

Environmental Assessment Sourcebook 1999

CHAPTER 6

SECTOR AND FINANCIAL INTERMEDIARY LENDING AND ENVIRONMENTAL REVIEW

1. Operational Directive 4.01, Annex A: "Environmental Assessment" (the EA OD) states the purpose of environmental assessment: "to ensure that the development options under consideration are environmentally sound and sustainable, and that any environmental consequences are recognized early in the project cycle and taken into account in project selection, siting, planning, and design" (para 2). Later on, in paragraph 9, the directive's requirements are applied to sector investment loans and loans through financial intermediaries as well; it carries a brief statement of special options for these loans. This chapter will explore those considerations and options in depth.

2. For convenience, key terms to be used in this discussion (and previously defined in Chapter 1) will be repeated here. Environmental review will be used to indicate the complete procedure for screening, evaluating and supervising projects and sectoral activities from the standpoint of environmental soundness. Environmental assessment (EA) will indicate a specific study, a component of the environmental review process. An environmental assessment report is the document that is produced by an EA.

3. The trend in Bank lending is toward greater use of financial intermediary (FI) lending and toward more onlending independence for the intermediary; however, FI lending presents some special considerations to environmental review. At identification, the TM often knows little about subprojects other than perhaps their sector. Subproject details may not be available even at appraisal. Funds are often onlent in small amounts and not always for specific projects; intermediate credit is commonly used, with other funds, to support expansion or continuing operation of existing enterprises. The TM and other Bank staff usually have little or no contact with the ultimate borrowers. Thus the TM may be able to screen the loan only on the basis of assumptions about the types of subloans likely to be made by the FI. Therefore, while screening of individual subprojects will normally be necessary and additional environmental study may be required, these tasks are defined by the EA OD, in paragraph 9, as responsibilities of the "project implementing institutions."

4. Implementing institutions, themselves, are a diverse group. Intermediaries include public and privately-owned institutions: central banks, sectoral credit agencies, commercial banks, development finance corporations, rural credit cooperatives and nongovernmental organizations (NGOs). Ultimate borrowers include municipalities, cooperatives, government-owned industrial and agricultural operations, NGOs, and public and private ventures.

Their capabilities and interests regarding the environment range from extensive to nonexistent, and they operate in contexts of environmental policy and regulation which vary widely from country to country, and sector to sector.

5. To provide a basis for ensuring that Bank participation in FI operations results in projects that are environmentally sound, this chapter will cover the following issues:

- . special considerations for screening financial intermediary loans (FILs);
- . institutional responsibility for environmental review;
- . guidelines for appraising institutional capacity to meet EA OD objectives for FIs;
- . options available for meeting EA OD requirements;
- . options for strengthening institutional capacity and/or national policy; and
- . options for financing the environmental review process

6. Annex 6-1 contains examples of approaches recently applied in Bank projects. Table 6.1 diagrams the environmental review components in FI credit operations and options for consideration by the TM. :

Screening of Loans to Financial Intermediaries

Screening Criteria

7. The TM will screen FILs loans at identification and categorize them as A, B, or C based on available information about the sector involved and/or the range of subprojects that could be financed. (See EA OD provided in Annex E for definitions and examples of categories.) Where there is complete uncertainty, it is sensible to assign the loan to Category B. This will give participants flexibility in reviewing a variety of subprojects and keeping the level of environmental analysis of each subproject in proportion to the significance of potential impacts. The following additional guidelines may be helpful:

(a) Category A: Any subproject that might be supported under the loan that would be categorized as an "A" project if it were financed directly by the Bank (e.g., land clearing that will affect tropical forest, thermal power development). A collection of subprojects whose cumulative impacts warrant an "A", although the individual subprojects are of a scale that would place them in a lower category.

(b) Category B: Any subprojects classified individually as "B" projects, or that have a cumulative impact on a particular resource which would require the environmental treatment appropriate for "B" projects. Subprojects amenable to application of design criteria or performance standards, and will this environmental management approach be effective in the particular regulatory and institutional context.

(c) Category C: Subprojects which normally do not result in significant environmental impact, and the same conclusion can be reached about the cumulative impact of the subprojects.

