated, new law is drafted to be adopted in 2008),
- The Law on National Parks (1994),
- The Water Law (2007),
- The Waste Management Law (2005),

⁷⁴ “The horizontal sector comprises environmental legislation on subjects that cut across other environmental legislation and the environmental media such as water, air or soil. In contrast to the media-related legislation, the horizontal legislation is procedural in character and provides for methods and mechanisms aimed at improving decision-making, legislative development and implementation.” Source: Berglund, Maria and von Raggamby ,Anneke. (2007). “Horizontal Environmental EC Legislation - A Short Policy Guide”. European Commission – Environment. http://ec.europa.eu/environment/enlarg/pdf/pubs/horizontal_en.pdf [13 September 2008]

⁷⁵ Government of Montenegro. (2008). “Draft: National Program for Integration of Montenegro into the EU (NPI) for the Period 2008-2012”. <http://www.vlada.cg.yu/biblioteka/1209999711.pdf> [01 September 2008]

⁷⁶ Government of Montenegro. (2008). “Draft: National Program for Integration of Montenegro into the EU (NPI) for the Period 2008-2012”. <http://www.vlada.cg.yu/biblioteka/1209999711.pdf> [01 September 2008]

- The Law on Air Quality (2007),
- The Law on Protection from Noise in the Environment (2006),
- The Law on Chemicals (2007),
- The Law on Forests (2000).

The Law on Environment⁷⁷ stipulates that the country modulates its economic and social development with the environment protection principles and prescribes basic principles and objectives of environmental protection, defines general guidelines for environmental protection measures, instruments for environmental management and other relevant issues. A new framework law on the environment fully harmonized with relevant EU legislation was adopted in July 2008, as the old law was not harmonized with EU standards, especially in regards to access to information and public participation. The new law, inter alia, regulates environmental protection measures for projects for which an EIA is not mandatory, access to information, public participation and access to justice in environmental matters, and will prescribe requirements for environmental monitoring and information system.

The Law on Strategic Environmental Assessment (SEA)⁷⁸ was adopted in 2005 and came into force in 2008, prescribes full procedure for assessment of environmental impacts of certain plans and programmes through integration of principles of environmental protection into procedures for preparation, adoption and implementation of plans and programs that have significant impact on the environment. The Law is aligned with the EU Directive 2001/42/EC. In accordance to the law, SEAs are mandatory for plans and programmes that could affect protected areas, natural habitats and wild flora and fauna, plans and programmes for agriculture, fisheries, forestry and water management etc. but can be obligatory for other plans and programmes as well, depending on the nature of the potential impacts.

Having in mind the purpose of the thesis, Mrs Markovic pointed out, that among new laws especially relevant for businesses and therefore indirectly relevant for banking business are the Law on Environmental Impact Assessment⁷⁹ and the Law on Integrated Prevention and Pollution Control⁸⁰.

The Law on Environmental Impact Assessment (EIA) was adopted in 2005, while the implementation started in 2008. The law sets up procedures for assessing environmental impacts of projects that can have significant impact on the environment, contents of the EIA study, responsibilities of the interested parties, and the government, public participation, procedures for evaluating EIA studies and issuing approvals, notification of other states in case of projects with potential transboundary effects and similar issues. The following bylaws are adopted in order to prescribe more detailed rules and enable the implementation of the law:

⁷⁷ Official Gazette of Republic of Montenegro "Sluzbeni list RCG" no.48/08. (2008). "Zakon o životnoj sredini" (Law on the Environment). Podgorica

⁷⁸ Official Gazette of Republic of Montenegro "Sluzbeni list RCG" no.80/05. (2005). "Zakon o strateskoj procjeni uticaja na životnu sredinu" (Law on Strategic Environmental Assessment). Podgorica

⁷⁹ Official Gazette of Republic of Montenegro "Sluzbeni list RCG" no.80/05. (2005). "Zakon o procjeni uticaja na životnu sredinu" (Law on Environmental Impact Assessment). Podgorica

⁸⁰ Official Gazette of Republic of Montenegro "Sluzbeni list RCG" no.80/05. (2005). "Zakon o integrisanom sprjecavanju i kontroli zagadjivanja životne sredine" (Law on Integrated Prevention and Pollution Control). Podgorica

- Decree on projects subject to EIA (2007);
- Rulebook on content of documentation to be submitted together with request for determination on the need for EIA (2007);
- Rulebook on content of documentation to be submitted together with request for determining the EIA scope and contents of the EIA study (2007);
- Rulebook on content, form and a way of keeping the public record on actions and decisions on EIA (2007); and
- Rulebook on contents of the EIA study (2007).

The EIA law and the related bylaws are harmonized with the relevant EU directive on environmental impact assessment for certain public and private projects (EU Directive 85/337/EEC and the amendments 97/11/EEC and 2003/35/EC).

