

## DRAFT

### International Financial Institutions, Environmental Standards and Foreign Direct Investment: Bringing the Learning Curve to Full Circle

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*“Prosperity is the result of matching brains with capital and holding both sides accountable.”*

Reuven Brenner, *The Force of Finance*

The ongoing debate over the environmental impacts of private foreign direct investment (FDI) has focused primarily on the role of multinational corporations (MNCs) in implementing diverse standards in countries at varying levels of social, economic and political development. Since the international debt crisis of the late 1980s foreign investment flows have become increasingly important, financing current account deficits as well as sustaining economic development. The flow of FDI to developing countries and emerging markets now exceeds official development assistance (ODA) by a factor of five, (Jeucken p. 50) peaking at \$220 billion in 1999. Therefore, the environmental impacts of FDI deserve at least as much attention as has been devoted to the impacts associated with structural and project lending by the International Monetary Fund, the World Bank and other, multilateral and bilateral forms of ODA. .

The “race to the bottom” hypothesis, played out in discussions about the appropriate relationship between trade and environmental protection has its counterpart in the literature on FDI. While the relationship between trade and environment is heavily focused on by official actors, nation-states, regional trading blocs and global regulatory institutions such as the WTO, the environment-FDI debate focuses primarily on non-state actors, including MNCs, NGOs and the international financial institutions (IFIs) that facilitate flows of FDI to developing and emerging markets.

The paper proposes to explore the role of IFIs in FDI and the implications their role has for the relationship between investment and the environment. The context for this paper is provided in the overview paper prepared by Jed Shilling which sets forth the following framework for this discussion:

“The environment is a global issue, as is international finance. . . . International capital flows impact macro economic stability, and unstable economies are less able to address long term environmental issues and avoid environmental risks. International capital flows finance specific investments which can have specific impacts on the environment. Contrary to conventional wisdom, international financial flows are critically related to environmental concerns.” (Shilling, February 2002)

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A primary assumption of this paper is that, unlike trade, where there are legitimate and relatively effective national and supra-national regulatory mechanisms to that set the “rules of the game” and arbitrate disputes, there is no comparable institutional framework for regulating FDI and its impact on the environment. Where such institutions exist, such as in the investor-state dispute resolution provisions of NAFTA, their legitimacy is fragile and limited in scope. As a result, the non-state stakeholders in FDI all have important roles to play in setting and arbitrating the rules of the game, particularly with respect to the environment. Among these actors, IFIs have an impact that is often disproportionate to their material role in the FDI process, and certainly greater than the role normally associated with “bankers.” Traditionally, compared to manufacturing and infrastructure companies, the financial transactions typically engaged in by banks have been regarded as environmentally “neutral.”

This image has undergone a “sea change” as banking institutions at both ends of the public-private sector “spectrum” encounter their respective learning curves of environmental risk, opportunity and adaptation. The optimal result of this adaptation will be the construction of what one observer calls “an international financial architecture” that is capable of dealing with environmental issues. However, the adaptation will only be complete if the differential learning curves of the public and private sector IFIs converge and thereby “bring the learning curve to full circle.”

Categories of IFIs Active in FDI. There are three broad categories of IFIs engaged at the nexus of international finance and the environment: multilateral development banks (MDBs), bilateral investment finance and export credit agencies (the later best known by the acronym, ECAs), and commercial banking institutions (“banks”)

The MDBs inhabit the public end of the spectrum. They include first and foremost, the World Bank Group (WBG), followed by the regional development banks such as the Inter-American, the Asian and African Development Banks, as well as the European Bank for Reconstruction and Development, the European Investment Bank and the North American Development Bank.

At the private end of the spectrum are purely commercial banks with large international project portfolios, such as Citigroup, Bank of America, Deutsche Bank, HBSC, AMB-AMBRO, Morgan Stanley, Chase Manhattan, Sumitomo, Nikko Asset Management, Credit Suisse Group, UBS AG, Barclays Group, Natwest Group, Lloyds TSB Bank ,etc.

In between are the bilateral institutions. This category includes two subgroups: investment finance agencies and ECAs. The former include organizations such as the Overseas Private Investment Corporation (OPIC), Germany’s Investment an Development company (DEG), the Netherlands Development Finance Company (FMO), Sweden’s Swedfund International, and the Swiss Development Finance Corporation..

Leading ECAs include the U.S. Export-Import Bank, the Export Development Corporation of Canada, France’s COFACE, the Export Credits Guaranty Department of

the UK and finally hybrid development bank/export credit agencies such as the Japan Bank for International Cooperation and Germany's KfW.

The role of IFIs in FDI. A recent paper issued in draft by the World Resources Institute cites the “surge in private development finance” during the 1990's as taking several forms, including classic FDI (defined broadly to include equity investment; securitized investment, and commercial bank loans). Whereas in 1991 the net flow of capital from North to South consisted about equally of official development assistance (ODA) and private capital flows, by 2000, private finance outstripped stagnated ODA by a factor of almost seven to one, after taking into account the dip induced by the financial crises of the late 1990s. Commensurate implications for environmental sustainability are attributed to this trend both in terms of the initial ecological footprint of specific investments as well as the development trajectory they reinforce. This is because as ODA (from both bilateral and multilateral – MDB – sources) has shifted from an initial emphasis on large physical infrastructure projects to human resource development, FDI has moved aggressively from pure natural resource extraction to long-term infrastructure development. AS Seymour points out “construction of new coal-fired power plants add to local air pollution, while locking in a fossil fuel-based electricity system for a generation.” (Seymour 4). [This is a little cryptic. Maybe quote Seymour And maybe note that private flows may have more environmental impacts since many are directed at economic activities that exploit resources and transform them, where there is a threat to the environment. These are private sector activities that the MDBs don't get involved in. the MDBs are more focused on 'soft investments in education, health etc. They also get involved in infrastructure, which does have environmental impacts. And they are more subject to public pressure]

The WRI paper assumes that the degree to which these private investments reflect sustainable development objectives “should ideally be governed by national-level development priorities and regulatory frameworks in the recipient countries.” However, “national-level capacity to promote sustainable development objectives has lagged behind the rapid pace of globalization.” To the extent that investments affect trans-boundary or global ecosystems for which governance infrastructure is not yet in place, “policy levers” in capital exporting countries assume an important role in ensuring environmental sustainability.