Recommending Type of Environmental Analysis

8. TMs are obliged to identify not only the project category but also the type of environmental analysis recommended. There are a number of possibilities, depending on circumstances.

(a) Category A or B Classification Based on Nature of Individual Subproject(s). In this situation, the EA OD requires the FI to screen subprojects and perform appropriate environmental analyses as described in the directive.

(b) Category A or B Classification Based on Estimated Cumulative Impact. In these cases, the subprojects have limited impacts individually. An efficient approach is to have the FI contract for a regional or sectoral environmental assessment, or a more restricted study, following the guidelines in Chapter 1 on regional and sectoral EAs and alternatives to EA. Bank staff will participate in scoping the study and will review it as a part of project appraisal. The study or assessment will provide an understanding of the major environmental issues and impacts, a set of measures to avoid them or to mitigate those which are unavoidable, and the estimated costs of those measures. The Bank can require the financial intermediary to include measures as conditions for subprojects loans; however, in many cases additional environmental studies of individual subprojects will not be necessary.

(c) Category C Classification. These projects typically do not require special environmental studies. However, depending on the nature of the loan, it may be necessary to establish a review and supervision procedure to ensure that subprojects financed are ones which actually do produce the intended environmental benefits.

Planning Institutional Responsibility for Environmental Review

General Considerations

9. One of the TM's primary tasks during preparation is to formulate arrangements whereby EA OD requirements will be met. Delegation of Bank decision-making and loan administration authority represents one of the main advantages to FIL operations. If procedures for subloan approval are too restrictive or if they require a great deal of Bank involvement, this advantage will be diminished. TMs should therefore seek a balance of independent action and Bank oversight that minimizes the risk of approving subloans for environmentally unsound projects. This will vary with country, sector, loan amount, lending institution, and type of borrower, and thus necessitates a flexible approach.

10. The most desirable context for intermediary lending, from an environmental management perspective, is one in which:

- . national policy and legislation require environmental impacts to be taken into account;
- . regulations (or inducements) have been enacted to protect the environment;
- . competent institutions exist to administer regulations; and
- . enforcement is consistent and sufficiently stringent, and incentives are sufficiently attractive, to ensure compliance.

To the extent that a given situation departs from that ideal, environmental management will be more difficult to achieve.

11. When environmental requirements are attached only to Bank loans (and those of other international development agencies), Bank funds will be perceived as more costly than funds with no such conditions attached. This creates two particularly undesirable situations in intermediary lending: intermediaries using Bank funds for a large fraction of their portfolios will be at a competitive disadvantage, and individual intermediaries will be onlending funds both with and without environmental requirements. Borrowers and intermediaries likely will seek other sources of financing, and environmentally unsound projects could be implemented with the unrestricted funds.

12. Each Bank loan should be regarded as an opportunity for incremental improvement in a country's overall management of its resources. The strategy for FI lending, therefore, should include some linkage between demonstrated progress in overall environmental management and continued lending. The long-term objective is to make enough progress that special considerations for environmental review procedures are unnecessary. Until that objective is reached, each loan will require procedures to meet the Bank's environmental objectives.

Considerations for Formulating Institutional Arrangements

13. Various arrangements exist for implementing environmental review -screening, scoping, developing terms of reference, conducting the assessments, reviewing the results, and monitoring subproject implementation (see paras 23-25). Except in the ideal case where environmental review procedures are established and enforced in the borrowing country, some project-specific arrangements consistent with the EA OD will have to be made. A primary task for the TM during project preparation will be to decide what will be effective and efficient in the particular circumstances, so that subloan processing is not unduly costly or delayed, and acceptable to the Bank and borrower.

14. It is important that there be consistency in the approach to intermediary lending in a particular country. Procedures chosen should be well defined and the guidelines for their application clear, so that each time a similar set of circumstances arises in one country, the environmental review approach applied to the loan will be essentially the same. Clear definition in the loan documents will also facilitate monitoring to evaluate the effectiveness of the selected approach and the extent to which implementing agencies are following it.

15. The level of effort devoted to environmental review should be commensurate with risk. For instance, greater potential risks to the environment are posed by loans for certain sectors or subsectors and by

projects of larger size (see descriptions of categories in paras 78). Less obvious variables are the overall regulatory climate in the country and the resources and experience of the FIs involved.

