1. Objectives and overview

- Objectives and benefits of early coverage of E&S
    1. Identification of the E&S screening and due diligence (DD) process which will be followed during the transaction approval process for various FI products and services.

    2. Early identification of 'no-go' issues which may stop the transactions from moving to the next stage of the approval process (e.g. client undertaking a prohibited activity listed on a FI's Exclusion List or transactions with E&S issues outside of the FI's risk tolerance or policy), saving time and resources.

    3. Early identification of issues that may require significant time and/or resources to resolve, avoiding unnecessary delays and/or misalignment with commercial timelines.

    4. Early identification of key E&S risks that may warrant further attention during the DD stages of the transaction approval process.

    5. Signalling to a client that the FI takes E&S seriously, facilitating more detailed and fruitful discussions later on. This will also enable an early assessment of the client's commitment to E&S matters and whether the FI is going to be able to effectively engage with the company on E&S matters.

    6. Enabling the FI to plan and assign appropriate resources to the E&S risk assessment and analysis of it (i.e. E&S DD and its associated cost).

An overview of the activities included in the screening and categorisation (screening) stage is shown by the graphic below.

CLICK TO VIEW DIAGRAM

2. Activities

2.1 Ensure compliance with lists of excluded/prohibited activities (Exclusion Lists)

Investors and lenders such as BII (refer to "BII's Policy of Responsible Investing" and "BII's Fossil Fuel Policy") have a list of activities they do not finance. Therefore, FIs must ensure that each transaction application it considers for financing complies with and is not engaging in any Exclusion Lists activities. If FIs are unsure whether a specific transaction application complies with an investor's (including lenders') Exclusion List, they should contact the investors for advice.

2.2 Ensure compliance with key financial crimes compliance and regulatory requirements

N.B. As indicated previously, this Transaction Cycle section of this Toolkit focuses on E&S matters as Business Integrity is covered under the Business Integrity section. However, the section includes some high-level guidance on Business Integrity risk management.

An FI's regulatory requirements and financial crimes compliance considerations are critical at this stage. As a basic rule, all FIs must carry out DD on all their customers at onboarding and then on an on-going basis throughout the customer relationship. Customer DD includes identifying and verifying the customer's identity, together with the ultimate beneficial owner and relevant associated parties of non-personal customers. Additionally, FIs are typically required to undertake a check at onboarding and then regularly throughout the relationship, to confirm their customers are not on any local or international sanctions or terrorist watchlists (e.g. the United Nations Security Council (UNSC) sanctions list) and there is no material negative media or potential financial crime-related risk associated with them, via undertaking adverse media checks or checks against lists held on individuals committing fraud or other crimes.

FIs should adopt a risk-based approach to financial crime DD and apply enhanced DD in respect of customers presenting heightened risk, based on the customers geographical location (e.g. countries with poor corruption scores), sectors (e.g. money service businesses or jewellers), products and services offered (such as wealth management, offshore banking or correspondent banking), the delivery channel used (e.g. remote banking) and the customers characteristics (e.g. identified negative news, fines or close political connections such as politically exposed persons (PEPs)). Based on a risk assessment, simplified DD may be conducted for low risk customers e.g. retail customers in low risk countries receiving loan or mortgage products. FIs typically risk-rate customers, with higher risk customers requiring closer monitoring (e.g. annual DD refreshes).

Throughout the customer relationship, FIs must ensure they follow and apply their financial crime policies and procedures to prevent money laundering, terrorist financing, bribery & corruption, sanctions, fraud and tax evasion associated with the FIs customers and third parties. FIs should also implement a whistleblowing procedure and a process to capture and report suspicious activity and transactions for review and if necessary, disclosure to the regulator. Detailed guidance on financial crimes compliance is presented in the Business Integrity section.

2.3 Determine the level of E&S assessment and potential applicable standards for different transaction applications

From an E&S perspective, the level of information to be reviewed at screening and DD stages should be commensurate with the level of E&S risk and impact a specific transaction or client presents. The level of DD will generally be driven by (i) the type of transaction (e.g. type, amount and tenor of loan, given that the longer the loan term, the higher the FI's exposure to its client's E&S risks. Similarly, project finance and corporate finance could mean more exposure to a client's E&S risks than short-term credits or trade finance), and (ii) the client's or project's E&S risk, impact profile and category. In some cases, the risk profile of a transaction or client may change over time. For example, in some sectors the construction phase of a project finance transaction could present higher E&S risks than the operational phase. Refer to the section covering the E&S categorisation of transaction applications.

