

Environmental and Social Risk Management:

The FMO Approach

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Introduction

Microfinance has started a positive social and economic movement in many developing countries. Considerable numbers of the world's poor now have access to financial services, giving them opportunities to start building businesses and focusing on a better future for themselves and their children. Microfinance has shown that it can transform lives.

It can also be an agent for a more conscientious approach to environmental and social issues, which will shape the world for future generations. This corresponds with the mission of many microfinance institutions and development finance institutions who are committing themselves to more far-reaching environmental and social goals.

Because of the required efficiency of loan officers and the informal environment in which the micro entrepreneurs work, the challenge lies in developing adequate and practical tools which connect the daily reality and ambitions of micro-entrepreneurs with the goals of MFIs and DFIs in regard to profitability and sustainable development.

In cooperation with MFIs worldwide and with support from Triodos Facet and Triple Value consultants, FMO has developed a toolkit, with insights and practical guidelines, for loan officers and other MFI staff members to use when working with clients on E & S issues. For FMO as a development finance institute, the creation of tools like this is critical for adding value to the microfinance industry beyond financial resources.

Divided into three sections, the toolkit includes an Office Guide, Field Guide and Training Guide and enables an MFI loan officer to assess the environmental and social impact of a business. Together with his client, the loan officer can work on developing ways to reduce the environmental impact, and/or improve the labour, health and safety circumstances of the business. With this toolkit, FMO hopes to have developed the basis for a standardized approach for environmental and social risk management that can be used by MFIs worldwide.

From Equator Principles to Micro Business

Over the past years, it has become evident that a business case could be made for environmental and social management at financial institutions in general: Environmental and social - including labour—risks in a client's business can mean various risks, such as credit and reputation, for institutions financing these clients.

Therefore, financial institutions have developed environmental and social management systems aimed at screening out potentially risky clients in these fields. A number of large international commercial banks have developed and adopted the Equator Principles, based on the IFC Performance Standards. Those financial institutions that are adopters screen all their projects that they are financing over USD 10 million against the IFC Performance Standards.

Common Social and Environment Issues

The main social issues faced by micro-finance institutions are: sanitation and living conditions, child-labour, safety in the work-place, education, illegal activities, including illegal CD copying, illegal sales of alcohol, infrastructure.

The main environmental issues faced are: pollution (waste, water, air), use of chemicals and pesticides, use of energy, destruction of forest (brick-burning, charcoal production and logging).

FMO has adopted this approach in all our financings. We evaluate our direct investment clients (factories, production companies, project finance, and infrastructure) against the same IFC Performance Standards. With financial institution clients, FMO aims for sustainability by requiring the development, implementation and operation of an Environmental and Social Management System (ESMS) to manage and mitigate E&S risks in the portfolio. FMO provides training and follow-up support to assist FI clients in developing and implementing an ESMS.

However, in general, businesses served by microfinance are not associated with the same scale and types of environmental and social risks as larger corporate clients and projects served by other financial institutions. Moreover and naturally, the focus in microfinance lies in the development of positive social and economic impact, and the measurement of such.

Nevertheless, when considering the broad spectrum of micro-entrepreneurs, specific environmental and social risks should not be overlooked. Child labour associated with textile production and other businesses, groundwater pollution from the use of agrochemicals, soil pollution by an automotive repair workshop are a few examples of businesses and industries that present a social or environmental risk.

When such negative impacts are ignored, the net social benefit of microfinance activities decreases. It is for this reason that BRAC, one of the largest MFIs in Bangladesh, has researched the potential negative environmental impacts of their lending activities, and as a result developed methods for improvement by providing guidance to their loan officers.

Although the argument can be made that the adverse environmental and social impacts of one micro entrepreneur are small, it should be remembered that the numbers of microfinance clients are in the millions, creating a large cumulative effect.