16. The approach chosen should be appropriate in the demands it places on participants. It should allow the TM to take advantage of the strengths and missions of the organizations involved.

Guidelines for Appraising Institutional Capacity

17. TMs should consider the following in order to appraise borrowers' capabilities to meet the EA OD requirements:

- (a) The status of national requirements for environmental review.
- (b) The status of national environmental legislation and regulations and the record of their enforcement.
- (c) Where applicable, the status of international treaties on the environment signed and the record of compliance.
- (d) The status of national, regional or local regulations and procedures relevant to the project (e.g., facilities siting, pollutant discharge limits, performance standards, construction and operating permits and licenses, building and plumbing codes, erosion controls, monitoring programs, etc.).
- (e) The existence of government agencies with responsibilities for environmental assessment preparation and/or review and for administration of environmental regulations or functions described in (a) through (d), above.
- (f) The effectiveness and consistency of administration of environmental functions and enforcement of environmental laws and regulations.
- (g) The existing capabilities of the FI to screen subprojects, develop TORs for assessments, review assessments and monitor implementation of assessment recommendations.
- (h) The advisability of developing such capacity for the FI (in terms of its primary mission, resources to attract and retain qualified staff, workload for the unit, degree of interest in having such capacity, and existence of alternatives such as qualified consulting firms and agencies of local government).
- (I) The capacity of ultimate borrowers to conduct assessments or other studies.
- (j) The availability elsewhere in the country of expertise in environmental review, e.g., consulting firms, NGOs, academic and research institutions, government agencies.
- (k) The record of Bank experience with environmental issues in projects in same country or sector.
- (l) The record of Bank experience with the implementing institutions.
- (m) The project sector and likely subproject characteristics (i.e., higher risk categories will require more environmental capability).

18. Findings in these areas will be the basis for recommending environmental responsibilities and guidelines for carrying them out. Issues related to national environmental policy and its management will emerge, as will needs for institutional development and technical assistance.

Options for Strengthening National Policy or Institutions

National Policy

19. The Bank may lend in situations where capacity to deal with environmental concerns is not well developed because of weaknesses in national policy and its execution. In addition to supporting development in sectors for which subloans are to be made and strengthening FIs, the Bank should also work with the government to improve environmental planning overall. However, to overload a single intermediary loan or credit operation with conditions, covering a wide range of concerns, may jeopardize project success. Thus, while a project may contain a component of institutional strengthening, issues of national policy probably should be kept separate as much as possible from those specific to the intermediary and the loan.

20. Progress in policy formulation and institutional strengthening will be gradual and may require technical assistance, and a flexible approach is called for. For example, a multiyear loan commitment, with an emphasis on strengthening institutional and policy areas, could be formulated. In such a case, evidence of overall progress in environmental management in the country could be a condition of continued Bank lending to FIs in the country. Thus, environmentally sound management of resources in all development projects would be addressed, not just those that are Bank financed.

21. In some cases, FI operations may be inappropriate altogether. Bank appraisal may reveal that the climate for environmental management in a given country is and will continue to be such that FIs are unlikely to pay adequate attention to negative impacts in appraising or implementing projects. The Bank must then make a special effort to avoid supporting through FIL projects that have high environmental risk, and to work toward policy change that will make such lending possible.

Institutions

22. The various environmental functions associated with FI lending many times will entail using existing environmental agencies or units, or creating new ones. The Bank can provide guidelines for capabilities and resources such groups should have. It should also be prepared to include technical assistance as a project component, and may make improvement of capability a determinant of the degree of decision-making flexibility to be granted to the FI. In multiyear loans, a mid-term review could be required, with adjustment of loan conditions contingent on demonstration of satisfactory progress (e.g., diminishing Bank involvement in environmental review could be a result). :

Options for Meeting Environmental Assessment Operational Directive Requirements

Options for Subproject Screening and Review of Assessments

23. An organization with capacity for screening can probably also undertake review of environmental assessments, hence both functions are grouped here. It is certainly possible to assign these responsibilities separately, and it may be necessary when review is required by a government agency.