Additionally, other factors such as contextual risks (e.g. regional security risks, conflict zones and areas with strong human rights challenges or geographies with significant climate risks) may influence the applicable E&S standards and the level of E&S DD to be undertaken. Therefore, it is important for FIs to develop tailored processes, informing the level of E&S assessment to be undertaken and respective transaction approval processes depending on the transaction characteristics.

Refer to section 2.6. Confirm applicable standards for further details.

2.4 Identify key E&S risks, impact and opportunities

FIs must identify the key E&S aspects (risk, impacts and opportunities) of a transaction, considering the client's or project's characteristics including status (brownfield vs.

greenfield), phase (construction, operation, decommissioning), scale, location, sector, sponsors and supply chain. Screening is typically a desk-based exercise.

The Sector Profiles section of this toolkit highlights typical E&S aspects associated with different sectors, providing a starting point for the screening exercise. FIs may also find BII's E&S Topics, Business Integrity (BI) and Resources sections helpful.

For further guidance and tools, see Resources.

- E&S aspects

	E&S aspects
Relevant to most businesses/companies	- Management commitment, capacity and track record (CCTR) - Quality of a company's existing E&S Management System(s) - Labour and working conditions/job quality - Occupational health and safety (OHS) - Stakeholder engagement - Resource efficiency and pollution prevention - Climate change
Relevant to some businesses/companies	- Community health, safety and security - Land acquisition and involuntary resettlement - Biodiversity and ecosystems services - Cultural heritage - Indigenous peoples - Supply chain E&S risks - Animal welfare - Cumulative impacts - Safeguarding including gender-based violence and harassment, modern slavery and child labour - Data privacy

- Information and resources which feed into the E&S screening process

Screening is generally a desk-based exercise. The process shall be described in the FI's Environmental and Social Management System (ESMS). Several types of information and resources may be used in the screening process of a transaction and may include: (i) the FI's Exclusion List, (ii) international and local E&S guidelines and standards, (iii) publicly available information about the client or project (e.g. sustainability reports, annual reports, publicly available news, internet searches), (iv) the FI's previous experience(s) working with this client or in this sector, (v) early discussions with the client or project applicant, (vi) a focused/basic client screening E&S questionnaire or checklist (to be shared with clients for their feedback), and, in some cases, (vii) review of some key E&S documents (e.g. Environmental and Social Impact Assessments, E&S audits).

- Using questionnaires at the screening and E&S categorisation stage

  Using standard high-level E&S questionnaires can be useful at this stage (see BII's environmental and social screening checklist). E&S questions may also be suggested by transaction fundamentals (e.g. overall value proposition, a client company's strategy and business plan, what sectors/products/business segments the FI's capital will be allocated to, and presence of other investors).

2.5 Determine E&S category of transaction applications

E&S categorisation includes identifying potential E&S risks and impacts associated with a transaction to inform the level of E&S DD during the transaction cycle. Given the plethora of different FI products available in the market and the different client profiles, this is an important step in ensuring that appropriate time and resources are assigned to managing E&S risks and impacts for different transactions.

Once the main potential E&S risks and impacts of a transaction have been identified, the transaction application should be assigned an inherent E&S risk/impact category (e.g. 'Low', 'Medium', or 'High') in accordance with the FI's ESMS. This categorisation may be revised later in the transaction approval process as more information becomes available. However, at the screening stage, it is advisable to be cautious and if the category is unclear, assign a higher category so as not to underestimate the time and resources that may be needed for DD.

- Benefits of assigning an inherent E&S risk/impact category

  Assigning an inherent E&S risk/impact category ('E&S category'):

  - Gives an indication of the likely time and resources required for DD, including the need for external consultants;
  - Guides the level of engagement between the FI and its clients required during the monitoring stage of the credit cycle;
  - Allows investors and lenders to see at a glance the inherent risk profile of the FI's portfolio to understand where most attention is needed and to judge whether the FI ESMS is adequate to manage the risks in the portfolio; and
  - May guide the FI in determining the E&S standards that shall be applied to a transaction.