According to the law, for projects that possibly will have significant impact on the environment, identification and assessment of the impacts has to be conducted prior to the project approval. Impacts that have to be identified, described and assessed include direct and indirect impacts on: a) human life and health, flora and fauna; b) soil, water, air, climate and landscape; c) material assets and cultural heritage; and d) interactions between these elements. The EIA is conducted for projects in industry, mining, energy, transport, tourism, agriculture, forestry, water management, municipal environmental infrastructure, for all the projects in nature protected areas and all the projects in the vicinity of immovable cultural monuments. Project owners bear all the costs connected to the EIA, public consultation and information disclosure, as well as the costs of the Committee for Impact Assessment. The Committee is appointed by the responsible governmental body and in charge for determining the scope of EIA and assessment of the study.

The Decree on Projects subject to EIA contains lists of projects categories for which the EIA is mandatory and projects categories for which an EIA may be required, depending on project characteristics, project location, and potential impacts. Thresholds are prescribed where applicable. Mrs Markovic noticed that although generally consistent with relevant EU regulation (Annex I and Annex II of the EIA Directive), certain thresholds set in the Decree are stricter than in the EU legislation, for example for certain projects in agriculture. According to the Decree, changes and expansions in already approved projects may be subject to a new EIA, depending on their potential for significant adverse environmental impact.

Authority for conducting the EIA procedures (making decisions on the need for EIA, the scope and content of the EIA study, evaluation of the quality of the study and issuance of approval or rejections of projects) is the state administration body responsible for environmental protection for projects for which other approvals and/or permits are issued by other administration bodies at the national level. At the moment, this body is Ministry of Tourism and Environment. Local self-government organs responsible for environmental protection are in charge for other projects in this respect.

The EIA law and the rulebook on the content of the EIA study prescribe that for all identified adverse environmental impacts, measures for prevention, elimination, mitigation or remedy are included and detailed in the study. Project sponsors bear costs for preparation of the EIA study and are responsible for implementation of all mitigation measures identified in the study. A competent authority is responsible for monitoring. Issuing of operational permits depends

on the verification by the competent authority that all mitigation measures included in the study are being implemented. In addition, public information disclosure on the EIA procedure is a requirement in all stages:

- screening stage, when decision on the need for EIA is made,
- scoping, when decision on the scope and content of the EIA is made,
- decision making phase (approval or rejection of the project).

A public hearing, organized by the competent authority is required for the EIA studies.

Recently in Montenegro many construction projects took place (ranging from residence buildings to large tourist complexes). Mrs Markovic was asked to comment on what control mechanisms were put in place in relation to those projects to ensure that only projects that are in accordance to the abovementioned regulations are implemented. Mrs Markovic explained that construction or reconstruction (in case of changes in the size of the particular object) of facilities requires obtainment of three permits: location, construction and operation permits.

The location permit is a document allowing the holder to obtain other permits and consents necessary for carrying out works at the particular location. The permit is issued based on the relevant urban plan and it specifies type and purpose of object or works to be performed. The permit comprises urban and technical conditions that include information such as: maximum allowed capacities of the object, site plan, horizontal and vertical outlines of the object, seismic parameters, connections to infrastructure, etc. as well as environmental protection requirements.

Construction permits are issued by the responsible state administration body (currently Ministry of Economic Development) for facilities in the areas covered by state planning documents and those that are of determined to be of national importance, such as large industrial installations, fuel storage tanks, all types of infrastructure, landfills and installations for treatment of solid and hazardous wastes, as well as commercial and residential buildings with a surface of more than 1,000 m² or more than 4 floors. For other facilities, construction permits are issued by local authorities. In order to obtain construction permit, a project proponent must present the following documents to the relevant authority: location permit, main project with urban consent, technical verification that the main project meets requirements of relevant regulations, proof of ownership or other types of rights over the construction land, proof that related fees and charges have been paid, and consents, approvals and other relevant documentation required by regulations, including water use consent and environmental consent (an approved EIA for project subject to environmental assessment, and other consents).

Operation permits are issued after a technical assessment of the constructed object is performed, if the assessment shows that the object is constructed in compliance with the construction permit, main project and other relevant documentation. Before technical clearance of the facility is made and operation permit issued, it has to be verified that mitigation measures defined in the EIA study have been implemented and that water permit has been obtained.

Mrs Markovic pointed out that even though in charge of different ministries and other governmental bodies, permitting procedures for construction projects under Montenegrin legislation provide controlling mechanisms and make safe that only projects that get

environmental approvals based on the accordance to the above mentioned regulations are being granted with necessary consents, permits and approvals for implementation. In similar way, consideration of environmental regulations are incorporated in other permitting procedures in Montenegro, making sure that investors can not get permits without complying with environmental regulations.