(a) By government agency. Where there are well-established environmental regulations and responsible agencies for implementing them, screening and/or review of assessments by those agencies may be required or customary, and probably is the best option for FI lending. Appraisal should include identifying the requirements, determining their consistency with the Bank policy, and developing supporting procedures. If environmental review is not a requirement, the mission can identify this as a national policy issue. If a sectoral ministry other than an environmental agency performs reviews, whether and how it addresses intersectoral issues should be determined. Ideally, certification by a reviewing government agency would be the only proof needed that subprojects are environmentally sound.

(b) By existing procedure within FI. A large FI may have in-house environmental capability to screen projects, identify issues, determine appropriate studies needed, and review results. Bank appraisal of such capability should focus on: procedures, experience, staff and resources relative to workload, access to specialists when needed, and ability to influence decisions -especially decisions of project approval, modifications in design and implementation, and environmental performance conditions in loan contract documents.

(c) By new procedure within FI. The loan may provide the opportunity to develop environmental review capacity. This is sensible for large development financing agencies and may be appropriate for large banks active in development financing. It is inappropriate for most small institutions or for any in which development projects or other activities with environmental implications represent a minor fraction of business. Appraisal should focus on the intermediary's degree of commitment to active involvement in

environmental management of development lending and the resources accessible to it for that purpose. The Bank can provide advice on the staffing needs and appropriate procedures.

(d) By environmental consultants. An FI may contract review services by consultants. This is perhaps the most practical option for smaller commercial banks and other purely financial institutions where establishing in-house capability would not be cost-effective. It is also potentially useful as an interim measure while capacity is being developed under one of the preceding alternatives. The Bank should review the consulting agreement. (For a discussion of procuring consultants for EA, see Chapter 1 [paras 59-71].)

(e) By local, scientific institution. An FI might arrange for screening and review by a local university or environmental research institution. This would be much the same as working with a consulting firm. Advantages to such an arrangement are that the institution may be a repository of information on the local environment and may be perceived as responsible and unbiased. Disadvantages include: risk that an academic or research organization may not be sufficiently diversified to deal with the full range of potential environmental issues; incompatibility of academic and research work schedules with the demand for rapid response on subproject proposals; and political alignments of some institutions which may have bias findings.

(f) By special-purpose organization. In the case of an apex loan or other situation in which a relatively large number of commercial banks or similar financial entities will be intermediaries, it may be cost-effective for them to cooperate in establishing and funding an organization to review their projects. The Bank should assess whether the organization would have sufficient influence over subproject approval and preparation.

(g) By the Bank. Where capacity of the FI needs strengthening, or where country regulations and institutions may not provide environmental review consistent with the EA OD requirements, or where the Bank simply has not had sufficient experience with a particular intermediary, the Bank may wish to review results of screening and EA reports of projects which pose significant risk to the environment. Criteria for determining which subprojects would require Bank concurrence prior to approval can be developed to suit the circumstances (see Annex 6-2 for sample). The loan agreement might include provisions for gradually reducing Bank involvement.

Options for Conducting EAs

24. TMs may discuss with the FI the following alternatives when deciding who will be responsible for conducting EAs:

(a) By ultimate borrower. This parallels typical arrangements for Bank project lending. The borrower would typically rely on consultants or academic/research institutions to conduct the assessments. Subproject approval would be contingent in part upon submission of the study. Bank and/or national guidelines could be used by the FI in assisting the borrower.

(b) By financial intermediary. The regional/sectoral assessment approach has already been discussed (para 8[b]). It is particularly attractive for multiple, relatively homogeneous subprojects. It offers the possibility of "generic" assessment, leading to development of guidelines or standards for subprojects (including, for example, reliance on local licensing and permitting functions). The FI would use the guidelines in subloan agreements, and subprojects would be exempt from further study provided they were in conformance. Again, consultants or academic/research institutions would be used to carry out the work.

(c) By government agencies. In countries where assessments are routinely conducted by agencies of the central or regional governments, FIs may be able to take advantage of such arrangements, or may be required to do so. Questions which may arise are whether the environmental study process is sufficiently independent of development policy-making to allow for unbiased analysis and conclusions, whether NGO and community involvement would be possible, and whether adequate resources are available to the agency to sustain the workload which would be produced by the loan.