However, this paper goes further and argues that international investment on the part of the IFIs remains largely outside the scope of these “policy levers” to the extent that the financial institutions themselves have become the arbiters of their own behavior and that of their clients, albeit influenced by external stakeholders in both capital exporting and capital importing countries. Or as Sherle Schwenninger has put it in a broader context, “the nexus between international finance and the environment offers a way to bridge the differences that now exist between international environmental groups and the economic leaders of the developing world....Yet the current international financial architecture is not very well equipped to deal with these problems....” (Schwenninger)

The IFI Learning Curve: Of way of characterizing the development of a international financial architecture to deal with environmental challenges is as a learning curve. Categories of IFIs active in FDI have and are continuing to face a learning curve as they come to terms with the environmental impacts and risks of project finance, and to a growing extent, corporate finance and portfolio management in developing and emerging markets. The shape of the curve, its drivers and implications vary from one category of IFI to another, but at various points they converge.

Marcel Jeucken of Rabobank, provides a useful model that can be used to describe the various phases of this learning curve. for the evolution of international financial architecture in the banking sector. Although intended primarily to describe the evolution of private sector banks, it is equally applicable to public sector IFIs . The four phases, which he calls “defensive” banking, “preventive” banking, “offensive” (by which I think he means “proactive”) banking and “sustainable” banking are not mutually exclusive and may all continue throughout the life of an institution. (Jeucken 71-74)

*Defensive* banking characterizes a bank’s initial reaction to environmental risk, which typically takes the form of denial and even active opposition to the imposition of regulatory requirements or expectations of any voluntary change in behavior, based on the sincere belief that banking is a neutral transaction with no effect on the environment or vice versa. Any environmentally driven decision is viewed as an irrational response that will only add to transaction costs to the detriment of both the borrower and the lender. While it is difficult to imagine any major internationally active bank today taking this stark a view, it is not that difficult to find decision-makers and entire units within banks who view the environment as irrelevant to their business, a job for someone else in the organization to be concerned about. Examples of banks remaining in the defensive mode include those U.S. regional banks that are active in international markets, but remain only indirectly exposed to the environmental risks of such involvement, due the fact that they retain full recourse to the domestic assets of their borrowers.

*Preventive* banking flows from the recognition that environmental factors can impact a bank’s bottom line through direct costs from wasteful use of natural resources internally to customers risk ranging from environmentally induced operational shut-downs , devalued collateral, and in some cases lender liability for environmental damages. A risk management strategy is developed with a level of effort, either internal or outsourced, that is commensurate to the perception of risk. This can take the form of conducting environmental due diligence in the form of environmental assessments of prospective borrowers and requiring borrowers to develop and implement environmental management and remediation plans should detrimental environmental impacts be identified. Banks that experience actual rather than potential losses tend to take these risks more seriously and expend more resources in learning how to manage them. Banks that view environmental risks as potential rather than actual risks tend to commit fewer resources. If banks do not incur environmental impacts, or fail to acknowledge them, they risk slipping back into a defensive mode, making them more vulnerable to the environmental risks they are attempting to deny, and to reputation risks. This eventually makes preventive banking an effective floor or minimum standard of environmental

## DRAFT

management. Most major U.S. international money center banks and practice preventive banking in their use of internal audits to reduce the costs and reputational risks associated with excessive waste, practice environmental philanthropy and issue annual “Environmental Reports” on such practices. Most bilateral investment finance and export credit agencies fall into this category.

*Proactive* banking arises from the recognition that there are concrete benefits to be gained rather than simply losses to be avoided from optimizing the environmental impacts of their lending activities. In this phase, the bank will expand its customer base into markets that produce environmentally valued goods and services, such as renewable and alternative energy, profitable conservation initiatives, sustainable forestry, or organic produce, sectors that it may previously have regarded as too risky or simply not a viable business opportunity. Examples include the development of environmental investment funds, adherence to codes of conduct, such as the UNEP Principles for Financial Institutions, participation in debt-to-nature swaps and financing of carbon trading or Clean Development Mechanism initiatives. The best known examples include arguably, The World Bank Group (including the IFC), OPIC and a few other European development finance agencies, international banks, including Natwest in the UK., Deutsche Bank, Fleet Boston Financial Corporation, and Rabobank in the Netherlands.

In *Sustainable* banking, by Jeucken’s definition, “the starting point is not environmental regulations or the market as such, but the vision regarding the environment, the organization’s goal and the role that the organization wants to play in society.....the bank lays down qualitative preconditions that all its activities are sustainable...[and that] certain forms of lending and participation no longer take place while others do.” Such banks are prepared to accept lower margins and/or higher risks to stimulate certain activities. Examples of banking institutions that have reached this “state of grace” (my term) might include micro-credit facilities, and “pure play” environmental funds, although the aggregate environmental impacts of such activities should be open to environmental assessment rather than a prior assumption of beneficial environmental impact. According to Jeucken, only a few niche players, such as the Triodos Bank in the Netherlands and the Cooperative Bank in the UK can aspire to practice sustainable banking.

This model is useful in examining the learning curves of all categories of IFIs, as well as individual IFIs considered in this paper and for identifying gaps that each type of institution has yet to address. Some institutions are better positioned than others, by virtue of the larger roles they fulfill in supporting FDI, to apply lessons learned at different stages of the learning curve. Collectively, through greater sharing of respective experiences and co-financing of projects, IFIs can advance the process of environmental management and bring the learning curve “to full circle.”

Multilaterals as “Standard Bearers”. Environmental conditionality began to develop at the public end of the IFI spectrum during the 1980’s when the public sector lending arm of the World Bank Group (WBG), the International Bank for Reconstruction and Development (IBRD), issued its first Environmental Guidelines designed to set

## DRAFT

parameters on the IBRD's sovereign lending for large scale infrastructure and manufacturing projects in developing countries. This initiative resulted from a number of well-publicized environmental and social disasters associated with the building of large roads, dams and other infrastructure projects of questionable economic viability in areas containing fragile ecosystems, primarily tropical rainforest or areas where many thousands of local inhabitants had to be displaced and their traditional lands inundated or paved over..

Environmental assessment became standard procedure at the IBRD in 1989 in the form of Operational Directive 4.00, amended to Operational Policy 4.01 in 1991. That same year IBRD issued its three-volume Environmental Assessment Sourcebook, a hands-on manual for conducting environmental reviews. Initially, the World Bank's Environmental Guidelines were applied only to the project and eventually sector loans that the IBRD made to governments of developing countries.