- How to use the E&S categorisation system

  It is important to assess each transaction application on a case by case basis and where possible not solely rely on industry-wide risk ratings as a basis for categorisation. In this regard, a transaction may not present the same E&S risks or impacts than other transactions within the same sector or industry. In other words, the E&S categorisation shall be considered on a transaction by transaction basis as otherwise the FI may expose itself to undue risk or liability in the future. For example, an agricultural client that is expanding its plantation with +300 people that need to be resettled will present a higher risk than a similar expansion which will not lead to resettlement provided that all the other impacts are similar.

  For some investors, categorisation may also be important as the E&S standards that investors in the FI expect the FI and its clients to meet, may be influenced by, *inter alia*, the transaction's E&S category.

- Key factors that can inform the transaction risk E&S categorisation
    - ***Use of proceeds:*** The FI should consider scope of the use of proceeds, where this is known (e.g. project finance, SME loans, credit lines targeting renewable energy projects, etc.).
    - ***Subsidiaries, joint ventures and other activities:*** When categorising, FIs should consider the E&S risks of the client's operations, as well as subsidiaries and/or joint ventures where applicable (as these may also present significant E&S issues).
    - ***Business plan:*** FIs should consider whether clients are planning to expand existing assets, build new assets, integrate their business vertically, and/or operate in new sectors and/or geographies, as this could affect the E&S risks and impacts associated with the transaction application. New developments involving construction are typically associated with higher E&S risk categories.
    - ***Sector:*** Some sectors present higher inherent risks than others. If the client is in a diversified group, there may be multiple sectors to consider. The categorisation rating should consider all the activities in which the client (borrower) is involved in. It shall be noted that some sectors (e.g. healthcare, education, hospitality, information and communication technology) which have typically been considered as low risk by many FIs, may include medium to high E&S risks (e.g. gender-based violence and harassment, child safeguarding risks, risks associated with data privacy). The FI's ESMS shall take into account these risks so that they are assessed, managed and monitored.
    - ***Technology/techniques:*** Clients operating in the same sector, location, and with similar scale of operations may present different risks and impacts as a result of the use of different technologies (e.g. the use of Best Available Techniques will reduce the risks and impacts).
    - ***Scale:*** Different clients operating in the same sector and similar locations may present different risks and impacts depending on the size and/or production capacity of their assets (e.g. a mini-hydro will have different impacts in comparison to a large dam).
    - ***Location:*** Different clients operating in the same sector and with similar scales of operations/assets may be associated with different risks/impacts depending on

the location (e.g. companies located in fragile and conflict states, triggering resettlement and/or impacting critical habitats, present higher risks/impacts). Location includes country-specific, region-specific, and site-specific E&S issues. Clients that have, or are likely to have, significant impacts on local communities' (including Indigenous Peoples), health, safety, security, livelihood (e.g. resettlement), and/or biodiversity (e.g. impacts on protected areas) should be associated with medium to high E&S risks and impacts and should be categorised accordingly.

- ***Contractors:*** May also involve high risks that affect the overall risk rating of the business based on the number of contractors involved and the services provided.

- ***Supply chains:*** May also involve high risks that affect the overall risk rating of the business based on the services provided (suppliers exposed to child and forced labour risks, using conflict minerals, contributing to deforestation, etc.).

- Proposed inherent E&S risks/impact categorisation system

  There is no single correct way to assign E&S categories. A typical E&S categorisation method for a standard commercial bank in an emerging market is shown below. The system proposes categorising the transactions with 'Low', 'Medium' (may be split into 'Medium-High' and 'Medium-Low') or 'High' inherent risks/potential impacts. This categorisation system is solely based on the inherent E&S risks and impact associated with a transaction and does not consider other elements such as the FI's leverage.

  This process should also consider changing market conditions and environmental circumstances (i.e. regulatory/policy changes and physical climate change), as well as emerging E&S risks associated with country specific political and demographic changes and digital transitions/changing consumer preferences that are creating material and near-term risks for FIs. These include issues such as cyber security, data privacy and security, physical climate risk, modern slavery and human rights, etc.

  CLICK TO VIEW DIAGRAM

  However, it shall be flagged, the above-mentioned E&S categorisation system is not the only element that FIs frequently use to determine the level of E&S DD and the applicable standards.