The Law on Integrated Prevention and Pollution Control (IPPC)⁸¹ regulates environmental pollution prevention and control through integrated permits for facilities and/or activities that may have a negative impact on human health, the environment or material resources. Mrs Markovic pointed out that the permitting system is set down to prevent or to reduce emissions to air, water and soil, including measures concerning waste, efficient energy consumption, reduction of noise and vibrations, use of raw materials, prevention of accidents, and risk assessment. The system is based on the concept of best available technique (BAT). Inter alia, following bylaws were adopted in 2008 under the IPPC law: the Decree on types of activities and installations subject to integrated permits; the Decree on criteria for determining best available techniques, for application of quality standards and for determining limit emission values in the integrated permit; and the Decree on content of the program of measures for adjusting the existing activities or installations to prescribed conditions. Mrs Markovic pointed out that under the regulations existing installations are required to comply with the IPPC requirements by 2015 and that an inventory of IPPC installations has not been completed yet.

As a concluding remark, Mrs Markovic stated that the legislative basis for environmental issues in Montenegro is solid and to a great extent up to date with European standards. However, the implementation greatly depends on institutional capacities and it is still not clear if the implementation will be on satisfactory level and what are the practical outcomes of the laws. Governmental bodies have been experiencing a lack of well trained professionals in previous years, but lately certain progress has been made in improving capacities by employing more staff and working towards their education. Another issue is work on preparing bylaws that are still to be adopted, such as regulations related to the BAT. One of the key issues is the Environmental Protection Agency and its staffing as the Agency will be authorized and responsible for broad set of environmental issues.

5.4 Environmental Considerations in Montenegrin Commercial Banks

Desktop research of the corporate product portfolio offered by Montenegrin commercial banks show similarities in the product portfolios between banks, i.e. banks in Montenegro offer similar products to their clients: short and long term loans for purpose of working capital or specific projects financing. For all loans different types of collaterals can be required: land, buildings, or even securities, and in some cases guaranties from other banks. The information presented is quite general in most cases. The reason for this can be individual treatment of each corporate client in banks in terms of credit conditions offered, depending on eventual clients' previous cooperation with the bank. Some banks cooperate with governmental agencies and funds and offer loans for projects in agriculture, tourism, food production, energy, IT, usually for small and medium sized enterprises.⁸² These activities are

⁸¹ Official Gazette of Republic of Montenegro "Sluzbeni list RCG" no.80/05. (2005). "Zakon o integrisanom sprjecavanju i kontroli zagadjivanja zivotne sredine" (Law on Integrated Prevention and Pollution Control). Podgorica

⁸² More information available at Prva banka Crne Gore website: <http://www.prvabankacg.com/index.php?strana=proizvodniiusluge&tip=2&id=31> and Development Fund of the Republic of Montenegro website: <http://www.fzrcg.cg.yu/>

mainly aiming at fostering SMEs development, and do not target directly environmental issues.

There are no environmentally related corporate products explicitly offered by the banks on the websites. Possible reasons are a too small market for environmental products or the absence of environmental awareness on the banks' side.

Desktop research results also show the absence of considerations of direct environmental impacts in local commercial banks' websites, i.e. internal environmental management systems are not mentioned in the banks' presentations. There are some individual cases of environmentally related activities, such as the Partnership for Sustainability, a joint initiative between the United Nations Development Programme (UNDP) office in Montenegro, a local mobile telecom company and a local bank. The aim of the initiative is to demonstrate the potential for energy savings in selected companies' buildings, i.e. to promote energy efficiency and therefore to support the Ministry for Economic Development's efforts in that direction. Also, involvement in the National Council for Sustainable Development is another example of environmentally related engagement of local banks.⁸³ However, this information is obtained from other sources and not from the bank's website.

In the interview with the banking risk management specialist, Mrs Ljumovic explained that in the client appraisal all additional factors that are not strictly related to the current financial performance of the clients are taken into account as well, provided that the bank is aware of them. The interviewee stated that although environmental risks are not explicitly mentioned, they are most likely taken into account as risks that a client will not comply with the legal requirements. An example given is a loan provided to a company which is in business of spring water extraction and bottling. A local bank has provided a loan to the company for the business start-up. According to the regulations, the company has to renew its permit for the extraction and bottling. The permit confirms that the water is of satisfying quality and that all necessary sanitary measures are in place. As the banks' representatives are aware of the provisions regarding permitting, the company has to report to the bank on the permit renewal. It is a part of the monitoring activities set up by the bank in order to manage its risks.

⁸³ Promonte Media Center - News.(2008). "Partnership for Sustainability (05 March 2008)".
http://www.promonte.com/eng/about_us/media_center/news [26 August 2008]

6 Findings and Analysis

6.1 Analysis of Current Situation in Montenegrin Commercial Banks' Corporate Lending: Credit Management and Environmental Considerations

In order to analyze current corporate lending practices in Montenegrin commercial banks, the scheme presented in the Section 2.3 in Chapter 2 (Weber, Fenchel, Scholz, 2008) and a scheme created by Guo (2004, p.64) will be used for constructing a framework for analysis, as shown in Table 3.

