ESG Knowledge Series

Environmental and Social Risk Management for Financial Institutions

Introduction

Financial institutions play a critical role in promoting and delivering sustainable development in two keyways: by mobilizing capital for sustainability projects and by incorporating environmental and social risk management into their lending and investing operations. Effective environmental and social risk management practices enable financial institutions to identify, assess, and manage E&S risks that could affect their financial performance, legal liabilities, and reputation.

What are E&S risks, and why is their adequate management important for financial institutions?

E&S risks are the potential negative consequences for business, the environment and society of impacts on the natural environment, for example, air, water, soil, ecosystems or communities, such as employees, contracted workers, local residents and others.[1]

Financial institutions (FI) are primarily exposed to E&S risks indirectly – by providing loans and investments – through their portfolio of projects and clients' operations and activities (referred to as 'sub-projects'). If not effectively identified and managed, the E&S issues in sub-projects may lead to financial, legal and reputational consequences for the FI.[2]

For example, a sub-project may be unable to repay a loan due to unexpected environmental costs and liabilities, revocation of environmental license due to non-compliance, or absence of social license to operate; or the FI may face reputational damage through association with a client's environmental and social controversies.

By effectively managing E&S risks, financial institutions can safeguard their operations, enhance their reputation, and contribute to the broader goals of sustainable development and environmental, social and governance (ESG) responsibility.

Potential consequences to FI of unmanaged E&S risks	
Credit Risk	Poor E&S practices by clients can increase the risk of default, affecting financial institution's credit portfolio.
Financial Impacts	Failure to manage E&S risks can result in direct financial losses arising from environmental liabilities, legal penalties, remediation costs, reduced asset value due to contamination.
Reputational Damage	Negative publicity from E&S incidents can damage an institution's reputation, leading to loss of clients and investors.
Legal Risks	Legal liability for damage to the environment, human health or property (e.g. compensation claims). Legal obligations to restore land contaminated due to client operations (e.g. collateral).
Operational Disruptions	E&S controversies can lead to project delays, operational stoppages, and increased costs.
Regulatory Sanctions	Financial institutions are increasingly subject to stringent regulatory requirements regarding E&S performance and reporting.

Opportunities:

- Market opportunities: incorporating E&S considerations can open up new business opportunities in sustainable finance, green bonds, and social impact investments.
- Long-term sustainability: by promoting sustainable practices, financial institutions contribute to the overall stability and health of the markets they operate in.

What are E&S impacts and risks in FI operations?

E&S risks that an FI can be exposed to – through its clients and projects it finances – depend on a range of factors such as the specific environmental and social aspects and circumstances associated with the FI client's operations, sectors, and geographic context.

Environmental impacts and risks include issues related to pollution and contamination, depletion of natural resources, biodiversity loss, and climate change.

Social impacts and risks encompass adverse effects on local communities and indigenous peoples, loss of livelihood, gender-specific impacts, labour disputes, occupational health & safety hazards.

Indicative E&S issues to consider are presented below, though the list is not exhaustive.

ENVIRONMENTAL ISSUES:

- emissions to atmosphere
- noise and vibration
- greenhouse gases
- physical climate change risks
- water use and conservation
- waste management
- wastewater treatment and discharge
- biodiversity and ecosystem quality
- hazardous substances handling
- environmental legislation compliance

SOCIAL ISSUES:

- land acquisition and resettlement
- occupational health and safety
- community health and safety
- labour conditions
- gender-related impacts
- cultural heritage
- indigenous peoples
- stakeholder engagement

How Financial Institutions Can Manage E&S Risks?

Environmental and Social Management System

Financial institutions can effectively manage E&S risks by establishing a robust Environmental and Social Management System (ESMS). The ESMS is a set of internal policies, procedures, tools, capacity and competency devised to identify and manage a financial institution's exposure to the environmental and social risks.