It was not until 1993 that the IBRD guidelines, first proposed in 1984 and then formally adopted in 1988, were first applied and later adapted to the loans and equity investments made to the private sector under the auspices of the Bank's private sector affiliate, the International Finance Corporation (IFC) and not until 1998 by the Bank's political risk insurance affiliate, the Multilateral Investment Guarantee Agency (MIGA). Through the 1990's variations of the World Bank Guidelines were ultimately applied to private sector lending undertaken by the regional development banks through specialized affiliates or private sector "windows and in the late 1990's to the financial intermediaries (on-lending, venture and equity funds) sponsored by the MDBs.

The process through which these institutions adopted and applied environmental standards was, and continues to be, highly bureaucratic, at times highly academic and at other times highly political, or both, depending on the public sensitivity surrounding the topic. Issues such as dams, tropical forests, protected areas, and the rights of indigenous peoples are typically driven by heavily orchestrated campaigns by environmental non-governmental organizations (NGOs). NGO campaigns are targeted directly at the Bank itself, to Bank environmental staff that may be sympathetic to environmental concerns and in need of external allies in order to influence less sympathetic Bank finance officers or senior management.

To be effective, such campaigns must ultimately enlist the support of sympathetic donor governments, typically the US, the UK, the Netherlands and the Scandinavian countries. The US Congress, has gone so far as to condition annual U.S. Treasury appropriations for Bank activities and operating expenses on the adoption of particular environmental protection procedures. An example of this is the "Pelosi amendment," which restricts US Executive Directors to all MDBs and private sector affiliates, from voting to approve an environmentally sensitive project unless an environmental impacts assessment for the project has been made available to the public for at least 120 days. In deference to the significant donor role of the US and like-minded countries, the IBRD subsequently adopted the 120-day requirement as an integral part of its environmental procedures. (The IFC and MIGA have held to a 60 day minimum comment period. This has resulted

## DRAFT

in abstentions on the part of the US ED, on those rare occasions when the actual comment period has fallen short of the 120 day USG requirement).

The deliberative process involving such issues, about which there is limited consensus, particularly between donor and recipient countries, tends to be complex, lengthy, and often inconclusive. Issues that are highly divisive, such as those involving the regulation of greenhouse gases implicated in global climate change, tend to be relegated to generic recommendations, rather than strict guidelines. In all cases, the Bank is careful to couch even the most quantitative of its standards as “guidelines” and eschews the word “standard,” out of respect for the sovereignty of the borrowing countries who are, nevertheless, expected to apply them as “conditions” of IBRD lending.

The adoption and implementation of the IBRD environmental guidelines on the part of the private sector affiliates, IFC and MIGA, was in part a “trickle down” process initiated by IBRD Management, and part an iterative process between environmental officials at the institutions with considerable input from expert panels, industry and NGOs. As in the case of IBRD, a number of real and/or perceived environmental and related social impact failures have galvanized NGOs, the media and public opinion on the need to “reform” the environmental procedures and policies of the institutions. In the case of IFC and MIGA the projects included the cumulative human impacts of involuntary resettlement and ecosystem change resulting from support of one of series of dam projects in Chile and more recently Uganda, the management of toxic chemicals and other wastes at mining sites in Peru, Guyana, Kyrgyzstan, and Papua New Guinea; the development of oilfields in sensitive marine environments in the Russian Far East and other such projects .

It is generally assumed that the IFC and MIGA “lag behind the [IBRD’s]’s direct lending programs in integrating environmental standards and safeguards into their work.” (Final Report, Project on International Finance and the Environment, April 2001.) However true in a purely chronological sense, this statement might be qualified by the fact that the safeguards take on a different profile when applied by the IFC or MIGA to transactions involving strictly private companies. In place of a loan agreement between a multilateral agency and a sovereign member government, the vehicle for implementing conditionality in a project loan or equity investment is a contract between the lending institution and a private borrower, or in the case of MIGA, a political risk insurance contract. Although both World Bank and IFC loans have default provisions that may include environmental requirements, these are not as easily “enforced” on a sovereign borrower than on a corporate entity.

This suggests that environmental conditionality in IFC lending , and to a lesser extent, MIGA, insurance, has more “teeth” than a sovereign loan by IBRD. IFC’s leverage may be further enhanced by its tendency to take minority equity positions in projects, which provides direct access to management, although IFC’s interests as an equity investor has the potential to come into conflict with its interests as a lender. Likewise, MIGA’s leverage may be limited by the fact that the majority of its clients are themselves minority investors or institutional lenders to the projects for which MIGA issues coverage, a status which limits their ability to unconditionally guaranty that environmental conditions will

## DRAFT

be met. Nevertheless, because of their smaller size, less bureaucratic structure and participation in a more dynamic private sector, the IFC and to a lesser extent, MIGA, have arguably been more agile in adopting and promoting leading edge environmental practices in their lending and among their clientele than the IBRD. For example, it was IFC's Environment Division that issued the "good practice manual" on "Doing Better Business Through Effective Public Consultation and Disclosure" in response to criticisms that its corporate clients lacked the capacity to engage the public in a meaningful consultation process. Yet many IBRD projects have long been criticized for an absence of effective public disclosure and consultation on the part of host governments.

Probably the most significant impact of the migration of environmental guidelines from the public to the private sector activities has been the adoption by the private sector affiliates of public disclosure requirements for environmental impact assessments, previously treated by private companies and lending institutions as "business confidential." Such disclosure has opened up the decision-making process to locally affected populations, NGOs and other "stakeholders," in a manner previously reserved to publicly financed infrastructure projects in highly regulated industrialized countries.

Other leading edge environmental procedures have emerged from this need to accommodate greater public involvement in both public and private sector lending. Although IFC and MIGA have officially adopted a shorter public disclosure period (60 days) compared to the 120 days required by IBRD, in practice it is rare that IFC and MIGA projects are brought to the Board in less than 120 days, partially in deference to the fact that the US ED cannot otherwise vote in favor of them.

Beyond public disclosure at the initial decision-making stage, public accountability by lenders and borrowers through the project implementation stage has been initiated by the creation of an Independent Inspection Panel at IBRD and a counterpart Compliance Advisor/Ombudsman (CAO) at IFC and MIGA. Both are complaint-driven mechanisms that are designed to identify and correct flaws in the environmental assessment and oversight processes at these institutions through a mediated process that effects change without jeopardizing otherwise worthwhile projects.