Options for Subproject Monitoring and Evaluation

25. Similar alternatives are available for monitoring subprojects during operation and evaluating their adherence to environmental considerations.

(a) By government agencies. Environmental and sectoral ministries may have monitoring responsibilities, especially with regard to operation of subprojects. They should be taken into account in developing monitoring procedures in order to avoid duplication. There may be cases where a government agency monitoring program is sufficiently complete that no additional environmental information is required. Again, this is the preferred circumstance as it affects all development in the country, not just Bank lending.

(b) By financial intermediary. When FIs have capability to screen subprojects and review environmental assessments, they also should be able to monitor subprojects for implementation of mitigating measures, guidelines and standards, and other environmental protection features. They could compile information needed by the Bank to evaluate projects after completion, as well. Monitoring and evaluation can be carried out in part through reporting requirements levied on the borrower, but the FI will need trained staff to make periodic inspections of activities in the field.

(c) By consultants or research institutions. Either intermediaries or borrowers can make use of outside consulting assistance in monitoring subprojects, as they would for screening, environmental studies, and reviews.

(d) By nongovernmental organizations. NGOs can be helpful in monitoring certain aspects of project implementation, especially where issues identified by affected communities have resulted in incorporation of special measures in subproject designs or implementation plans. For example, an NGO might monitor and report on progress in resettlement.

Financing Environmental Review and Assessments

26. There are four areas in financial intermediary (FI) lending where cost may be associated with environmental review:

- . subproject screening, assessment review and supervision processes;
- . environmental assessments or other studies of subprojects;
- . institutional strengthening to support the environmental review process for specific intermediary loans;
- and . institutional strengthening at the national level.

27. None of these cost categories is extraordinarily large. For instance, a single qualified environmental expert, with a modest amount of consultant support to deal with special issues, can screen at least 50 subprojects per year, develop terms of reference for those requiring further studies, and supervise implementation from an environmental standpoint. Environmental assessments themselves rarely amount to even 1 percent of project capital costs, except in the case of complex projects unlikely to be financed through intermediary lending. Developing review procedures and conducting training programs are not costly items either.

28. Institutional strengthening, such as retraining existing staff or establishing an environmental review unit, can be financed as technical assistance components of loans. Alternatively, environmental trust funds and bilateral donor agencies may make grant monies available for these purposes. Routine operating costs will become the responsibility of the FI or other implementing agency after the technical assistance is complete. Similarly, institutional strengthening at the national level can be supported as technical assistance or public administration training components of project loans. Again, grant funding may also be possible.

29. Although financing EAs is normally the responsibility of the ultimate borrowers, a case can be made for considering regional/sectoral assessments by the FI as project preparation costs, eligible for support under the loan.

Conclusion

30. As stated in the introduction, FI lending and environmental review present situations that can become complex. There is little experience available as reference, so care must be taken to formulate procedures that are unburdensome but effective. Such effort can be expected to yield benefits not only to the specific circumstance of FI lending, but to the environmental review process as a whole. FI lending may present an invaluable opportunity for significant progress in the management of a country's resources. It should be expected, however, that as procedures are being developed a flexible approach will be required. Again, the long-term objective is to attain institutional capacity such that special Bank involvement in environmental review of subprojects is no longer necessary.

ANNEX 6-1

Examples of Arrangements for Environmental Reviews in Financial Intermediary Credit Operations

Agricultural Credit

1. The Pakistan Agricultural Credit Project (FY90) provides an example of institutional strengthening in the context of an intermediate credit operation. Bank loan funds of \$148.5 million are to be on-lent by the government of Pakistan to the Agricultural Development Bank of Pakistan and five nationalized commercial banks. These intermediaries will in turn lend for a variety of agricultural improvement purposes, such as farm mechanization, livestock production, and inland fisheries development. Included in the project's implementation provisions are measures to increase environmental awareness: : (a) Developing a training course for credit officers covering safe use of pesticides, pesticides restricted or not recommended, integrated pest management, effects of excessive fertilizer applications, and soil conservation practices.

(b) Establishing linkages to extension services and increasing the emphasis on the environment in their training forums.

