Guideline on Environmental and Social Risk Management

Environmental and social risk management process adds a new dimension to the existing risk management approach that already focuses on assessing risks such as credit risk, market risk and operational risk etc. Environmental and social risks associated with the CBL's lending operations are systematically addressed in the procedure for identifying and assessing risks, in the assessment tools and through internal capacity to identify and manage these risks. In order to manage E&S risks and opportunities, a structured management approach is needed. Such a management approach is called Environmental and Social Management System (ESMS). The objective of an ESMS is to support the Bank in better understanding of the environmental and social risks related to its portfolio, and to (1) evaluate, mitigate and monitor these risks on a structural basis, (2) maximize opportunities for environmental and social benefits that arise from the obligation of its borrowers to comply with national standards and applicable international covenants and (3) establish a good reputation among clients, investors and other relevant stakeholders.

1 APPLICABLE ENVIRONMENTAL AND SOCIAL REQUIREMENTS

The Applicable Environmental and Social Requirements CBL will impose on its own operation and on activities of its borrowers include:

- National laws on environment, health and safety and labor issues; the environmental and social risk management requirements of Bangladesh Bank;
- "Excluded Loan Types & Industries", consisting of activities which CBL agreed not to finance including for instance activities involving forced or child labor; business relating to pornography or prostitution; production or trade in weapons and ammunitions; as well as the activities involving the production, use of or trade of hazardous substances and other activities.
- The 8 IFC Performance Standards (PSs), also available at http://www.ifc.org/performancestandards. which cover such issues as labor and working conditions, pollution prevention and abatement, community health, safety and security, land acquisition and involuntary resettlement, biodiversity conservation, indigenous people and cultural heritage;
- Other case to case specific environmental and social requirements arising from the contractual obligations CBL may have to its local or international financial partners.

2 APPLICABILITY OF ESRM GUIDELINES

As per regulatory directive, ESRM guideline has to be considered as one of the core risk management guidelines of the Bank. The spirit of this directive is to practice the environmental and social risk assessment and management techniques in the internal operation as well as in the financing decision. As such environmental and social risk assessment should be carried out along with credit risk assessment for any credit proposal (fresh, rescheduling, renewal and restructuring). ESRM Guideline is applicable for all credit proposals of agriculture, retail, trade, microfinance, SME, corporate finance and project finance.

Applicability of the Guideline by the Transaction Type

Transaction Type	Exclusion List	ESDD checklist	Third party ESIA (Environmental & Social Impact Assessment)***
Agriculture activities involving farming, crop production*	✓	✓	
Other agricultural activities	✓		
Retail, Trade, Microfinance	✓		
Small sector falling in one of the categories listed below (a-h) **	✓	✓	
Small sector NOT falling in one of the categories listed below (a-h)**	✓		
Medium sector	✓	✓	
Corporate Finance	✓	✓	
Project Finance	✓	✓	✓

* In the agriculture sector, if a loan application (New/Renewal/Rescheduling/Restructuring) involves farming/crop production activities, poultry and dairy then in addition to exclusion list, it is to be checked using the generic ESDD checklist, if there is any environmentally or socially adverse agricultural practices involved such as use of pesticides, agro-chemicals leading to top soil depletion, ground water contamination; use of nitrogenous fertilizers instead of organic fertilizers leading to nitrous oxide emissions etc. Agribusiness involving sorting, packaging, distribution and sales will not require completing ESDD checklist.

** In the small enterprise category sector, if the following activities are involved, then a loan application (New/Renewal/Rescheduling/Restructuring) worth above BDT 1.00 million (BDT 10.00 Lakh) will be subject to due diligence using generic ESDD checklist (copy enclosed), in addition to exclusion list, even if the loan amount is less:

a) Washing, dyeing and finishing units of RMG sector (water, chemical pollution)
b) Small steel re-rolling mills (operational health and safety, thermal, air pollution)
c) Brick kilns (air pollution, child labor, burning of fossil fuel)
d) Units for tanning, dressing and dyeing of leather and fur (water, chemical, air pollution)
e) Pesticides, agrochemical and nitrogen manufacturing units (land contamination, water, air pollution)
f) Chemicals and chemical products manufacturing units (safety, pollution)
g) Rubber and plastic products manufacturing units (pollution)
h) Batteries and accumulators manufacturing units (chemical pollution)

*** ESIA will generally be arranged by the client at his/her/its own cost and submitted along with loan application. The Bank will ensure that the third party will be qualified by the criteria set by Bangladesh Bank in this purpose.