In its most recent Annual Report to Congress on the Environment and the Multilateral Development Banks, issued in December 2001, the U.S. Department of Treasury reported "significant progress" among MDBs in the handling of environmental issues, attributed in part to U.S. leadership and advocacy. The report included specific observations on the IFC and the private sector affiliates and windows of the other MDBs. In general, the most significant developments involved improved transparency and accountability through better information disclosure policies, consultation requirements and independent inspection panels, such as the CAO. Areas noted for improvement included the need for both internal and external capacity building, holding management responsible for compliance with safeguards; a stronger emphasis on quality assurance, focusing on outcomes and development effectiveness as well as proper procedures and planning.

## DRAFT

The evolution of the WBG in the direction of “proactive” and arguably “sustainable” banking is implemented through the Global Environmental Facility, which is administered jointly by the Bank, the UN Environment Programme (UNEP) and the UN Development Programme (UNDP). The concessional nature of the GEF places it outside of the scope of this paper, which is focused on FDI. However, the IFC has established several equity funds, which combine GEF, IFC equity features and commercial debt and are targeted exclusively toward environmental projects in developing countries. These include the Terra Capital Fund launched in 1996 and targeting ecotourism, sustainable agriculture, forestry and other sectors that can sustainably use and protect biodiversity in the Latin American region ; and the Renewable Energy and Energy Efficiency Fund, targeted toward both on and off-grid renewable energy projects

Recent critiques of the WBG, issued by broad consortia of environmental and social NGOs, argue that despite the WBG’s evolution in the direction of proactive, if not sustainable banking, work may remain to be done in order to complete its evolution from the defensive to a preventive phase of environmental learning curve. The critique concluded that WBG “has not mainstreamed environmental considerations into its general economic development work” based on “its record of non-compliance with its own environmental and social policies.” Although the critiques makes few distinctions between public and private sector policies and programs, they cite IFC and MIGA in connection with a demand that the Bank open Board proceedings to the public and the media and provide minutes and transcripts. They also recommend that the IBRD’s expand the oversight of its Inspection Panel to include IFC and MIGA.

NGOs are critical of proposed a revision of the WBG’s forest policy that would substitute other protections for an outright ban on direct support for logging in tropical moist forests. It recommends that the WBG and other MDBs shift their lending portfolios away from investments in pollution and greenhouse gas intensive extractive (minerals, oil and gas) projects towards renewable energy projects and projects designed to deliver energy services directly to the poor rather than to centralized power grids. It advocates strict adherence to the recommendations of the November 2000 report of the World Commission on Dams, which the Bank co-commissioned in 1998 as a decision-making tool for the articulation of a new Bank policy on such dams. Neither the Bank nor other MDBs have been willing to endorse the report in its entirety, preferring to use them as a “reference point” on a case-by-case basis for financing of dam projects. With respect to pesticides it advocates limiting support to projects with ecologically based integrated pest management plans. (The Atmosphere Alliance, et. al.; U.S. Civil Society Coalition)

In a more balanced view the U.S. Department of Treasury, in its most recent Annual Report to Congress on the Environment and the Multilateral Development Banks, issued in December 2001, reported “significant progress” among MDBs in the handling of environmental issues, attributed in part to U.S. leadership and advocacy. The report included specific observations on the IFC and the private sector affiliates and windows of the other MDBs. In general, the most significant developments involved improved transparency and accountability through better information disclosure policies, consultation requirements and independent inspection panels, such as the CAO. Areas

## DRAFT

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More recently, and particularly since the anti-globalization movement targeted the Bank for extinction, along with its sister institution, the International Monetary Fund, the environmental agenda at the IBRD has been driven in part by reputational risk to the viability of the institution itself. It remains to be seen whether this urgency to reform will be diluted by donor and institutional refocusing on core poverty alleviation and development issues as well as the reduced public profile of overt environmental protest in the wake of September 11.

The Bilaterals: Reluctant Referees: Environmental Defense, WRI, Worldwatch and other NGOs have documented the increasingly important role assumed by the bilateral ECAs during the past decade. However, public recognition of the environmental impacts of bilateral IFIs began not with the ECAs but with the bilateral investment finance agencies as early as the mid-1980's and specifically with one agency, the Overseas Private Investment Corporation (OPIC).

OPIC is unusual among bilaterals in providing three services to private investors not typically offered by a single organization: political risk insurance, project finance, and support of financial intermediaries (IFIs), in the form of both on-lending institutions and equity funds. Political risk insurance covers the risks of expropriation, currency inconvertibility and political violence (including associated risks of business interruption); finance includes the issuance of all-risk investment guarantees to U.S. financial institutions who lend directly to projects at US market rates of interest (with OPIC as the lender of record) and direct loans to small business. OPIC's support of IFIs, including equity funds, is provided through its investment guaranty authority rather than through equity on its own account (as is the case for the IFC and some other bilaterals).

OPIC's initial approach to environmental issues was driven primarily by concern over project risk rather than by US international environmental policies. As early as 1971 OPIC's Board of Directors passed a resolution directing Management to consider the environmental, human health and safety impacts of projects as factors in evaluating project risk. OPIC's 1974 reauthorization legislation contained hortatory language encouraging OPIC to "take environmental impacts into account" in its programs, but made no reference to any US or international environmental policy motive. In the early 1980's OPIC began to systematically examine the environmental, health and safety impacts of projects as part of an expanded emphasis on development impacts and project risk.

However, OPIC's nascent awareness of environmental risk was overtaken by events when the U.S. Congress reacted to the Bhopal accident in India that occurred in December 1984. Although OPIC was not involved in the Bhopal project, it was a

## DRAFT

seminal event in worldwide perception of the potential impacts of foreign direct investment (FDI) by multinational corporations (MNCs) in developing countries.

The accident resulted in the release of a cloud of toxic gas used in the manufacture of agricultural pesticides in the direction of a shantytown inhabited largely by plant workers and their families and located directly adjacent to the plant. Approximately 3,000 fatalities and more than 10,000 injuries resulted, making Bhopal the largest industrial accident in history. The U.S. investor, Union Carbide, suffered immediate and long-term repercussions to both its bottom line and corporate reputation. The Government of India blamed Union Carbide for among other things, not fully informing the Indian government of the potential severity of the hazards associated with the manufacturing process and for failing to adapt its technology to local conditions.

