Opinion

MONDAY, FEBRUARY 25, 2019

INEQUITABLE REPRESENTATION

Kalvakuntla Kavitha, TRS member of Parliament

"Today, I again reiterate that no party—it could be TRS, it could be Congress, it could be BJP, whichever party, it will not give equal space to women unless and until it is mandated by the Election Commission of India or the Parliament"

SHOBHANA SUBRAMANIAN

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RBI, SEBI should have kept closer watch

Hungry for market share, lenders have failed to cover their risks adequately while promoters have bent the rules

ONE NEEDS TO respect the professional judgment of mutual fund managers when it comes to any stand-still agreements they may enter into with borrowers. After all, if the NAV of a scheme falls because the fund manager didn't sell the shares in time, and the price tanks, the reputation of the fund will be at stake. However, that RBI is frowning on such an arrangement is not surprising. The regulator's concerns revolve around the chances of such unhealthy practices triggering a liquidity crisis in the financial markets. One default is enough to shatter investor confidence and trigger redemptions from MFs. That would compel MFs to sell equities or bonds at sub-optimal prices or to recall loans to borrowers. And we have not even begun to dwell on the exposures to real estate. RBI is worried because, according to Prime Database, banks account for a not-so-low 15% of pledged shares transactions while NBFCs account for an uncomfortably high 40%.

Even otherwise, by not selling the pledged shares in the market, the price of the stock is being artificially held up as is the NAV of the scheme. It is surprising that Franklin Templeton agreed to do this in the case of some ADAG Group shares because it is misleading to investors; any kind of evergreening is. Already, most bonds are not valued correctly because the bond markets are so illiquid; while the outstanding value of corporate bonds was ₹29.5 lakh crore, trading volumes in December were close to ₹41,500 crore. The unrealistic valuation means there is no commensurate increase or decrease in yields on certain classes of paper.

While pledging shares is, in itself, not harmful, the disclosures have been very inadequate with promoters camouflaging the true quantum of shares pledged. So, while the official data may show that the share of pledged promoter holdings—within the BSE 500—was just 6.7% in the December quarter and similar to that in the September quarter, the truth may be quite different. The Securities and Exchange Board of India (SEBI), which regulates mutual funds, needs to figure out how to ensure promoters disclose the true value of the shares pledged. Also, SEBI must insist on a big-enough cushion in terms of the loan-to-value ratio of at least 1:5 or better.

While bankers and fund managers must take their own investment decisions, it is also true credit rating agencies are simply not able to give lenders a good enough assessment of the state of a company's finances. More critically, they've been very late to spot any turn taken for the worse, as was the case with IL&FS which should have been redflagged a year back, if not earlier, and, by then, the damage has been done. It is possible the lenders, too, don't always want a realistic rating; in the case of banks, for instance, they would need to raise the risk weights and set aside additional capital which would push up their costs. So there is, at times, a cozy relationship between lenders or investors and rating agencies. And this perception that ratings can be tweaked could cause a loss of trust which will hurt all lenders and mutual funds until rating agencies show us they can be a lot more capable.

In many ways, this is the price that an economy pays for growth. Banks, NBFCs, mutual funds, and insurers are all hungry for market share and, in the process, tend to bend the rules. The markets must evolve and disintermediation in the financial markets is needed but the NBFC sector has grown way too fast for its own good and this disproportionate gain in asset share—especially in real estate—threatens to upset the ecosystem. As Jefferies has pointed out, while core developer loans—relatively more risky—have grown at 18% between 2014-15 and 2017-18, the portfolio for non-banks grew at a high 46% while for banks it increased just 4%. As a share of total credit of NBFCs and HFCs, the mix of total developer loans increased from 6.2% in 2014-15 to 10.7% in 2017-18. Builders today are sitting on large inventories and little cash.