The ESMS is an integral part of the overall management system of a financial institution. It serves as a practical tool to incorporate ESG and sustainability consideration into the lending and investment process. Hence, the ESMS should be commensurate with the type and level of E&S impacts and risks the institution is exposed to through its client businesses and activities.

NDB's approach

Through loans, equity investments, and other financial instruments and services, NDB works with financial sector clients to finance infrastructure and sustainable development projects.

NDB Environment and Social Framework (ESF): The Bank assigns 'Category FI' to a project if it involves investment of funds to or through a financial intermediary.

All FIs are required to have in place or establish an appropriate environmental and social management system which ensures the achievement of objectives of NDB's ESF.

Through this approach, NDB delegates responsibility for E&S risk management of sub-projects to its partner FIs, subject to implementation of appropriate ESMS by the FIs and regular oversight by NDB.

What makes a robust ESMS – key components

The ESMS should be tailored to the specific needs and business environment in which the FI operate. The following are the key components of a robust ESMS. They, however, can be adjusted to the specificities of the FI business, its clients, and existing management procedures.

Environmental and Social Management System
1. E&S Policy
2. Organizational Capacity
3. E&S Performance Requirements
4. Risk Assessment and Management
5. Monitoring and Reporting
6. Portfolio Review
7. External Communication Mechanism
8. Continuous Improvement

1. E&S Policy

An overarching E&S policy outlines the FI's commitments to sustainable and responsible finance and E&S risk management in lending and investment operations.

The policy provides a foundation for assessing potential investments and establishing criteria for project approval based on E&S considerations.

The E&S policy should be endorsed by the FI's senior management or board of directors.

2. Organizational Capacity

The FI should designate senior management and qualified staff to implement and oversee the ESMS and E&S risk management in its operations, and clearly define roles and responsibilities for ESMS processes between various FI divisions.

ESMS personnel should have expertise in environmental and social risk assessment and management, and the FI should provide regular training regular training for staff on ESMS policies, procedures, and tools to maintain internal competency.

3. E&S Performance Requirements

The ESMS defines E&S performance requirements and standards that the clients and projects must adhere to when receiving financing from the FI.

The E&S performance standards and requirements shall incorporate, as a bare minimum, the country regulatory requirements; they may also include additional ESG requirements based on the FI's policies and international good practices.

'E&S Exclusion List' defines projects or activities that the FI will not finance due to high E&S risks or controversies.

4. E&S Risk Assessment and Management

E&S Screening and Categorization: Screening involves evaluating the potential E&S risks at the early stages of a loan or investment. This process includes checking that projects align with the FI's E&S policy, identifying potential red flags, and categorizing projects by their E&S risk level.

E&S Due Diligence (ESDD): ESDD is a comprehensive evaluation of a project's E&S risks and impacts. This step often includes reviews of project E&S documents, site visits, stakeholder consultations, and detailed assessments of E&S factors specific to the project. ESDD ensures that all potential impacts and risks are identified and that appropriate mitigation measures are considered. The results of due diligence feed into the development of E&S risk mitigation strategies and are essential for high-risk projects.

E&S Action Plan (ESAP): An ESAP outlines specific measures the FI's clients / borrowers must take to address identified E&S impacts and risks and to ensure that the project meets the FI's E&S performance requirements, including the regulatory compliance. The ESAP includes actions, timelines, and responsibilities for implementing necessary E&S improvements. The ESAP is a binding commitment that ensures that E&S standards are maintained throughout the project lifecycle.

E&S Covenants: E&S covenants are legally binding clauses included in loan agreements. They set out specific E&S obligations for the borrower, such as compliance with local laws, adherence to the E&S performance requirements and ESAP, conducting E&S monitoring and reporting. Non-compliance with these covenants may lead to breach of loan conditions, non-disbursement of funds, acceleration of loan repayment, or other consequences as specified in the loan agreement.