Congressional concern over the Bhopal accident found no immediate statutory or regulatory outlet, until OPIC came up for reauthorization in early 1995. Following hearings on the causes and implications of Bhopal, several amendments were added to OPIC's statute. The "Bhopal amendments" required OPIC to conduct an environmental assessment (EA) for each and every project it considered for insurance and finance; directed the Corporation to "decline support for projects posing major or unreasonable environmental, health or safety hazards," and, for "environmentally sensitive" projects, to notify host governments of potential environmental hazards and applicable international standards and, where feasible, U.S. regulations, and take host government comments into account, prior to providing insurance and finance.

Additional amendments adopted at the behest of environmental NGOs required the Corporation to avoid adverse impacts of prospective projects on "tropical forests," "endangered species" and "biological diversity" in general, as well as to "national parks and similarly protected areas" and to implement its policies in a manner consistent with World Bank guidelines .

As the World Bank developed and elaborated on its first generation environmental guidelines in the 1980's OPIC was faced with the challenge of adapting the policies and procedures of a large MDB, then still lending almost exclusively to governments, to the constraints of a much smaller organization providing services exclusively to the U.S. private sector. This made OPIC a pioneer among all bilateral investment agencies as well as export credit agencies (ECAs), none of which had an environmental "mandate" comparable to that of OPIC. Nor, for that matter, did most of OPIC's corporate clients, financial institutions or private sector political risk insurers have environmental policies requiring the level of awareness and due diligence expected of OPIC at the time.

As a result of this process, OPIC declined support for several projects each year, when its own environmental "intelligence" and assessments led it to conclude that a particular project could not be implemented without "major or unreasonable hazard" to the environment, health or safety (including that of workers as well as the public). Such projects tended to involve extractive and related infrastructure (road, pipeline and dam construction) in pristine areas such as tropical forests, national parks and other

## DRAFT

“biological hotspots” where oil spills could not be effectively mitigated without catastrophic results or where new access roads and rights of way would invite large-scale immigration accompanied by destructive “slash and burn” agricultural practices and threats to the health or livelihoods of indigenous inhabitants. In some cases, the proposed projects involved technologies not adapted to safe operation in developing countries or products in the process of being phased out by regulatory authorities in the U.S. or other industrialized countries.

The early 1990's brought new challenges as well as new resources to OPIC's environmental policies. The expansion of OPIC's portfolio to the countries of the former Soviet Union and the privatization of former public monopolies such as power generation, oil and gas development, telecommunications and other infrastructure services was accompanied by an OPIC Board decision to increase OPIC's per project participation limits from \$50 and \$100 million for finance and insurance respectively, to \$200 million each. This gave OPIC the opportunity to participate as a senior lender and/or primary supplier of political risk insurance to major projects in developing and emerging markets, on a scale previously reserved to MDBs or large syndicates of private financial institutions. Unlike the greenfield projects OPIC considered in the 1980's, many of these projects involved privatizations of previously constructed facilities that had operated with few if any environmental controls but could, with the right technology and management, support economic development with minimal adverse environmental impacts..

Until 1995, OPIC's environmental assessment process was implemented without much scrutiny from NGOs or the media, who remained focused on the World Bank, the regional development banks, and increasingly IFC. No public environmental controversies erupted over projects in OPIC's portfolio. When OPIC rejected or discouraged an application on environmental grounds, that fact was (and still is) treated as a confidential business matter.

The landscape shifted dramatically in 1995 when as a result of a routine monitoring exercise, OPIC determined that a mining project in Indonesia undertaken by Freeport McMoran, with OPIC insurance in 1990, had expanded well beyond the scope of the project approved by OPIC's Board and with what OPIC determined, were “major and unreasonable” adverse impacts to the environment. OPIC's unilateral cancellation of its political risk insurance contract, which was publicly contested by the project sponsor, was closely watched by the political risk insurance industry, investors and the NGO community.

OPIC learned several important “preventive” lessons from the experience and the resulting controversy. The first was not to compromise on the level of environmental due diligence required of project sponsors where the potential exists for significant environmental impacts, not even in order to accommodate an existing project with a long-term client. The second was to explicitly (i.e. contractually) condition its support for projects on acceptable environmental practices and outcomes rather than rely exclusively on sponsor representations in application materials. (Doing so in this case

## DRAFT

would have likely allowed OPIC to avoid the time, money and adverse publicity resulting from arbitration preparations). The third lesson concerned transparency was brought home to OPIC by the NGO community, and it has been a dominant theme in OPIC's environmental policy ever since.

The major argument made by the NGOs was that OPIC's lack of transparency during the application process had deprived it of the opportunity to consult with NGOs, and locally affected people, who, presumably, would have alerted OPIC to real and/or potential environmental problems with this particular project. Whether or not the NGO or local communities would have provided OPIC with such intelligence at this stage of this particular project is debatable; however the general point that better decisions are made with better information was acknowledged.

In any case, OPIC was now very much on the NGO "radar screen" and became the newest object of the same reform movement previously focused on the World Bank and IFC. The difficult 1996 reauthorization process presented the NGOs with an opportunity to leverage their concerns about OPIC in the form of a temporary alliance with Congressional critics of corporate welfare (critics who are not generally sympathetic to environmental causes). This contributed to OPIC's small margin and short time frame for reauthorization, which was revisited in 1997.

The United Nations General Assembly Special Session on Sustainable Development (UNGASS) provided the substantive opportunity to "reform" OPIC's environmental policies and procedures when a list such proposed reforms was announced by President Clinton as part of his address to the UNGASS. The reforms included new initiatives with respect to the following issues considered important to both the NGO community and the Clinton Administration:

- ?? Transparency and consultation: i.e. "a full opportunity" for public comment for all "environmentally sensitive" projects prior to OPIC's final commitment, consistent with principles of business confidentiality;
- ?? Categorical prohibitions on infrastructure and extractive projects in "primary tropical forests" and designated internationally protected areas, certain large dams and restricted chemicals;
- ?? Independent certification of forestry projects and independent monitoring of other "environmentally sensitive" projects;
- ?? Attention to the impacts of certain projects on climate change via emissions of greenhouse gases;
- ?? An annual environmental report on OPIC's compliance with its statute, policies and procedures

These reforms were the basis of OPIC's Environmental Handbook, issued in draft in the Federal Register and through other forums for public comment in February 1998 and finalized in April 1999. OPIC began implementing the provisions of the Handbook on a trial basis during the comment period, and OPIC and many OPIC clients now have almost four years of experience with the new policies and procedures.