Mix of developer loan in total NBFC/HFC credit has inched up from 6.2% in FY15 to 10.7% in FY18

NBFC/HFC developer finance book (₹ trn)
As a % of overall NBFC/HFC credit (RHS)

FY14 FY15 FY16 FY17 FY18

Mix of developer loan in total system credit has inched up from 3.9% in FY15 to 5.0% in FY18

Developer Finance Book (₹ trn)
As a % of overall system credit (RHS)

FY14 FY15 FY16 FY17 FY18

Source: Jefferies estimate, company data, RBI

The fact is, India's bond markets aren't deep enough to absorb a big liquidity shock. And with the stock markets having performed so poorly for more than a year now—80% of all stocks with a market cap of ₹1,000 crore or more in January 2018 are now in the red—even HNIs who may otherwise have invested in stocks or bonds will think twice. Should there be a crisis in the market due to this, the sad fact is that the regulating system—RBI and SEBI—has been caught napping once again. SEBI hasn't monitored whether adequate disclosures were made about loans-against-dues—and their impact—and while RBI has flagged risks in the past, it raised risk weights on loans to NBFCs to 150% only on Friday.

For now it would be prudent to let the market correct and let some NBFCs or Mfs fail; only then will there be some correction. This will lead to many M&A opportunities—we have already started seeing these—and the stronger players will be able to pick up assets at attractive prices. A purging of the system can't hurt; in fact, it will make it stronger.

TwinBenefits?

Chinese gene-editing experiment resulting in live babies may have had unintended—and unpredictable—consequences

CHINESE RESEARCHER HE Jiankui's gene-editing experiment with the Chinese twins—Nana and Lulu—that earned him much censure, and possibly even disciplinary action by the Chinese government, may have had unintended consequences. Jiankui used CRISPR, a gene-editing tool, to eliminate the chances of the pair of twins contracting HIV from their biological father, an HIV-positive individual by deleting the CCR5 gene from the girls' genome. The deletion, existing research shows, has significant influence on improving cognitive abilities in mice experiments. Scientists also postulate that the deletion can be linked to faster recovery from brain stroke among humans and greater success in school.

However, it is not as rosy as it may sound at the first instance. A neurobiologist quoted in an article in *The MIT Technology Review* believes that the simplest interpretation from the mice experiments can be that the mutation will impact the cognitive abilities in humans—and, crucially, it is difficult to say what the exact impact will be. This means, while there are chances that the twins could be blessed with superior IQ, it may be that the mutation could end up harming their intellect or other cognition-related functions. Given how, exceptional cognitive abilities in certain areas correlate strongly with impaired social skills, it could turn out to be far lesser than a blessing eventually. And, even if there are no noticeable 'problems', and the twins are endowed with superior intellect in the bargain, conducting experiments that produce live, mutated subjects, without having fully understood the consequences, is entirely unethical. It is also likely that, if the twins turn out to be intellectually gifted, along with being invulnerable to HIV, a race for designer babies may ensue. The world needs to accept that, for now, editing genes in embryos with the intention of seeing these through gestation to produce a live human being is a fraught proposition.

HIDDEN UNCERTAINTIES

THE NARRATIVE OF ROMANTIC GDP ESTIMATES HAS SUBMERGED THE DOUBTS ABOUT THE STRONG ECONOMY THAT LURK BENEATH, FAILED TO BOOST ANIMAL SPIRITS

Private investment slumbers as uncertainties fester

RENU KOHLI

New Delhi-based macroeconomist

THE RECENT GDP revisions for 2016-17 and 2017-18 would have surprised even an ardent supporter/admirer of the Central Statistical Office (CSO). Unwittingly though, it has made the lives of doubters like this author a lot easier! For, those who repeatedly pointed to the dissonance between these GDP estimates and other lead indicators can now assert with reasonable certainty that the Indian economy has two parallel narratives: One that paints a fairly rosy picture based upon official statistics, describing the country as the "fastest growing large economy in the world", and another, quite the opposite, of one bogged down by subdued economic activity that has failed to ignite the animal spirit of investment.

Until the revised GDP estimates came out on January 31, the general perception was of an economy driven largely by consumption. But, suddenly, the storyline changed. Investment, it seemed, was actually upward bound and has been so since 2013-14. Gross fixed capital formation (GFCF) grew strongly at 8.3% and 9.3% in FY17 and FY18 respectively, and is projected to accelerate at 12.2% in FY19. But if you look for supporting evidence, there is hardly anything convincing!