Table 3 Current credit management practices in Montenegrin commercial banks

Corporate credit management segment	Corporate credit management phase	Risk management phase	Current practice in Montenegrin commercial banks	Environmental risks considerations	Findings
Pre-lending	Rating	Risk identification	Risks identified based on “hard facts” (clients’ current financial performance) and “soft facts” (clients’ expected future financial performance, management credibility, market share, reputation on the market and other factors important for a client’s creditworthiness identified by banks’ personnel)	Environmental risks explicitly not mentioned or assessed; environmental issues implicitly incorporated through assessing clients’ compliance with legal requirements (e.g. if a client has all necessary permits)	Lack of environmental indicators in corporate clients’ credit rating
On lending	Costing	Risk evaluation	Internal systems for evaluation based on findings of risk identification phase	Implicitly through risk of clients’ legal incompliance	Lack of environmental risks inclusion in overall risk evaluation
	Pricing	Risk controlling	Evaluated risks reflect in price offered to clients to an extent	Environmental risks not explicitly included in pricing	Lack of environmental risks consideration in pricing
Post-lending	Monitoring		Monitoring only during loan disbursement in case of projects financing; monitoring for working capital loans not common	Implicitly, checking legal compliance of clients	Lack of environmental risks monitoring and prevention
	Work out		Corrective measures such as calling in security on a loan and subsequently selling it to cover losses.	No	Banks unaware of credit defaults due to environmental risks

Montenegrin commercial banks do not separately consider environmental risks in the overall credit risk assessment. Moreover, it is understood that environmental risks are primarily connected to legal compliance of the clients, which is in competence of governmental authorities. Also, it seems that banks' perception is that new businesses development in the country is not in industries associated with high environmental risks. Banks' corporate clients developing new businesses mainly in service sector, tourism, construction, production of small scale. On the other hand, old companies known as biggest polluters in the country have legally set time limits to bring their operations, i.e. their environmental performance to a certain level. Since the grace period is up to 2015, the general understanding expressed in the interviews is that there is enough time for banks to adjust their business with these companies accordingly. This can be a reason for lack of interest for environmental issues demonstrated by Montenegrin commercial banks and low awareness on possible roles of banks in efforts towards sustainable development.

The other reason, as mentioned in one of the interviews, is the high competitiveness in the Montenegrin banking sector, which can imply low negotiation powers of commercial banks: it can be that individually banks are not powerful enough to require from their clients performance better than required by the law or other banks. Additionally, if the banks put requirements on their clients higher than required by law and/or higher than other banks' requirements, they can lose their potential clients or reduce market for their products, since some potential clients will not be able to meet these additional requirements.

In one of the interviews, it is stated that although environmental risks are not explicitly mentioned, they are most likely taken into account as risks that a client will not comply with the legal requirements. However, if banks don't explicitly identify and assess environmental risks in connection to their corporate lending activities, and identification and assessments always include loan officers personal judgements, most likely environmental risks are not sufficiently covered in the process of clients' legal compliance assessments. This is especially critical currently, in year 2008, in the situation where a whole set of new environmental legislation previously adopted came into effect. It would be beneficial for the banks to analyse and manage the credit risks more carefully by putting special attention to environmental risks. As pointed out in an article of Frank Card, good credit management is far more than debt collection: "good credit management... finds the right customers, exploits the sales potential, protects the balance sheet, contributes across the business and delivers the cash"⁸⁴. Obviously, in order to make proper business decisions, complete information has to be available to management, and that is not possible without taking into account all factors potentially influencing the business, not only economic indicators, but also explicitly social and environmental factors as well: consequently these factors transform to the financial results. This would not mean necessarily going beyond compliance with legal requirements, but as mentioned, would ensure proper tracking of all risks connected to banks lending activities.

Practical consequences of the implementation of the new laws that are harmonized with EU legislation are yet to be seen. However, banks should prepare for the new conditions by working on more detailed risk management procedures: in loan appraisal process and monitoring, environmental risk assessment should be done separately and include checking the permits, as well as take into account if there is need for the EIA for a specific project. This will most likely require additional capacities in the banks.

⁸⁴ Card Frank. (2008). EOS Congress 2007. Credit Management, 36-37.

The author sees as additional reason for banks' inactivity in environmental issues, a lack of pressure from the public. Pressures from the public (e.g. NGOs) are mainly directed to companies, while banks are still "in the shadow". However, in the near future, the pressure can be transferred from banks' clients to banks as well, and the banks' reputation can be in danger. This is however still not considered adequately by them.

As a conclusion, internal credit rating systems which would include environmental risks considerations in credit rating are needed, but instruments for dealing with environmental risks in other phases of credit management are also needed. It is already mentioned that even for European banks, which consider environmental risks in their credit risk management (Weber, Fenchel, Scholz, 2008), the costing phase is most critical as banks are not fully aware of potential losses (credit defaults) that are resulting from environmental risks. Systematic and quantitative approach to include these risks in the process is still lacking. This is especially true for Montenegrin commercial banks which do not consider environmental risks separately. Additionally, not only that environmental risks are not adequately considered, but potential environmental benefits or environmental enhancements in the projects are as well out of the scope of analyses connected to credit management.