A Specific Approach for Microfinance

FMO hopes that eventually MFIs will guide their clients in practical ways in improvement of the environmental and social performance of their businesses. This could mean, for instance, that the loan officer assists the microclient in obtaining the necessary licenses or registrations, thus avoiding potential fines or even closure of the micro-business. Or, in the case of farming and agriculture clients who use agrochemicals, counselling on the proper personal protective equipment and the correct

What are the IFC Performance Standards and the Equator Principles?

The IFC Performance Standards were created to clearly define the roles and responsibilities of IFC and its client companies, in an effort to minimize the impact on the environment and the affected communities for the projects it finances.

The IFC Performance Standards cover:

1. Social and Environmental Assessment and Management System
2. Labor and Working Conditions
3. Pollution Prevention and Abatement
4. Community Health, Safety and Security
5. Land Acquisition and Involuntary Resettlement
6. Biodiversity Conservation and Sustainable Natural Resource Management
7. Indigenous Peoples
8. Cultural Heritage

The Equator Principles are a set of guidelines, based on the IFC performance standards among others, developed by private sector banks as a set of environmental and social benchmarks for managing environmental and social issues in development project finance in the emerging markets. Once adopted, the Equator Principles commit the adoptees not to finance projects that fail to follow the processes defined by the Principles. For detailed information on the Equator Principles, visit www.equator-principles.com.

disposal of the chemicals is clearly in the best interests of the MFI, the client, and the community at large.

In the end, the benefits of positive environmental and social guidance are many:

- 1) More business: If clients are guided to improve towards minimum standards, they become acceptable clients and hence the MFI can reach more microclients.
- 2) More professional business: Maybe even more importantly, the MFI helps to improve the situation of such microclients. This can lead to improved working conditions in terms of health and safety. This means an improvement of the business of the microclient: a more professional business.
- 3) More sustainable business: With fewer risks, the business has a better chance at sustainability.
- 4) More sustainable environment: In the improvement of the social and environmental impact of microbusinesses throughout a region, the MFI contributes to the overall improvement in the environmental and social status of the working areas.
- 5) More sustainable MFI: With the management of environmental and social risks, the value of an MFI is improved, along with its reputation, adding to its overall sustainability.

What About the Competition?

A question often heard is the following: "If I ask all these environmental and social questions, the client will get overwhelmed, and go to another MFI that doesn't ask these questions."

First, the practical issues mentioned here are part of the client's business, so addressing these can be done in the usual conversations about the business. One can even reason that the way an entrepreneur deals with environmental and social matters is an indicator of the overall performance level of the company. Next to that, the advice provided only works if the client acknowledges the benefits. In that way the advice from the loan officer will be valued by the client. So it is important that nothing is forced onto the client. We recommend addressing one or two issues at a time, and allow time for the entrepreneur to change practices.

Additionally, in the opinion of FMO, these environmental and social issues should not be the subject of competition. As reasoned above, any financial institution will have to address environmental and social issues in the portfolio sooner or later. In that sense the standard setting of this approach as foreseen by FMO will create a level playing field for MFIs.

The FMO E&S Risk Management Toolkit

FMO has developed practical and easy-to-use support tools and an educational course, with plans for developing Internet support, to help MFIs build an Environmental and Social Management System.

The E&S Risk Management support tools for MFIs include:

Part A: Office Guide

The Office Guide consists of guidance on how E&S evaluation and follow-up processes (the Environmental and Social Management System) can be put in place in alignment with the MFI's regular credit evaluation, approval, monitoring and reporting processes.

Part B: Field Guide

The actual Field Guide provides the MFI loan officer with practical guidance to address environmental and social themes with their clients. There are two main sections:

- An Activity Assessment Tool: This is a matrix, summarizing the key environmental and social risks for each of the various sectors that MFIs work in, encompassing various forms of agriculture, services, and manufacturing. This matrix is presented in Figure 1.
- 24 Fact Sheets, describing in a practical way for each sector as identified in the Activity Assessment Tool:
 - the relevant environmental and social themes, with simple to recognize icons.
 - guidance for the loan officer to assess the situation with the client for each of the relevant themes.
 - explanation of the benefits for the

microclients of improvement on environmental and social matters.