5. Monitoring and Reporting

FIs should conduct regular E&S monitoring of sub-projects, ensuring compliance with agreed E&S standards and legal requirements. This includes reviewing the implementation the ESAP, conducting site visits as needed, and assessing ongoing alignment with the FI's E&S performance requirements.

Borrowers must submit periodic E&S performance reports to the FI, detailing progress on ESAP implementation, incidents related to environmental or social risks, and compliance with relevant covenants. These reports provide critical data for the FI to assess risk levels and ensure accountability.

6. Portfolio Review

Periodic portfolio reviews enable FIs to evaluate the E&S risk exposure across their portfolio. This process involves identifying high-risk projects and sectors, assessing compliance trends and emerging risk areas, and adjusting the FI's risk management approach based on observed outcomes.

7. External Communication Mechanism

FI shall ensure that their borrowers or sub-projects establish and maintain accessible and effective grievance mechanisms. These mechanisms should allow communities, workers, and other stakeholders to raise concerns about environmental or social impacts, ensuring timely and fair resolution.

As part of its ESMS, FIs are required to establish their own external communication mechanism to engage stakeholders and address E&S-related inquiries and grievances.

8. Continuous Improvement

Continuous improvement is integral to any management system. FIs should regularly evaluate their E&S policies and procedures, incorporate feedback, and implement changes as necessary to enhance the effectiveness and resilience of their E&S risk management practices.

ESMS in Transaction Cycle

The ESMS and E&S risk management must be fully embedded into the overall loan and investment review process, ensuring that E&S considerations are systematically incorporated into decision-making at each stage of the project lifecycle. This integration helps ensure that all potential risks are identified, assessed, and managed effectively.

Loan Review Process	ESMS Process
Loan origination and concept review	E&S screening and categorization
Detailed appraisal	E&S due diligence & ESAP
Credit Committee / Loan approval	E&S Assessment Memo
Loan agreement	E&S Covenatns
Loan monitoring	E&S monitoring

Institutional Arrangements

FI should clearly define the roles and responsibilities within the organization for the E&S risk management. Typically, the overall responsibility for the E&S risk management and the implementation of the ESMS lies with the Chief Risk Officer, Head of the ESG Division or Sustainable Finance Division. This lead division is tasked with developing and maintaining ESMS, including drafting the E&S policy, conducting E&S due diligence, and monitoring and reporting processes.

Other divisions, such as Lending and Investment Operations, Credit and Risk Management, Legal, play important supporting roles by integrating E&S considerations into overall project preparation, credit risk assessments, loan covenants, and implementation monitoring. For complex or high-risk projects, external consultants may be engaged to provide specialized expertise, ensuring robust risk management and compliance.

Useful Tools and Resources

First for Sustainability Portal for Financial Institutions
https://firstforsustainability.org/

EBRD's Guidance Note on Performance Requirements 9: Financial Intermediaries, March 2024
https://www.ebrd.com/PR9-guidance-note-for-FIs.pdf

IFC's Guidance Note on Financial Intermediaries, March 2023
https://www.ifc.org/content/dam/ifc/doc/2023/202309-ifc-guidance-note-on-financial-intermediaries.pdf

World Bank's ESF Guidance Note 9 Financial Intermediaries, June 2018
http://documents1.worldbank.org/curated/en/484961530217326585/pdf/ESF-Guidance-Note-9-Financial-Intermediaries-English.pdf

DEG's E-Learning: E&S Risk Management for Financial Institutions
https://kfwdeg.sustainability.training/course/detail/State-of-the-art-E&S-Risk-Management-for-Financial-Institutions

---

References:
[1] Guidance Note on Performance Requirements 9: Financial Intermediaries, EBRD, March 2024.
[2] Guidance Note on Financial Intermediaries, IFC, March 2023.

NDB website: https://www.ndb.int
ESG Department: esg@ndb.int
NDB Headquarters: 1600 Guozhan Road, Pudong New District, Shanghai 200126, China

NDB Sustainability