6.2 Analysis of EBRD Lending Practices: Credit Management and Environmental Considerations

EBRD is involved in numerous international environmental initiatives. Apart from that, its environmental mandate is to promote high environmental standards, on the level of the EU standards, in all countries of operations. EBRD is owned by 61 states, and it has a steady capital base. However, similar to any other commercial bank, EBRD participates in financial markets in order to find necessary funds for financing of its lending and equity business activities. In one of the interviews, it was pointed out that even if the EBRD operates in unstable markets, it has conservative policies and procedures which save the bank from a high risk exposure (for example, by getting guarantees from local governments, EBRD avoids great deal of risks connected to certain lending activities). The information on the profits of the bank in previous years is an indication of how environmentally sound business practices can be highly profitable as well.

EBRD's environmental work is organized in a systematic way, with clearly delineated responsibilities. An example for this is cooperation between the Operation Leader and the Environment Department. There are environmental components incorporated in all activities in the loan appraisal and monitoring process. Each activity or operation is screened for its environmental performance, and the results are compared to predetermined criteria. In this way, the decision made is based on adequate information. Environmental risks are analyzed in detail. However, in some cases costs of the assessment of environmental impacts related to a project or activity can be quite high. According to EBRD policies and procedures, clients cover these costs. It can be said as well that due to its profile, reputation and position in the regional market, EBRD has quite high negotiation powers, while this is not necessarily the case with commercial banks.

In the following table, EBRD corporate lending practices will be analysed focusing on practices recommendable for improvement of Montenegrin commercial banks' corporate credit management:

Table 4 EBRD credit management environmental practices

Corporate credit management segment	Corporate credit management phase	Risk management phase	EBRD environmental practice	Recommendations for national commercial banks and possible issues
Pre-lending	Rating	Risk identification	Initial environmental screening; preliminary assessment of env.risks and rejection of projects from the exclusion list; identification of necessary additional environmental information	Adopt exclusion lists based on EBRD and similar lists; develop simplified procedures for initial environmental risks assessment (procedures can be based on national legislative as well)
On lending	Costing	Risk evaluation	Compliance checks and site visits; further investigations and environmental experts review for medium and high env.risk projects; result is final environmental report	Adopt procedures for dealing with projects that are connected with medium and high environmental risk: define information and documentation required from clients in order to evaluate compliance; lack of developed internal system for environmental risk evaluation possible issue
	Pricing	Risk controlling	Apply environmental conditions to credit agreement, based on recommendations from ED	Define procedures and responsible persons for applying environmental conditions to credit agreements; lack of trained staff possible issue
Post-lending	Monitoring		Monitoring environmental compliance, changes in legislation, changes in clients business activities	Include environmental monitoring in credit monitoring; lack of trained staff possible issue
	Work out		Before taking possession on an asset consider possible environmental liabilities attached	Consider potential environmental liabilities in regards to collaterals (assets that guarantee loan repayments)

7 Conclusions and Recommendations

In the previous section it is shown that there is a lack of environmental consciousness among Montenegrin commercial banks, both in terms of the environmental impacts of their internal processes and environmental impacts deriving from the operations of their clients for which the banks provide funding. However, based on an analysis of recent legislative changes in Montenegro, as well as global trends and the environmental practice of EBRD, it can be argued that Montenegrin commercial banks should establish procedures and rules for including environmental considerations in their business practices and environmental risk identification as part of the overall credit risk. More detailed information on incorporated risks will lead to better risk management and have positive effects on environmental awareness in case of the banks and the banks' clients as well.

Analysis of the lending practices and corporate credit management in Montenegrin commercial banks has shown that there is clear lack of environmental considerations in the business practices today. While environmental issues are implicitly incorporated in the corporate credit management processes (through clients legal compliance checks), banks are not prepared for probable future challenges primarily in relation to new national environmental legislation. As long as environmental issues are not considered properly and environmental risks assessed individually and not only in light of clients' legal compliance, Montenegrin commercial banks are exposed to risks, both financial and reputational, they don't account for.

It is recommended for the local banks to slowly start to develop procedures similar to the EBRD procedures, which will enable gathering and assessing of environmental information from the clients in a simple and systematic way. Appropriate environmental risk management steps need to be incorporated in the corporate credit management process as identified in the previous section. Montenegrin commercial banks are recommended to undertake the following:

- Adopt exclusion lists based on EBRD's lists, newly enforced national environmental legislative or similar lists and develop simplified procedures for initial environmental risks assessment;
- Adopt procedures for dealing with projects that are connected with medium and high environmental risk identified in the initial environmental risk screening step;
- Define information and documentation required from clients in order to evaluate environmental compliance;
- Define procedures and responsible persons for applying environmental conditions to credit agreements;
- Include environmental monitoring in credit monitoring; and
- Consider potential environmental liabilities in connection to collaterals, i.e. assets that are accepted as a guarantee for loan repayments.