2.6 Confirm applicable E&S standards

The FI's management systems shall clearly define the level of E&S DD and the E&S requirements which the FI will apply to a transaction or require a client to comply with. When determining which standards shall be applied to a specific transaction/client, FIs shall generally consider, *inter alia*:

- The inherent E&S risk/impact category and the key E&S risks and impacts associated to such transaction;
- The transaction characteristics including (i) type of transaction (e.g. project finance, corporate debt, trade finance, insurance), (ii) the size of the loan/transaction, and (iii) the tenor of the loan (or equivalent in non-debt transactions). Some FIs and DFIs use certain transaction thresholds (e.g. loan size and tenor) and characteristics (e.g. type of financial product) as proxies to focus E&S DD requirements and effort and applicable E&S standards; and
- Contextual risks which may be outside the FI's and its clients' control, but which can affect the FI or its clients/transaction (e.g. security risks in specific region).

Many investors/lenders, such as BII and other DFIs, would require FIs to apply international standards to transactions presenting medium to high E&S risks and impacts (and this may be determined via proxies driven by the transaction characteristics, as stated above). An example of how to determine which standards apply is shown below.

CLICK TO VIEW DIAGRAM

2.7 Build a common understanding

A key aim of early conversations with the FIs' clients is to build a common understanding of the main E&S factors to engage on and to assess whether a client is willing and able to address them. Therefore, FIs are encouraged to present the business case to the clients they are considering to finance. This is a combination of downside risk management and upside value creation.

- Benefits of building a common understanding from an early stage

  Early discussions on key E&S aspects typically expedite the DD process and legal negotiations. It can be helpful if the Relationship Manager/Loan Officer responsible for the transaction starts the conversation around main E&S expectations. By the time discussions commence on the transaction term sheet, the client should have a clear understanding of key E&S provisions and requirements that the project will need to adhere to.

  In order to assess a company's willingness and ability to address E&S aspects, it is advisable to start a commitment, capacity and track record (CCTR) analysis at this stage and complete this at the DD stage. In many circumstances, FIs may already have a good understanding of the company's CCTR as it may already be an existing client.

- Presenting the E&S business case to clients

  FIs shall consider that expectations about their role in (i) supporting a transition to low carbon economy and (ii) addressing other E&S issues, are growing. These expectations are being reflected in regulations, industry standards, demands from customers and investors and expectations from FIs' staff and civil society. This also applies to E&S regulations and expectations applicable to FIs' clients as there is increasing pressure from many stakeholders to ensure every company operates in a sustainable manner. This trend and associated factors shall be considered by FIs in their E&S strategies and form part of discussions with clients as failure to address and manage these issues may result in risks for the FIs and their clients.

  However, the management teams of some clients may not fully see the benefit of employing robust E&S practices. Therefore, FIs are encouraged to present the business case to clients. In some cases, it can be helpful to map the business case onto a table similar to the one shown below to structure the discussion and prioritise which E&S factors to address early on, as well as to highlight potential opportunities for value creation.

  Click to view diagram

2.8 Define the scope of and plan the E&S DD

One of the key outputs of the screening and categorisation phase is an understanding of the key E&S factors to be assessed at DD as well as of the resources required to conduct adequate DD.

- Main elements of typical high-level DD that should be considered at screening include:
  1. Desk-based review;
  2. Conversations with the FI's client management team and/or relevant E&S teams; and
  3. In some high risk circumstances, a site visit by deal team, typically including the Relationship Manager/Transaction Officer and/or the E&S Coordinator.

  See Resources for sample screening and DD questions and checklists which can be used by an FI as part of the transaction assessment process.

3. Outputs

Key outputs of the screening stage:

- Identification of 'no go' issues (e.g. irremediable breaches of the Exclusion List or a company's unwillingness to address key E&S issues).
- An understanding of the key E&S factors that could impact (positively or negatively) the deal, the DD process and/or the FI's reputation.
- Inherent E&S risk/impact categorisation.
- Determination of applicable standards.
- Preliminary view of a client's capacity, commitment and ability to address E&S factors.
- Plan and budget for DD.

- In the case of some FIs, there may be a transaction screening memorandum. If this is the case, it shall contain an E&S section prepared by the FI's transaction team.

- Potential implications from an FI strategy and portfolio composition perspective (e.g. backing a specific transaction may make achieving certain FI climate-related commitments harder for the FI).