- recommendations for possible prevention and mitigation measures (actions to agree upon with the client, practical advice), best practices.

A sample fact sheet is provided in Figure 2.

Part C: Training Guide

The Training Guide provides practical training courses to client MFIs and MFI Funds to help them in setting up the relevant management systems. This Training Guide contains all the necessary materials, which can also be used in-house by the MFI to train staff.

Implementation

As this is a new approach, MFI's should be careful when implementing it. In the implementation of the toolkit some key issues should be taken into account:

- On which sector or geographic area is the focus? An MFI can not implement and commit to this new approach for its whole portfolio. It probably has to start with a pilot for a certain group of clients with key questions: "Are there significant social or environmental risks and can we influence them?"
- Fact sheets should probably be adapted to local conditions in sectors and with clients. Agriculture in Argentina has different issues than agriculture in Cambodia.
- Advice in fact sheets could be made more specific with references to local products (water and sanitation), organisations (support in schooling) and legislation (available subsidies) which can help in the implementation.
- Careful definition of monitoring and reporting goals. Microfinance has become a success through its focus on profitability. The administrative processes accompanying new ambitions should not hinder this prime condition.

To address the issues identified, an MFI will have to develop, implement and operate an Environmental and Social Management System. In practice, this means that in each step of the loan cycle, E&S is built in, as illustrated in Figure 3.

The E&S content in each step can be described as follows:

1. **Application:** Here an MFI uses the environmental and social exclusion list—an overview of those activities that (in the opinion of FMO) under no circumstances should be financed.
2. **Assessment:** The environmental and social performance of the client has to be assessed. For this, FMO developed the Field Guide with an assessment matrix and sector fact sheets, describing the most relevant potential environmental and social issues related to each business sector.
3. **Contracting & Disbursement:** In this phase, environmental and social improvement measures can be agreed upon with the client.
4. **Recovery & monitoring:** The follow-up of environmental and/or social advice and conditions is followed here.
5. **Reporting:** The results of the ESMS are to be presented in various reports. In this way the environmental and social benefits to the clients and the MFI can be substantiated.

In Latin America and Asia the Implementation Has Started

Courses on the subject have been conducted in India, Peru, Bolivia, Cambodia and Kenya. Key staff members of MFIs have been trained, and in-house training sessions with loan officers have been completed.

EDYFICAR of Peru has already started the process of including environmental and social assessment of their clients in the loan cycle, using the FMO fact sheets as a starting point for evaluation.

FIE (Fondo Financiero Privado para el Fomento a Iniciativas Economicas) in Bolivia is using the FMO field guide approach to evaluate and rate the environmental and social performance of their clients.

TPC (Thaneakea Phum Cambodia Ltd) of Cambodia has already developed a dedicated fact sheet for a specific line of business (pig raising), based on the FMO field guide approach.

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Figure 1. Activity Assessment Tool

◆ indicates when a risk is possible, but not probable, ✕ indicates when in a sector there is a relevant risk possibility	...when the client is ... ↓																		
	...using (a) machine(s)		[E]																
	...using chemicals/paints/solvents/lubricants/pesticides/fertilizers		[H&S]																
	...employing children				[L]														
	...working in bad conditions				[L]														
	...disposing of organic/production/chemical waste																		
	...causing emissions to air																		
	...polluting water																		
	...processing food																		
	...clearing forest for land cultivation																		
	...extracting clay or minerals																		
	...catching fish																		
	...keeping animals																		
	Environment																		
	Health and Safety																		
	Labour																		
	Crop growing	A1																	
Animal husbandry	A2																		
Fishery	A3																		
Shop/Retail/Market	S1																		
Restaurant/Tea Stall	S2																		
Tourism	S3																		
Healthcare	S4																		
Transportation	S5																		
Wholesale Trade	S6																		
Handicrafts	P1																		
Leather tanning	P2																		
Brick/tile manufacturing	P3																		
Metalworking & Electronic	P4																		
Painting & Printing	P5																		
Auto/Motor repair	P6																		
Wood/metal Processing	P7																		
Charcoal Production	P8																		
Garments Production	P9																		
Textile dyeing	P10																		
Ceramics, Pottery Glaz	P11																		
Glass Manufacturing	P12																		
Mining	P13																		
Forestry	P14																		
Food Processing	P15																		