These measures would enable banks to better keep track of their clients' legal compliance, and also prepare them and allow them to gain necessary experience for possible future challenges in this field. As banks are still not exposed to pressures from the public in regards to their

clients' activities, the situation can soon change, following trends in other countries. This could jeopardize banks' reputation among clients, and could lead to loss of clients.

In the analysis, the following possible issues are identified:

- Lack of developed internal system for environmental risk evaluation;
- Lack of trained staff.

However, as already mentioned, most of the national commercial banks are parts of bank groups mainly from EU countries, and, consequently, the author thinks that it is possible that Montenegrin commercial banks should consider sharing experiences and to a certain extent getting know-how from their mother banks. As well, it is recommended that the commercial banks give necessary attention to proper training of the staff. Both of the identified issues are connected to additional costs for the banks, and this is a drawback. However, in the author's opinion, the presented benefits arising from reduced financial and reputational risks outweigh their identified drawbacks.

Additionally, as a way of market exploration, it is recommended that the banks in their corporate products portfolio include environmental products. This would open possibilities for identification of new market as well as to promote the bank and have positive effect on the bank's public image. Additionally, this would attract new customers.

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<http://www.environmentforeurope.org/institutions/ppc.html>

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Opportunity banka, <http://www.opportunitybank.cg.yu/>

Podgorička banka, <http://www.pgbanka.com/banka/index.htm>

Prva banka Crne Gore, <http://www.prvabankacg.com/>

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The European Commission – Environment, http://ec.europa.eu/environment/index_en.htm

The European Commission - Justice and Home Affairs, http://ec.europa.eu/justice_home/index_en.htm

The European Investment Bank (EIB), <http://www.eib.org/>

The Nordic Environment Finance Corporation (NEFCO), <http://www.nefco.org/>

The Nordic Investment Bank (NIB), <http://www.nib.int/en/index.html>

UNEP Finance Initiative, <http://www.unepfi.org/about/background/index.html>

World Bank, <http://www.worldbank.org>

Abbreviations

BAT	Best Available Technique
CBOM	Central Bank of Montenegro
CEB	Council of Europe Development Bank
DTIE	Division of Technology, Industry and Economics
EBRD	European Bank for Reconstruction and Development
EC	European Community
ED	Environment Department
EEA	European Economic Area
EHS	Environment, Health and Safety
EIA	Environmental Impact Assessment
EIB	European Investment Bank
EP	The Equator Principles
EPA	Environmental Protection Agency
EPE	European Principles for the Environment
EPFI	Equator Principles Financial Institution
ETB	Economic and Trade Branch
EU	European Union
FI	Financial Institution
FII	Financial Institutions Initiative
IFC	International Finance Corporation
IFI	International Financial Institution
III	Insurance Industry Initiative
IPPC	Integrated Prevention and Pollution Control
MFI	Multilateral Financing Institution
MTE	Ministry of Tourism and Environment

NEFCO	Nordic Environment Finance Corporation
NGO	Non-Governmental Organization
NIB	Nordic Investment Bank
OECD	Organisation for Economic Co-operation and Development
PR	Performance Requirements
PRI	Principles for Responsible Investments
SEA	Strategic Environmental Assessment
SME	Small and Medium Sized Enterprise
SPE	Special Purpose Entity
UN	United Nations
UNDP	United Nations Development Programme
UNEP	United Nations Environmental Programme
UNEP FI	United Nations Environmental Programme Finance Initiative
UNFCCC	UN Framework Convention on Climate Change

Appendices

Appendix no 1: List of EBRD member countries⁸⁵

Member country	Date joined	Capital subscribed (EUR million)
Australia	29-May-90	200
Austria	29-May-90	456
Belgium	29-May-90	456
Bulgaria	29-May-90	158
Canada	29-May-90	680
Cyprus	29-May-90	20
Denmark	29-May-90	240
Egypt	29-May-90	20
Finland	29-May-90	250
France	29-May-90	1,703.50
Germany	29-May-90	1,703.50
Greece	29-May-90	130
Hungary	29-May-90	158
Iceland	29-May-90	20
Ireland	29-May-90	60
Israel	29-May-90	130
Italy	29-May-90	1,703.50
Japan	29-May-90	1,703.50
Korea, Republic of	29-May-90	200
Liechtenstein	29-May-90	4
Luxembourg	29-May-90	40
Malta	29-May-90	2
Mexico	29-May-90	30
Morocco	29-May-90	10
Netherlands	29-May-90	496
New Zealand	29-May-90	10
Norway	29-May-90	250
Poland	29-May-90	256
Portugal	29-May-90	84
Romania	29-May-90	96
Spain	29-May-90	680
Sweden	29-May-90	456
Switzerland	29-May-90	456

⁸⁵ Source: EBRD website, <http://www.ebrd.com/about/basics/members.htm>.

