



## MANAGING THE ENVIRONMENTAL AND SOCIAL RISK OF LENDING

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### Environmental Management System of the ProCredit group

As a development-oriented group of commercial banks, we must continuously evaluate the relevance of our actions with regard to our concept of development. This goes well beyond considering economic growth and encompasses a broader sense of responsibility towards the societies in which we operate. More than merely promoting financial growth, our definition of development entails fostering democracy and free speech, respect for fellow human beings, social justice, ecological awareness and ethical behaviour. If we are to truly live this concept of development, we as ProCredit must continuously assess our actions and decisions, not only from the perspective of profitability and of our clients' needs, but also and above all in terms of their potential impact. We must not allow anything – not even a significant profit – to lead us astray from our primary goal of minimising the negative impact of our business decisions on society and the environment.

Therefore, we believe that the implementation of social and environmental standards is a fundamental element of a responsible business model. This applies both to our lending operations as well as to our day-to-day work. In order to avoid and effectively manage any potentially negative impacts on society, be it our social environment or our ecological footprint, we have developed a clear Environmental Management System (EMS) across all ProCredit banks. It consists of internal measures to encourage the efficient consumption of resources as well as several measures to promote investment projects with a low environmental impact. The ProCredit Environmental Management System is based on three pillars and is designed to ensure that direct and indirect environmental impacts are minimised. The three pillars are as follows:



## Our environmental and social risk assessment framework

In this brochure, we present our approach to the second pillar of our EMS, management of environmental and social risk in lending, as it is a crucial part of our environmental strategy. We aim to minimise our indirect environmental impact by working with businesses whose activities do not harm the environment or society.

This objective is reflected in our creditworthiness analysis methodology, in which assessing environmental and social aspects plays an important role in the credit decision-making process. As a development-oriented banking group, we operate in countries where businesses are not always required to meet high environmental and social standards. In this way, we not only make sure that our clients comply with the law; we also carefully assess the risks associated with their production processes and production site.

Our efforts to minimise environmental and social risks are not based on simple scoring systems. Rather than simply refusing to do business with companies because they do not score well with regard to certain criteria, we prefer to engage them in dialogue to discuss how our services can help to improve their environmental and social performance in an economically sound way.

### *Our three-step process for managing the environmental and social risk of lending*



### Step 1: Our Exclusion List

Despite our inclusive approach and openness towards the many different business models of our clients, there are certain harmful practices and activities that ProCredit banks categorically refuse to support:

- A.** Unethical practices and labour conditions, such as activities that involve exploitative forms of labour and discrimination, or the production and trade in weapons and munitions.
- B.** Activities that are detrimental to the health and safety of workers and the community or pose significant risks to the environment, such as underground mining, the production or trade in radioactive materials, and unsustainable logging.
- C.** Activities having a negative impact on the community, such as projects that involve involuntary resettlement or have adverse impacts on indigenous peoples and vulnerable groups.
- D.** Activities with negative health and environmental impacts, such as the production or trade in tobacco and activities within or adjacent to certain types of protected areas.

<sup>1</sup> An on-site visit is mandatory for any legal entity financed with an exposure above EUR 750,000 whose economic activity is assessed as posing a high level of environmental risk.

To ensure that we apply this principle consistently across the globe, we have formulated an unambiguous Exclusion List. ProCredit banks do not enter into a business relationship with companies that are engaged in the activities specified in our Exclusion List (see our *Code of Conduct*, page 34f.).

Our Exclusion List is a living document, which we review on a regular basis. Through this, we strive to not only address global issues that are widely viewed as ethically questionable, but to also take practices into account that are more specific for our countries of operation or that have recently gained critical attention.

For example, in 2021, hunting activities, except for those whose core objective is the sustainable management of ecosystems, were added to our Exclusion List. This decision was taken based on our concerns that hunting is poorly regulated in some of the regions in which we operate and our critical perception of commercial hunting activities in general.

Another example is our decision to exclude the financing of single-use plastic producers, although this type of production is not restricted or prohibited in most of the ProCredit countries. To further reduce the use of plastic directly and indirectly, we have also developed a comprehensive Plastic Strategy that outlines how we aim to decrease our internal plastic footprint and defines our E&S approach towards clients producing plastic.

Because we do not wish to contribute to the further destruction of nature and its biodiversity, our Exclusion List also covers projects and business activities that are carried out within or adjacent to protected areas classified under IUCN<sup>2</sup> categories I-IV. In addition, we individually assess any risks and potential impacts of a client's business or project if it is located within other types of sensitive areas such as Natura 2000, Ramsar or Emerald Sites, and UNESCO Natural World Heritage Sites. Whenever a client's activity poses significant risks to a sensitive area of this type or clearly interferes with its purpose of protection, we either try to convince the client to improve their environmental practices accordingly or we decide not to provide financing.

In addition to the Exclusion List, an Environmental and Social Impact Watch List, which provides a system of triggers to identify projects or economic activities that can potentially be classified as Category A, is applied at the initial stage of the lending process. As defined by international financial institutions, Category A projects are those with potential significant adverse environmental or social risks and/or impacts that are diverse, irreversible, or unprecedented. To support our banks in the timely recognition of potential Category A projects or activities, a screening based on different criteria has been developed. This applies to greenfield projects or major expansions that, for example, have an impact on the current structures of social communities, including any activities which require resettlement, a public consultation process according to national legislation, or are located near to or within any sensitive area.

## Step 2: Our environmental risk categorisation system

To guide our staff in the analytical process, we have designed an environmental risk categorisation system based on international standards that assigns individual economic sectors to either a high, medium or low environmental risk category, according to their potential environmental impact.