Additionally IFC Performance Standard will be applicable to different credit/loan products in the following manner.

Subtype	Products	Applicable E&S due-diligence requirements
Project Finance/ corporate loans for projects	**<u>Lease / Long Term Loans</u>**: To finance the fixed assets such as land, new premises, equipment and machinery. It may be a greenfield project or an expansion of an existing plant.	• Irrespective of loan size, if the **capital cost** of fixed asset/ project being financed is equal to or more than or US$ 10mn and the tenor of exposure is more than 36 months.-**IFC Performance Standards 1-8 will apply to the project/end use.** • If the capital cost of the fixed asset/project is less than $10mn only national E&S laws will apply (not need to look at the tenor) • In case of syndicated project loans where City Bank's participation is below 25% of the total loan value, a go/no-go decision can be made based on a review against key objectives of IFC Performance Standards 1-8
Long term corporate Finance	**<u>Lease / Long Term Loans</u>** <u>[loans not associated with a project]</u>	• If the **loan size** is more than US$ 5mn and tenor more than 36 months- **IFC Performance Standards 1 and 2 will apply.** • Also, if the total cumulative exposure over prior 36 months (e.g., revolving facility) is more than US$ 5mn- **IFC Performance Standards 1 and 2 will apply.** • If the tenor is more than 36 months but exposure is less than $ 5mn, then IFC Performance Standards will not apply. • If the tenor is less than 36 months, irrespective of loan amount IFC Performance Standards will not apply.
Short/Mid-Term Finance (excluding project finance)	**<u>Mid Term Financing</u>**: Fund required for a longer period. (refer Long-term loans as well) **<u>Short Term Financing</u>**: Fund to utilize for a very short time due to either emergency or short term projects. This can be a Short Term Loan or a Short Term Revolving Loan either for inland business or cross-border payment in foreign trade.	Same as the two cases above for project/project associated loans vs non project/general corporate loans
Structured finance	**<u>Structured financing solutions</u>**: Principal to principal structured capital market transactions. **<u>Syndications</u>**: a group of Banks getting together (forming a syndicate) to provide the loan amount required by the customer under a set of common terms and conditions laid down in a loan agreement.	To be read in conjugation with project finance/long term /medium term financing. In case of secondary market transactions or syndicated loans where City Bank's participation is below 25% of the total loan value, a go/no-go decision can be made based on a review against key objectives of IFC Performance Standards 1-8
Working Capital Finance	**Overdrafts**: short-term financing for routine operating expenses and overheads. **Guarantees and Bonds**: full range of Performance Guarantees, Advance Payment Guarantees, Financial Guarantees and Bid bonds for supporting the underlying business.	**<u>Overdrafts:</u>** If the total cumulative exposure over prior 36 months (e.g., revolving facility) is more than US$ 5mn- **IFC Performance Standards 1 and 2 will apply.** **<u>Guarantee and bonds</u>**: A review against IFC **Performance Standards** 1 and 2 for the specific end use/underwritten project/purpose.

Subtype	Products	Applicable E&S due-diligence requirements
Trade Finance	**Imports**: Letter of Credit, Back-To-Back Letter of Credit, Deferred Letter of Credit, Import bills for collection, Shipping Guarantee, Import Financing, Performance bonds and other guarantees: **Exports**: Export letter of credit advising, Export letter of credit safekeeping, Export letter of credit confirmation, Pre-shipment export financing, Letter of credit checking and negotiation, Export bills for collection, Export invoice financing.	Requirements primarily for onshore entity. IFC **Performance Standards 1 and 2** in case of client relationships which have cumulatively been in the books for more than 3 years (starting January 2016).
Islamic finance	Bai Muajjal: For financing procurement of raw material where goods are kept under customer's custody. Bai Murabaha: For financing procurement of raw material where goods are kept under Bank's custody. Hire Purchase under Shirkatul Melk: For financing procurement of capital machinery. Bai Salam: For financing pre-shipment expenses by purchasing exportable goods in advance	Same as term loans or project finance loans above.
Investment Banking	• Debt Capital Markets • Asset Backed Securities • Credit Derivatives • Convertible Bonds / Equity Derivatives	Merchant Banking activities such as issue management, underwriting, portfolio management and corporate advisory. Any corporate advisory services to be in line with IFC Performance Standards. In case own funding is also involved, it will fall in one of the above mentioned products.
Any new product	Risk description to be provided in consultation with the E&S officer and chief risk officer	E&S due-diligence requirements will be commensurate to the risks of the new product and will seek guidance from the above rows.