Turkey	29-May-90	230
United Kingdom	29-May-90	1,703.50
United States of America	29-May-90	2,000.00
European Community	29-May-90	600
European Investment Bank	29-May-90	600
Albania	18-Dec-91	20
Estonia	28-Feb-92	20
Lithuania	05-Mar-92	20
Latvia	18-Mar-92	20
Russia	09-Apr-92	800
Ukraine	13-Apr-92	160
Uzbekistan	30-Apr-92	42
Moldova	05-May-92	20
Turkmenistan	01-Jun-92	2
Kyrgyz Republic	05-Jun-92	20
Belarus	10-Jun-92	40
Kazakhstan	27-Jul-92	46
Georgia	04-Sep-92	20
Azerbaijan	25-Sep-92	20
Tajikistan	16-Oct-92	20
Armenia	07-Dec-92	10
Slovenia	23-Dec-92	41.96
Czech Republic	01-Jan-93	170.66
Slovak Republic	01-Jan-93	85.34
Croatia	15-Apr-93	72.92
FYR Macedonia	21-Apr-93	13.82
Bosnia and Herzegovina	17-Jun-96	33.8
Mongolia	09-Oct-00	2
Serbia	19-Jan-01	93.5
Montenegro	03-Jun-06	4

Appendix no 2: List of countries in which EBRD operates⁸⁶

**Countries of EBRD
operations**

Albania
Armenia
Azerbaijan
Belarus
Bosnia & Herzegovina
Bulgaria
Croatia
Czech Republic
Estonia
Georgia
Hungary
Kazakhstan
Kyrgyz Republic
Latvia
Lithuania
FYR Macedonia
Moldova
Mongolia
Montenegro
Poland
Romania
Russia
Serbia
Slovak Republic
Slovenia
Tajikistan
Turkmenistan
Ukraine
Uzbekistan

⁸⁶ Source: EBRD website, <http://www.ebrd.com/about/basics/members.htm>.

Appendix no 3: EBRD Environmental screening form⁸⁷

Environmental screening form			
Name of applicant/ loan reference:			
Credit officer:		Date:	
Loan criteria	Risk ranking (indicate ranking for each criteria)	Risk weighting	Ranking* Weighting (calculate)
Business activity: (indicate below)	1 (low) 2 (medium) 3 (high)	40	
Size of loan (US\$): (indicate below)	1 (<\$200,000) 2 (\$200,000 - \$1 million) 3 (>\$1 million)	20	
Term of loan: (indicate below)	1 (< 6 months) 2 (6 months - 2 years) 3 (> 2 years)	20	
Nature of collateral: (indicate below)	1 (Liquid investments such as cash, guarantees) 2 (Land with no industrial history or adjacent industry, fixed assets, non-liquid current assets) 3 (Land with industrial history, known contamination or adjacent to such)	20	
Total (add column and compare total to ranges below)			
Resulting initial environmental risk rating (please indicate):	High	High range:	250-300
	Medium	Medium range:	150-249
	Low	Low range:	100-149
Comments:			
Further environmental risk evaluation and reporting required:			

⁸⁷ Source: EBRD website, Environmental Risk Management Manual. 07 August 2008
<http://www.ebrd.com/enviro/tools/fi.htm>

Appendix no 4: List of Interviews

Name and position	Organization	Date and time of interview	Topics covered in the interview(s)
Radoslav Ralevic, Analyst	EBRD Montenegro Country Office	20 June 2008 25 June 2008	Information on EBRD operations in Montenegro, ED of EBRD, environmental appraisal of the projects, the banks environmental procedures
Aleksandra Mitrovic, Head of Corporate banking dept	Hypo Alpe-Adria-Bank AD Podgorica Former employee of Crnogorska Komercijalna Banka	06 August 2008 14 September 2008 (phone interview)	Loan appraisal process for corporate clients; loan portfolio; Montenegrin market
Ana Krsmanovic, Analyst	Institute for Strategic Studies and Prognoses Podgorica	16 August 2008	Economic situation and banking sector in Montenegro, the role of Central Bank of Montenegro
Marina Markovic, Environmental specialist	Independent consultant	23 August 2008 25 August 2008	Montenegrin environmental legislation
Maja Ljumovic, Head of Risk Controlling Department Former employee of Euromarket Bank and NLB Montenegrobanka	Hypo Alpe-Adria-Bank AD Podgorica	25 August 2008 27 August 2008	Risk manamement in Montenegrin commercial banks
Mira Lakovic, Chief officer in the department for financing small and medium sized enterprises, Euromarket Bank, now Chief of Bank's Cabinet in NLB Montenegro Bank; Former employee of Euromarket Bank	NLB Montenegrobanka	09 September 2008	Euromarket Bank cooperation with EBRD (equity and lending)

Appendix no.5. EBRD Environmental Exclusion and Referral list for financial intermediaries⁸⁸

EBRD Environmental Exclusion and Referral List for FIs

1. [The FI] shall not finance or insure the production of or trade in any product or activity deemed illegal under host country (i.e. national) laws or regulations, or international conventions and agreements.