## DRAFT

The provision of the Handbook involving public disclosure was made statutory during OPIC's 1999 reauthorization with some modification. It now requires 60 days public disclosure of EIAs for "environmentally sensitive" projects, *prior to Board approval*. (The Handbook had applied the 60 day requirement to final commitment (i.e. execution of a political risk insurance contract or loan agreement, which could occur months after Board approval. This allowed for the possibility- as sometimes had occurred-- that the Board would approve a project before the end of the public comment period and therefore not have the benefit of public input before providing approval).

OPIC's experience in implementing its current environmental policies has been generally successful, at least from the perspective of other bilateral investment finance and insurance agencies who frequently cite OPIC as a model. US companies that use OPIC appear to have adapted their practices to OPIC requirements, many of which have become or are becoming the norm in international private sector investment. However, in some circumstances, OPIC's procedures can be burdensome and time-consuming. Institutional lenders and SME investors having a relatively small stake in large environmentally sensitive projects may not have direct access to the environmental information that OPIC requires for such projects both during application and through the life cycle of the project. The foreign enterprise may generate environmental information in a language and format designed to meet host country regulatory rather than World Bank environmental assessment requirements. New to market companies may not be familiar with World Bank requirements. OPIC's EA process for projects that are not particularly environmentally sensitive may become complicated if there is no accepted protocol for gathering data. OPIC has adopted some and is considering additional "streamlining measures" for such projects. A promising on-line system for assessing environmental risks of such "Category B" projects is being deployed by the Spanish export credit agency, CESCE and is being tested by OPIC for its applicability to small business investments.

The NGO community has publicly acknowledged that OPIC's environmental policies place it in the forefront of bilateral investment finance and political risk insurance agencies. NGOs have made use of OPIC's new disclosure procedures to engage selectively on a number of projects. However, NGOs have a number of continuing criticisms of OPIC' environmental policies and procedures. These include:

- ?? The relative lack of transparency post project commitment. Monitoring data and reports are still treated as business confidential
- ?? OPIC has limited capacity to interact directly with locally affected communities in the application or monitoring process and relies primarily on project sponsors or NGOs to communicate community concerns.
- ?? The fact that OPIC's power and energy portfolios are limited almost entirely to conventional fossil fuels (gas, oil, and coal), contributes to the increased greenhouse gas emissions in developing countries and allegedly undermines the US commitment under the Framework Convention on Climate Change to assist in

- transferring climate friendly (e.g. renewable and conservation) technologies to developing countries.
- ?? OPIC has not always applied its categorical prohibition on “primary tropical forests” in a manner consistent with scientific criteria on forests of “high conservation value”
  - ?? The need for OPIC to update its policies take into account the recommendations of the World Commission on Dams
  - ?? The expectation that OPIC will take a more formal leadership role in promoting stronger environmental standards among both public and private political risk insurers (as the U.S. Export Import Bank has done within the context of its counterparts through the OECD Export Credits Group.)

OPIC entered the proactive stage of the learning curve in the early and mid-1990’s with the use of its loan guaranty authority to provide partial commercial guaranties to three equity funds targeted towards projects with environmentally beneficial outcomes. These include the two Global Environmental Emerging Market Funds managed by Global Environment Fund, Ltd. (not to be confused with the World Bank’s GEF) and the Aqua International Partners Fund, which makes investments in the water supply and water treatment projects. Collectively three funds have raised more than \$400 million in capital, of which more than \$300 million is invested in operating projects in OPIC-eligible countries.

OPIC is not alone among bilateral investment finance agencies in recognizing the importance of environmental and related social impacts and incorporating them into its decision-making and monitoring procedures. Among the European bilaterals, the German DEG along with its sibling, KfW, have adopted environmental policies and procedures. So has the UK’s Commonwealth Development Corporation, recently privatized as CDC Partners, the Netherlands’ FMO and several of the Scandinavian development finance institutions.

However, with the exception of KfW, OPIC plays a larger role in project finance than its European counterparts, and also provides political risk insurance for investments, a service that is typically provided by ECAs. The common denominator that helps to explain the relative ease with which these bilateral financial institutions adopted and implemented these environmental mandates is the fact that all of them were created with a strong host country development mandate, to which environment could be seen as a natural extension. Moreover, unlike the MDBs they tended to be small relatively non-bureaucratic organizations that were more easily adaptable to changing priorities. Like OPIC, these organizations are well into the proactive phase of the environmental learning curve. To the extent that they can take direct equity positions risks in innovative financial mechanisms and provide subsidized financing to highly developmental ventures, they are beginning to experiment with sustainable banking activities.

Export credit agencies (ECAs) are undoubtedly major players in international project finance, collectively accounting for more than \$100 billion in annual long-term loans and guarantees. The anecdotal evidence for ECA involvement in a number of

## DRAFT

environmentally controversial projects is substantial ranging from the Three Gorges dam in China, the Maheswhar Dam in India, the Omai gold mine in Guyana, pulp plants in Indonesia, the Temelin nuclear power plant in the Czech Republic, and most recently the Ilysu dam in Turkey, to name just a few.

Unlike the MDBs and the bilateral investment agencies, the ECAs were latecomers to the environmental agenda, due largely to the fact that their primary mandates were, and to a large extent still are viewed as, exclusively commercial rather than focused on host country development objectives. Moreover, unlike the multilateral and bilateral development agencies that are lenders (and insurers) of last resort, the ECAs are engaged in a highly competitive exercise where the objective is to assist home country exporters to compete for opportunities in importing markets by aggressive financing of exports through direct credits, insurance and guaranties.

It is this competitive aspect that is both the driver and the inhibitor of the ECA environmental learning curve. Direct and overt competition among ECAs has stimulated the initial concern about differential environmental standards while at the same time, inhibiting agreement on what those standards should be.