(c) Providing four staff-months of environmental specialist services to design courses and recommend policy measures to intermediaries and the central government.

2. The section of the SAR on agreements and recommendations specifies among the assurances to be sought during negotiations that all participating banks would "establish training courses regarding environmental concerns in lending" and "formalize linkages with the extension service through creation of CECC [Credit Extension Coordinating Committee]."

Industrial Development

3. The Nepal Financial Institutions Development Project (FY91) is an example of institution-building and national environmental policy and regulation development within the context of an intermediate credit operation. It is aimed primarily at improving the efficiency of Nepal's financial sector but includes a component for environmental review of industrial projects. It consists (a) an IDA credit of US\$10-15 million to the Government of Nepal, to be on-lent as credit lines to eligible financial institutions, and (b) technical assistance of US\$1-3 million to finance restructuring programs for the government-controlled financial institutions and to support the introduction of environmental impact guidelines for industry. Participating institutions are Nepal Industrial Development Corporation, two state-controlled banks, and two or three commercial banks. The line of credit is to be used to finance private sector investments that meet technical, financial, economic and environmental criteria in the industrial, agroindustrial, and services sectors.

4. As part of project appraisal, a procedure for obtaining environmental clearance within Nepal for proposed subprojects is to be developed. The Government has agreed in principle to go beyond this, by incorporating in the project an environmental component covering the industrial sector as a whole. IDA is considering the option of supporting the creation of a unit in the appropriate ministry to conduct environmental assessments of industrial projects. IDA's support would include assistance in developing and formulating assessment guidelines and staff training in impact assessment and monitoring. All subloans in this project would require prior clearance from the new environmental unit, regardless of size, originating institution, and whether or not they fall within the free limit for IDA approval.

5. The India Cement Industry Restructuring Project (FY91) is an example of a Category A industrial intermediate credit operation in a country in which environmental regulations and institutions are well established. IBRD will loan US\$300 million to the Government of India (GOI). US\$298 million will be relent to Industrial Development Bank of India and Industrial Credit and Investment Corporation of India Limited, which will on-lend for subprojects to modernize the cement industry and associated transport system and expand capacity. US\$2 million will be allocated to the budget of the Office of Development Commissioner for Cement Industry to finance employee training and studies of sectoral policy options and environmental protection and pollution control measures.

6. National pollution control standards exist for the Indian cement industry and are being enforced by the states (although poor control equipment operation and inadequate monitoring systems lead to particulate emission problems at many plants). Cement is also one of the industries for which GOI requires environmental clearance as a condition of project approval. Environmental clearance must be received from state pollution control boards before a Letter of Intent for Industrial License is issued. When construction is completed, the state board must certify that installed pollution control equipment is appropriate and adequate before an Industrial License is granted. Both GOI and state governments may demand comprehensive environmental assessments for quarries and plants.

7. At the time of appraisal, five major subprojects had already been identified. The appraisal mission met with their sponsors and consultants and agreed on environmental design and operating requirements for the plants and quarries (generally consistent with Indian regulations, except for more stringent air emission standards, and with additional measures for noise abatement) and on the scope and schedule for comprehensive environmental impact assessment reports to be prepared for each subproject and reviewed by the Bank.

8. The loan agreement specifies that all subprojects must be equipped to meet Indian environmental protection standards. Completion of satisfactory EAs and receipt of clearance by the concerned state pollution control board and, where applicable, GOI are conditions for subproject approval. For subprojects exceeding US\$20 million, the Bank will review the IDBI/ICICI appraisal report and the EIA, to be prepared according the scope agreed-on during the appraisal mission.

ANNEX 6-2

Example of Criteria for Bank Review of Subproject Proposals

The borrower (financial intermediary X) shall not approve Category A subprojects involving the following activities without prior concurrence by the Bank:

- . Manufacture, transportation, storage, use or disposal of hazardous or toxic materials.
- . Encroachment on wildlands of regional, national or international significance.
- . Conversion of wetlands or forest tracts of 10 hectares or more to other uses.
- . Clearing or levelling land areas of 100 hectares or more.

- . Involuntary resettlement of 50 households or more.
- . Withdrawals from or discharges to surface waters or groundwater in excess of 5.0 liters per second.