Figure2. Example Fact Sheet





A1 Agriculture – Crop Growing			
Observe The Client is...	Analyse There is a risk if...	Explain What is important ...	Act Suggest the client to ...
...using (a) machine(s) 	[H&S] Machines look unsafe, ill maintained, have dangerous parts [H&S] No safeguards are available and/or used when necessary [E] Leakages, disposals, liquid waste or wastewater drains to stream /river/ ponds/soil	<ul style="list-style-type: none"> Well maintained machines are safe, not dangerous and cheaper in use Operating a machine with proper safeguards prevents accidents Machine can leak oil/lubricants and that will spoil drinking water Malfunctioning Electricity is dangerous and create fallout 	<ul style="list-style-type: none"> Take up maintenance routine, follow strict maintenance and lubrication practices for the moving parts of equipment Keep machines in good shape and clean Experience operators only Provide and use safeguards (goggles, gloves, mask) Re-use scrap/disposals Stop leakages Stop drinking liquid waste Establish contingency plans for accidents Have fire fighting equipment available Provide and use safeguards when working with chemicals (mask, goggles, gloves, overall) A separate storage is created, locked away from children and living/eating rooms Establish contingency plans for accidents Have fire fighting equipment available
...using chemicals/lubricants/pesticides fertilizers 	[H&S] No safeguards are used when necessary [H&S] No relevant Material safety Data Sheets (or other safety leaflet) are available [H&S] Storage is unsafe, since un-locked, near sleeping/eating	<ul style="list-style-type: none"> Applying/handling toxic substances with proper safeguards prevents illness Safe storage prevents from chemical reactions, explosions, fire, leakages and intoxication 	<ul style="list-style-type: none"> Agree only on permitted and sustainable forms of use of pristine land
... cleaning forest for land cultivation 	[E] Forest is managed unsustainable (without reforestation plan)	<ul style="list-style-type: none"> Deforestation, if not performed carefully and in a sustainable way causes land erosion and degradation, and eventually mud streams and water floods 	<ul style="list-style-type: none"> Have no children working Have children help with light duties only Only outside school hours and pupils must have time and designated place to do homework Children do not operate hazardous machines
...employing children 	[L] Children are being employed	<ul style="list-style-type: none"> Children should receive education, proper nutrition and health care. They should be protected from abuse and discrimination, able to play and enjoy their childhood 	<ul style="list-style-type: none"> Have no children working Have children help with light duties only Only outside school hours and pupils must have time and designated place to do homework Children do not operate hazardous machines
Background, relevant legislation, minimal requirements <ul style="list-style-type: none"> Waste(water)disposal without permit (e.g. Prevention and Control of Pollution Act, 1974) Don't install diesel generator sets without approval certificate Have MSDS available when working with chemicals 		Solutions, tips, further information <ul style="list-style-type: none"> Farmers should use pesticides that are permitted. Farmers should consider to carry out integrated pest management (biological – physical – chemical) Fix leaks promptly Dropping joints can waste over 76 liters of water a day In case there is no waste disposal facility Contact (alone or in collaboration with other entrepreneurs) local council and ask for improved public service 	

Figure3. E&S included in all phases of the loan cycle