The unilateral and progressive enactment by the US government of environmental standards for the U.S. Export-Import Bank (Exim), beginning in 1992, raised the issue within the OECD Working Party on Export Credits and Credit Guarantees. However, as recently as 1995, the OECD tabled the issue of environmental standards as hypothetical. The issue was resurrected in more concrete form after Exim's decision in 1996, following protests from the US NGO community and strong signals from the Clinton Administration, to refrain from financing export credits for the highly controversial Three Gorges dam in China, only to have Canadian, German, Swedish and Swiss ECAs, among others, actively compete for the billions of dollars of export opportunities presented by the project, U.S. exporters unable to compete except in joint ventures with their erstwhile competitors

The lesson for the NGO community was that institutional reform could not be achieved unilaterally in a competitive international investment environment, where capital competed at the margins and subsidized discounting was the norm as is the case with respect to export credits. In the absence of some threshold consensus among competing ECAs regarding common environmental standards for projects in developing countries, the result could be a "race to the bottom" in which the ECA with the lowest environmental standards, imposing the lowest cost to the project, would prevail in the competition for export opportunities. (Berne Declaration et al; Rich, *Exporting Destruction*, p. 32)

The NGO response was to escalate the issue to the highest political levels, i.e. the heads of state of the G-7 (later the G-8) countries, where progressively strong joint communiqués were made at annual summits culminating in the statement made in July 2000 acknowledging that "export credit policies may have very significant environmental impacts and committing member states "to develop common environmental guidelines,

## DRAFT

drawing on relevant multilateral development bank experience, for export credit agencies,” by July 2001. However, despite a strong commitment from within the OECD directorate and US leadership, the OECD Working Party has thus far failed to reach a consensus consistent with the statutory environmental standards applicable to the US Export-Import Bank, making it impossible for the US to endorse the “agreement.”

In spite of this lack of consensus on the political level, a growing number of individual ECAs, for a variety of political, operational and reputational reasons, have adopted environmental standards and have begun implementing them. Noteworthy examples include the UK’s Export Credit Guaranty Department, the Japan Bank for International Cooperation, Canada’s Export Development Corporation and Australia’s Export Finance and Investment Corporation. Several ECAs have publicly refrained from supporting specific projects on environmental grounds.

However laudatory these individual efforts may be and however desirable the adoption of common environmental standards for ECAs, their potential role in influencing the environmental impacts of FDI may be overstated, for several reasons. For one thing, the financial presence of ECAs in supporting FDI in developing and emerging markets may be overstated by the data on the total dollar volume of ECA activity. The vast majority of ECA financing is directed toward importers in industrialized rather than developing countries. Within developing countries and emerging markets, the majority of ECA financing is directed not to FDI but to host governments and parastatals, who use the financing the purchase products for public sector activities.

Finally, due to its role in financing export transactions rather than FDI itself (with some exceptions for those ECAs, such as Germany’s KfW, that engage in direct project finance), an ECA is not an ideal mechanism for assessing and managing environmental impacts. Investment finance agreements concluded by multilateral and bilateral investment finance agencies such as IFC and OPIC, respectively can be structured with environmental requirements as pre-conditions for disbursement with disbursements delivered in stages as successive conditions are met. In contrast, exports credits are one-time transactions that require short-turnaround between application and approval, and provide limited opportunity for post-transaction monitoring and recourse.

The most effective environmental decision for an ECA is a “go/no-go” decision on whether a particular project is sufficiently sound environmentally so as to justify the export guaranty. Such decisions can send a strong signal to markets about the environmental acceptability of particular projects, particularly if the same negative decision is made by more than one ECA. For some NGOs, the decision whether or not to support particular projects is of sufficient importance to warrant a major commitment of resources to the goal of promoting common environmental standards among ECAs through the OECD or some other binding mechanism. However, it can be argued that many important environmental decisions are made in the context of conditional support of projects. The absence of effective conditionality mechanisms and ongoing engagement through the project life cycle, limits the inherent potential for ECAs to the level of preventive or at most proactive rather than sustainable banking. However, given

that most ECAs are still at the defensive stage, there remains considerable room for them to progress along the environmental learning curve. .

### Commercial Banks and Investment Funds: Agents of Change

At the other end of the public-private sector spectrum, environmental factors are beginning to play a role in project finance among purely commercial financial institutions. A 1990 survey revealed that financiers had little interest in the direct or indirect environmental impacts of their activities or the risks such impacts could pose for them financially or institutionally. In another survey undertaken in the early 1990's, bankers attributed approximately ten percent of commercial loan defaults to environmental factors.

Unlike public sector IFIs, banks are not directly accountable to external stakeholders, be they governmental or non-governmental organizations, with respect to the environmental impacts of their activities. They are however, directly accountable to their shareholders for the financial and other risks that such lending entails. Jeucken classifies these risks into three categories: (1) a bank's direct liability for environmental damage caused by a borrower; (2); financial risks due to loss of creditworthiness of the client or the client's assets assigned as security for a loan; and (3) risks to the bank's reputation resulting from real or perceived environmental impacts of client activities. (Jeucken 118)

The enactment and enforcement of Superfund legislation in the U.S. awakened banks operating within US jurisdiction to the first category of risks and such banks were quick to develop and deploy preventive measures to identify and manage such risks. However, the absence of punitive lender liability laws in non-US jurisdictions has muted the response of private IFIs to this category of risk. Moreover, banks have been much slower to acknowledge and address financial and reputational risks. Financial risks resulting from environmental impacts are not always easy to identify as such. A lender's response to a client's inability to service debt in a timely manner may be managed by restructuring the debt or seeking other ways to avoid default without a need to determine or acknowledge the root cause of the default. If a host country regulatory authority has responded to the environmental impact with restrictive or punitive action, the risk may be viewed by both the borrower and lender as "regulatory" risk rather than "environmental" risk *per se*. It is only in an outright foreclosure and liquidation scenario that the lender may become aware of the impairment of project or borrower assets due to environmental contamination, at which point the lender is in a very weak position to effectively manage the risk.. Still, a survey of commercial loans defaults undertaken in the early 1990's attributed approximately ten percent to environmental factors. However, it is unclear whether the universe of loans included in the survey involved international transactions with borrowers in developing and emerging markets.