3 Environmental and Social Risk Due Diligence Process

The Bank has developed an environmental and social risk due diligence process for assessing and monitoring commercial lending transactions it provides. The objective of applying these Procedures is to focus upon the environmental and social issues associated with commercial lending and investments in order to maximize the opportunities for environmentally and socially responsible and sustainable economic development, and to minimize the Bank's exposure to environmentally or socially derived financial, reputational, legal risks and liabilities associated with its financial transactions.

Credit risk and E&S risk are two different types of risks that have different sources, mitigation measures, criteria and procedure for assessment and management. While assessing a credit proposal a Bank needs to consider both credit and E&S risks. Bank needs to include E&S risk related due diligence process in the credit appraisal and monitoring process.

3.1 Initial Screening

Goal: Transaction screening

Step: After receiving a credit proposal, Relationship Manager (RM) first for E&S risk management purpose conduct initial E&S screening against list of *"Excluded Loan Types & Industries"* mentioned in the Bank's Credit Policy Manual. If the proposed credit is on the list, credit proposal is not processed. If not, RM proceeds with the credit application to the next step; where unsure whether to reject or proceed, consult with the E&S Officer for further clarification.

Tool: List of Excluded Loan Types & Industries

3.2 Risk Categorization

Goal: Determine the required E&S due diligence

Step: If the credit proposal qualifies after verification with the "Excluded Loan Types & Industries" RM will identify the type & level of E&S risks and required due diligence for the proposed transaction, as the level of E&S risk will vary greatly for different types of financial transactions and by industry sectors. Before making a visit to the client's premises RM determine by the using *"E&S Categorization List"* the overall level of E&S risk associated with the client's activity depending on the nature of the business activity (sector) carried out by the potential borrower. This initial categorization can be done by considering DoE (Department of Environment) categories of Green, Orange A, Orange B and Red. A list of business categories is available in the Environment Conservation Rules (ECR), 1997.Before making a visit to the client's premises, RM determines by the use of the E&S Categorization List the overall level of environmental and social risk (Green = low risk, Orange A and B = medium E&S risk, Red = high E&S risk) associated with the client's activity depending on the nature of the business activity (sector) carried out by the potential borrower. The categorization helps RM to judge how much subsequent environmental and social (E&S) appraisal may be necessary.

After identifying the level of required E&S due diligence RM will visit the business and factory/project and prepared a visit report. At the time of project visit, RM will be accompanied by a member from Project Inspection & Assessment Department (PIAD) in case of project financing or financing to any manufacturing concern where the funded facility is more than BDT 5 crore and in cases where IFC Performance Standard is applicable. In any special case, if RM needed support from PIAD member than Head of CRMD recommendation is needed. Based on the visit PIAD will also prepare a "Project Visit Report" where all the technical aspects will be mentioned for the support of E&S risk assessment.

Tool: E&S Categorization List & Performance's Standard Screening Form

3.3 E&S Due Diligence

Goal: Identify and assess potential E&S impacts and issues

Step: After categorizing associated E&S risk, it is necessary to conduct the required due diligence in line with the applicability mention in the Art 3 of this document to mitigate the risk. The RM will conduct the Environmental & Social Risk Rating (ESRR) using the generic or sector specific checklist. If a transaction is in a sector which is covered by BB sector specific guidance notes then corresponding sector specific checklist will have to be used. For all other sectors the Generic Checklist will have to be used. If a transaction triggers IFC Performance Standard then the Performance Standard Screening Checklist will have to be completed in addition to either the generic or sector specific checklist provided by BB. The outcome of the ESRR helps in the assessment of the E&S risk and in the decision making.

The ESDD checklists (both generic and sector specific) will auto generate the E&S risk ratings – high, medium and low based on the responses provided to the questions in the checklist.

In cases where PS is applicable (as per Art 3) RM will use the *Performance Standard Screening Form* to review the client's operations to determine whether or not any of the eight PSs are applicable to the proposed transaction. If so, RM will inform the client of the relevant E&S issues and the requirements arising from the relevant PS, and ensure that the client complies with any relevant PS.