2. Without limiting the generality of the above, [The FI] shall not finance or insure the following activities:

a) Activities involving harmful or exploitative forms of forced labour/harmful child labour, discriminatory practices, or practices which prevent employees from lawfully exercising their rights of association and collective bargaining. 1

b) Production or trade in or use of unbonded asbestos fibers or asbestos-containing products²

c) Activities prohibited by host country legislation or international conventions relating to the protection of biodiversity resources or cultural heritage³

d) Production or trade in products containing PCBs⁴

e) Production or trade in pharmaceuticals, pesticides/herbicides and other hazardous substances subject to international phase-outs or bans⁵

f) Production or trade in ozone depleting substances subject to international phase out⁶

g) Trade in wildlife or wildlife products regulated under CITES⁷

h) Drift net fishing in the marine environment using nets in excess of 2.5 km. in length

i) Shipment of oil or other hazardous substances in tankers which do not comply with IMO requirements⁸

j) Trade in goods without required export or import licenses or other evidence of authorization of transit from the relevant countries of export, import and, if applicable, transit.

3. [The FI] shall not finance the following activities without the prior written approval of the EBRD:

a) Activities within, adjacent to, or upstream of land occupied by indigenous peoples and/or vulnerable groups including lands and watercourses used for subsistence activities such as livestock grazing, hunting, or fishing

b) Activities within, adjacent to, or upstream of designated protected areas under national law or international conventions, sites of scientific interest, habitats of rare/endangered

⁸⁸ Source: EBRD website: <http://www.ebrd.com/enviro/tools/procedur/exclude.pdf>

species, fisheries of economic importance, and primary/old growth forests of ecological significance⁹

c) Activities which may affect adversely sites of cultural or archaeological significance

d) Activities involving involuntary resettlement

e) Activities involving the release of genetically modified organisms (GMOs) into the natural environment, and trade in GMOs to be released into the environment

f) Energy generation using nuclear fuels

g) Production or trade of radioactive materials including storage and treatment of radioactive wastes¹⁰

¹ Reference documents are the ILO Declaration on Fundamental Principles and Rights at Work, and the principles enshrined in the following conventions: ILO conventions 29 and 105 (forced and bonded labour), 87 (freedom of association), 98 (right to collective bargaining), 100 and 111 (discrimination), 138 (minimum age) 182 (worst forms of child labour); Universal Declaration of Human Rights.

² This does not apply to the purchase and use of bonded asbestos cement sheeting where the asbestos content is <20%.

³ Relevant international conventions include, without limitation: Convention on the Conservation of Migratory Species of Wild Animals (Bonn Convention); Convention on Wetlands of International Importance, especially as Waterfowl Habitat (Ramsar Convention); Convention on the Conservation of European Wildlife and Natural Habitats (Bern Convention); World Heritage Convention; Convention on Biological Diversity.

⁴ PCBs: Polychlorinated biphenyls—a group of highly toxic chemicals. PCBs are likely to be found in oil-filled electrical transformers, capacitors and switchgear dating from 1950-1985.

⁵ Reference documents are EU Regulation (EEC) No 2455/92 Concerning the Export and Import of Certain Dangerous Chemicals, as amended; UN Consolidated List of Products whose Consumption and/or Sale have been Banned, Withdrawn, Severely Restricted or not Approved by Governments; Convention on the Prior Informed Consent Procedures for Certain Hazardous Chemicals and Pesticides in International Trade (Rotterdam Convention); Stockholm Convention on Persistent Organic Pollutants; WHO Classification of Pesticides by Hazard.

⁶ Ozone Depleting Substances (ODSs): Chemical compounds which react with and deplete stratospheric ozone, resulting in the widely publicised ‘ozone holes’. The Montreal Protocol lists ODSs and their target reduction and phase out dates. A list of the chemical compounds regulated by the Montreal Protocol, which includes aerosols, refrigerants, foam blowing agents, solvents, and fire protection agents, together with details of signatory countries and phase out target dates, is available from the EBRD.

⁷ CITES: Convention on International Trade in Endangered Species of Wild Fauna and Flora. A list of CITES listed species is available from the EBRD.

⁸ This includes: tankers which do not have all required MARPOL and SOLAS certificates (including, without limitation, ISM Code compliance), tankers blacklisted by the European Union or banned by the Paris Memorandum of Understanding on Port State Control (Paris MOU), and tankers due for phase out under regulations 13G and 13H of Annex I of MARPOL. No single hull tanker over 25 years old should be used.

⁹ Principal reference documents are the IUCN Guidelines on Protected Areas

¹⁰ This does not apply to the purchase of medical equipment, quality control (measurement) equipment and any equipment where the radioactive source is trivial and/or adequately shield