Banks and other private financial institutions, such as mutual funds, have not been immune from reputational risks that affect brand image. In an article that appeared in *American Banker* in June 2001, Ricardo Bayon traced the origin of this trend to an NGO campaign targeting a number of banks, including Morgan Stanley Dean Witter, Credit

## DRAFT

Suisse First Boston, Salomon Smith Barney (now part of Citigroup) and BancAmerica Securities (now part of Bank of America) for underwriting a \$330 million bond issued by the state owned Chinese Development Bank, to be directed in part to financing the controversial Three Gorges Dam project. As a result of this campaign, that included well publicized shareholder resolutions, a number of the financial institutions were compelled to obtain assurances from the Chinese government that the money would not be used for Three Gorges.

NGOs also targeted these institutions' highly valued branded products in the form of organized boycotts including Morgan Stanley Dean Witter's Discover credit card, and Citigroup Visa cards. Likewise, Goldman Sachs was attacked for helping to under-write an initial public offering (IPO) on behalf PetroChina in protest of China's human rights record and PetroChina's investments in Tibet and Sudan. NGOs claimed credit for the fact that IPO did not meet its objectives. Also that year the U'wa Defense Working Group embarked on a media campaign targeted at the Fidelity family of mutual funds for its ownership of shares of Occidental Petroleum, to protest "Oxy's" drilling in lands claimed by indigenous peoples in Colombia. When Fidelity sold nearly 60% of its Oxy holding later that year it described its decision as being made "solely on the merits of the company." Jeucken provides additional examples including the 1998 targeting of ABN AMBRO for its financing of the same Indonesian gold and copper mining project from which OPIC withdrew support in 1995; a number of Dutch banks for financial ties with palm oil plantations, also in Indonesia; and Sumitomo for its cofinancing of the controversial Sardar Sarovar Dam in India. (Jeucken 140)

Following an initial stage of defensive reaction, the response of commercial banks to a growing awareness of environmental risks has involved a mixture of internal and external preventive measures and some tentative ventures into proactive engagement. Internally, a number of banks have adopted environmental management systems along the same lines as many of their larger clients, opting for either ISO 14001 or the Eco-Management and Audit Scheme (EMAS) favored by the European Union. However, these EMAS programs are targeted primarily at the direct environmental footprint of the banks' activities, as consumers of natural resources including paper, energy, and extending up and down their supply chains. These EMAS programs are only in the beginning stages of deployment with respect to the environmental impacts of borrowers.

A number of banks have adhered to various codes of conduct that state or imply that the institution will take environmental impacts into account in their lending activities. The most explicit of these is the UNEP "Statement by Financial Institutions on the Environment and Sustainable Development" which has nearly 300 signatories from among a broad range of industrialized and developing countries. The UNEP statement itself contains substantial elements of the preventive and proactive phases of the environmental learning curve; it does not go so far as to commit adherents to "sustainable banking," as defined above. Moreover, a study undertaken in 1995, cited by Jeucken (174) showed no statistical difference between the environmental activities of signatories and those who have not signed. UNEP management has acknowledged that perhaps only 40-50 of the signatories are "actively engaged," and has begun charging nominal fees for

signatories and requiring annual reporting as a way of encouraging more meaningful commitments. Nonetheless, the fact that only a handful of North American banks have signed has been taken as an indication of concern about legal liability on the part of such US institutions as well as an inclination to avoid charges of “greenwashing” by institutions that may be committed in to the statement in principle but may not yet have allocated the resources to implement its provisions in a manner that will withstand scrutiny.

Bringing the Learning Curve to Full Circle: Growing linkages between public and private sector IFIs are potential vehicles for bringing the differential environmental learning curves of the IFIs to full circle. Co-financing is an obvious vehicle for cross-training among public and private sector IFIs. However, if OPIC’s experience is any guide, such potential will remain unfulfilled so long as the private sector is content to let the public sector take the lead in assessing and managing environmental risk. Given the well institutionalized preventive approach of most public IFIs, a passive role for the private IFI tends to be the norm, with little if any sharing or transfer of active risk management in fact occurring.

A more promising vehicle for cross-training are the large networks of financial intermediaries (FIs) that IFC, EBRD, IADB and OPIC and others public IFIs have developed, usually at the regional or local level in target market, that provide equity, debt and other forms of capital to companies and projects in beneficiary countries. The growing proportion of MDB financing delivered by these FIs initially led to concerns both within the MDBs and external stakeholders that the FIs could become vehicles to circumvent environmental safeguards and due diligence thus dissipating many of the improvements made by the MDBs in their direct lending activities. To respond to this concern these MDBs have developed training modules designed to sensitize and prepare FIs to screen projects for environmental sensitivity and to conduct EAs for less sensitive (“Category B”) projects, and to deploy environmental management systems, subject to procedural supervision by the MDB and substantive management by the MDB of more sensitive (“Category A”) projects. OPIC, in contrast, has chosen to internalize the environmental risks faced by its FIs and conduct EAs for all FI projects in house, rather than delegate responsibility to the FIs. With more than 25 FIs in its current portfolio, OPIC is beginning to consider other approaches, including the IFC model, described below.

With financial support from the Japanese Comprehensive Trust Fund, IFC has institutionalized its FI training program into the “Competitive Environmental Advantage (CEA) Workshop” series and opened it to local financial institutions that do not have FI relationships with the IFC on a space available basis at a nominal fee. The objectives of the workshops are to: (1) understand the importance of environmental and social risk management (ESRM) principles; (2) apply ESRM principles to investment policies; and (3) implement value adding ESRM techniques institution wide. To date representatives from more than 300 IFIs have participated in the CEA workshops.

## DRAFT

EBRD has embarked on a similar program in its operating region. IADB has encouraged its FIs and other financial institutions in Latin America and the Caribbean to enroll in the IFC program. Such relationships, if sustained beyond initial training, have the potential to institutionalize MDB environmental policies and procedures among FIs throughout the developing and emerging markets.

Another indication that the environmental learning curve among public and private financial institutions is beginning to converge is the recent collaboration between UNEP (a quintessentially “public sector” UN organization driven by public policy concerns) and the Environmental Bankers Association a non-profit trade association that represents the US financial services industry and describes itself as a “response to heightened sensitivity to environmental risk issues and the need for environmental risk management and due diligence policies and procedures in financial institutions.” And finally, the fact that the newest adherents to the UNEP Statement are public sector IFIs such as the Canadian Export Development Corporation, and Germany’s DEG/KfW, is an indication that the “business case” for preventive and proactive environmental management is gaining credibility among public sector IFIs that have traditionally permitted themselves to be driven by exclusively by public policy mandates.

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