- Low risk sectors could have a minimal to limited negative impact on the environment. This category typically includes service-oriented businesses, such as grocery stores, schools or fitness studios.
- Medium risk sectors utilise production processes that could have adverse effects on the environment, but which can usually be improved by applying simple mitigation strategies. This category typically applies to food processing industries or to production activities that do not use chemical processes.

<sup>2</sup> International Union for Conservation of Nature = IUCN

- High risk sectors are engaged in activities which involve complex, differentiated production processes or which are severely detrimental to their surroundings, such as raw materials extraction or chemical production. These businesses require much stricter and more sophisticated mitigation action to minimise their impact on the environment.

Our categorisation system is binding for all ProCredit banks and does not vary from country to country. All companies whose business activities fall into the medium or high risk categories<sup>3</sup> are subjected to an individual assessment of their performance with regard to environmental, health and safety issues.

Regardless of the sector-inherent environmental risk of our client's activity, we always conduct an individual social assessment that reviews the health and safety and overall working conditions of a financed company.

### Step 3: Activity-specific assessment

*When we receive loan applications from companies whose activities could be hazardous to the environment or society, we analyse their situation and identify the available options to mitigate the risk.*

The purpose of this assessment is to make sure that the company's owners are aware of all environmental, health and safety issues, and that appropriate processes are in place to manage any risks.

In particular, we look at the following aspects:

- Legal compliance: Does the company bear liability for any damage to the environment? Does it have the necessary permits? Is it operating in accordance with laws and regulations?
- Production risks: How clean are the company's production methods? Is management aware of potential risks? If so, how are these risks mitigated? How is waste disposal handled? What safety measures are in place?
- Environmental and site factors: Where are the business premises located? Can any noise or emissions resulting from the business activity disturb neighbours or pose a threat to sensitive ecosystems?
- Social integrity: Are the working and employment conditions satisfactory? Are labour rights fully respected?

In 2013, we began to intensify our approach to environmentally responsible banking. We conducted broad-based research with the aim of creating an activity-specific environmental and social risk profile of each economic activity that could potentially have a medium or high environmental impact. We used the findings of our research to develop activity-specific assessment forms, which explain the potential adverse environmental impacts for all relevant kinds of economic activities and specify which technologies can be applied to prevent or mitigate these impacts. The assessment process takes various aspects into account, such as water pollution, soil pollution, air pollution and waste management.

The ProCredit banks employ different assessment forms to analyse and evaluate the environmental, health and safety performance of their clients. During an assessment, the staff responsible for the lending process refer to the criteria below to identify the areas in which clients already manage their environmental and social impact. However, we also help clients to develop an even greater awareness of environmental and social risk and support them to enhance their processes accordingly.

<sup>3</sup> For companies with an exposure above EUR 50,000.

We analyse our clients' environmental, health and safety performance against the following criteria:

The infographic consists of four green, house-shaped boxes arranged horizontally. The background features a stylized illustration of a globe with various icons: a sun, a wind turbine, solar panels, a factory, and a gear with the letters 'ESG' on it. The boxes contain the following text:

- Advanced technology and environmental management in place**  
This includes the best available technology for the business processes of a given economic activity.
- Compliance with national standards and requirements**  
This describes the current legal background and country industrial standards. Companies grouped under this category manage their businesses according to local standards.
- Practices that are common in the sector, but which could result in environmental problems**  
In the countries in which we operate, environmental legislation is becoming increasingly more stringent, meaning that most of our clients are undertaking investments to adhere to the laws. We pay close attention to the issues that are addressed in this section and work with our clients to improve the situation over the long term.
- Environmentally risky habits/poorly managed processes**  
When analysing a potential or existing client's business, we identify environmental and safety violations which result or could result in serious environmental pollution and/or harm human health. If the business engages in any of the practices described in this category, adequate mitigation options must be discussed and implemented before we enter into or continue a business relationship.

In order to assess the environmental and social risk of the client, the assessment type required is defined according to the environmental risk category and the amount of the total exposure. Although we are a banking group that focuses on small and medium enterprises, we support our clients in their endeavours to successively increase their capacities and achieve sustainable growth. On the other hand, an increase in investment size also means that for some clients the bank's internal E&S assessment can no longer sufficiently assess the magnitude of potential impacts and risks. Therefore, in cases such as these, we have decided to engage external experts to conduct a comprehensive E&S risk assessment, in order to reduce possible negative impacts.

Therefore, for larger exposures with medium or high environmental risk, external and independent experts conduct two types of assessments, depending on the activity or project: an Environmental and Social Impact Assessment (ESIA), which is an ex-ante evaluation of potential impacts that may arise from a project in the planning phase; or an Environmental and Social Due Diligence (ESDD) for investments in ongoing businesses that are up and running and for which no major changes are foreseen. In the latter type of assessment, the current impacts and risks derived from a company's practices as well the client's E&S performance are assessed.

The ESDD was recently added to our external assessments, as the majority of our business clients are owners of companies that are already operational and for which no major expansions or greenfield projects are foreseen.

*Our assessment forms support the credit decision-making process by providing a clear overview of environmental, health and safety issues for each individual business.*

Regular training and clear assessment forms ensure that our staff understand the environmental and social risk management issues that the companies they analyse are faced with. They are then well-positioned to advise their clients on mitigation strategies and the investments needed to implement them. Nevertheless, we have decided to go even further: the findings of internal ESAFs and the external assessments are integrated into loan agreements in the form of covenants to be fulfilled either before or after the disbursement of the loan. By doing so, we can ensure that good practices are being implemented and that the environmental and social risk of lending is minimised.