High Risk: Transactions typically involve clients with business activities with significant adverse environmental and social impacts that are sensitive, diverse, or unprecedented. A potential impact is considered sensitive if it may be irreversible (such as loss of a major natural habitat), affect vulnerable groups or ethnic minorities, involve involuntary displacement and resettlement, or affect significant cultural heritage sites.

Medium Risk: Transactions typically involve clients with business activities with specific environmental and social impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures and international best practice. Potential adverse environmental impacts on human populations or environmentally important areas are less adverse than those of High Risk transactions.

Low Risk: Transactions typically involve clients/investees with business activities with minimal or no adverse environmental and social impacts.

Tool: E&S Due Diligence Risk Assessment Tools

3.4 Review and Approval

Goal: Credit decision based on the risk appetite.

Step: RM will submit the Application for Limit (AFL) and Credit Memorandum (CM) to the Risk Manager. Along with credit documents AFL and CM will be supported by the E&S related documents fully completed E&S checklist along with project visit report, copies of all permits, clearances (Department of Environment clearance certificate, fire license, boiler license, buyer's audit report in case of RMG and other export industries etc),. On receiving the documents Risk Manager review the summary findings of the E&S risk assessment prepared by the RM. The key objective is to check that the RM has followed appropriate process in identifying the important E&S risks and ensuring that they will be adequately mitigated and managed. Based on its review, the Risk Manager then writes his/her recommendation and places the same for approval. The approver reviews the recommendation of the Risk Manager and makes the credit decision. It is to be mentioned that all High E&S risk credit must be approved by the Board of Directors and Low and Medium risk credit will be approved by following Bank's standard credit approval authority. In absence of the Board, the high risk transactions can be approved by the Executive Committee.

Tool: Escalation Matrix

3.5 Risk Mitigation & Control

Goal: Due Diligence to mitigate the E&S risk.

Step: Based on the assessment made earlier the Bank than determine the appropriate procedures to mitigate and control the risks e.g. inclusion of covenants and clauses in the credit agreement. If approved, the credit agreement should then include relevant E&S Covenants or Action Plan where applicable. The recommendation in the credit agreement should also make mention of a frequency of monitoring and how to signal any deterioration in the ESRR.

In case of identified non-compliances with the PS, depending on the severity of the issue, Risk Manager will develop an E&S Action Plan (ESAP) with the support of PIAD members or with the support of third party consultant for addressing the issues within a reasonable timeframe. RM should communicate the content of the ESAP with the client.

Low Risk: If the ESRR outcome is "*Low*" then in-depth assessment is not required. However, it is the responsibility of the RM to ensure the E&S compliance. RM has to ensure the regular compliance throughout the whole credit tenor.

Medium Risk: If the ESRR is "*Medium*", then the RM will identify the gaps and with the consent of the borrower will develop an Action Plan to minimize the gap. The Action Plan must have specific timeline for each of the required action. The Action Plan will be a part of the Credit Memo or Loan Agreement as an E&S covenant. Risk Manager will ensure the compliance of these covenants with the support of the RM.

High Risk: For *High* ESRR, in-depth assessment is required, if necessary with the use of qualified external consultants. Where external assessments (e.g. ESIA) are required by law or regulatory authorities, these should be collected and reviewed. Recommendation and summary findings, including any remedial actions to be agreed with the borrower for closing the gaps on identified non-compliances should become a part of the Credit Memo or Loan Agreement as an E&S covenant. Therefore for the transaction of ESRR "High", CRM should always draft an E&S Action Plan (ESAP) and additional covenants/conditions to be used to mitigate the identified problems.

Tool: E&S Covenants and Corrective Action Plan

3.6 Monitoring & Supervision of E&S Performance

Goal: Managing E&S risks

Step: Monitoring and supervision of borrower's E&S risk related activities will be conducted by the RM. For High Risk clients, RM needs to conduct on-site monitoring by visiting at least half yearly basis and in case of Medium or Low risk atleast on yearly basis. In case of High Risk at the time of visit RM will be accompanied by a member of PIAD. Like any other financial covenants the agreed E&S covenants will be registered in the system and monitored by Credit Administration Department (CAD) based on the follow up visit and documents collected by RM. Based on the follow up RM may re-conduct the ESRR and report it to Risk Officer and CAD. In case of making any improvement or downgrade in ESRR, E&S Officer recommendation is necessary.

Tool: Monitoring Checklist