Many point to the recent credit pick-up that supports official data. But if we look at sector-wise details, it is still a consumption-side growth story. Credit growth to industry remains very weak. In fact, real or inflation-adjusted credit to industry contracted an average -1.7% each month in April-December 2018. This turned positive only in the last quarter; then, too, a 2.3% (y-o-y) growth in December 2018 was lower than seen four years ago (2.9% in December 2014). Although one can draw comfort from the fact that this is half the average monthly decline observed during the previous year (April 2017-March 2018), in which credit to all industries shrank -3.6% in real terms, in 2016-17, the fall was even steeper, averaging -6.1% each month.

Another piece of evidence depicts an even bleaker picture. CMIE's project-tracking database shows new project announcements at their lowest level since mid-2004; stalled projects reached a near record. Such announcements have steadily trended downhill from a December 2014 peak; in annual and sequential terms, these were 48% lower in the December 2018 quarter.

What is striking is the remarkable parallel with the downward trend in new project announcements and accumulating stalled projects, captured in the same data not long back. Recall the 2011-2013 period, when GDP growth slowed sharply, underpinned by a precipitous fall in private investment that was driven by uncertainties attributed to policy paralysis. That period was defined by poor governance, strict environmental regulations, difficult land acquisition, and retrospective taxation, all of which dented business confidence. In fact, applying the Bloom-Baker-Davis policy uncertainty index, the IMF argued that heightened policy uncertainty had a particularly pronounced link with the decline in new investments and increasing share of postponed or cancelled investments.

The new government that came in May 2014 appeared to have addressed many of these issues, achieved macroeconomic stability and introduced some key structural reforms to foster growth. And yet, the animal spirit that urges businessmen to act has not sprung alive. This is not only worrisome but also raises some concerns. For example, if the world economy slips into another round of recession, the Indian economy runs the risk of getting trapped into a prolonged investment drought! It is seven-to-eight years now that investment has not returned to life.

During UPA-II, businessmen were forthright in attributing this to the widespread governance deficit and corruption, but in the current NDA regime, hardly anyone has spoken! On the face of it, this silence is interpreted as 'all is well'. But the lack of interest in pushing investment points to something underneath is holding them back. That something is possibly 'hidden uncertainties'—related to sudden disruptions to an existing business ecosystem, dampening risk appetite and making businesses unsure if they have the right platform to seek redressal!

We point out several such 'hidden uncertainties' subduing this animal spirit. In the first round, uncertainties arose from demonetisation and a poorly-implemented GST. Both upset the established viability and future prospects of many existing businesses, besides behavioural effects related to cash transactions, disclosures, and all such. In the next round, policy zig-zags and a lack of action in some spheres have aggravated and/or induced further uncertainties. For example, the festering NPAs and lack of clarity about the direction of public banking has been exceptionally stretched and none too close to a foreseeable end. The fate of an estimated ₹3.8 trillion invested in power projects and numerous others stuck at various stages of resolution hangs in the air. A general drift of economic policies towards excessive state intervention and lesser market-orientation has made businesses very cautious. The tax-terrorism that is being spoken of, and an approach that views every aspect of business from the sole standpoint of taxation, tax-evasion, money-laundering, fixing promoters/directors' liabilities, etc., has created a different set of uncertainties in the business environment.

These run parallel to the arrival of a new bankruptcy law that has jolted an established equilibrium; on top of this, a constant stream of interpretations and amendments to this law cumulates uncertainty about future directions and prospects. The enormous scale of wealth destruction, as assets go up for sale at severe discounts—within the confines of this law and outside its boundaries—is something that is bound to make businessmen think a hundred times over before committing fresh capital.

Frequent changes in taxation, rules and the sudden introduction of new taxes (like the GST, 'angel tax' and start-up norms, e-commerce, etc.) add to the long list. All these sum up to an increasing difficulty of doing business despite the rise in EoDB rankings. Finally, a rising incidence of fresh business failures and financial stress, such as those in the telecom, aviation, infrastructure, and, of late, the shadow banking segments, with cascading effects in related parts, also escalates doubts about future business prospects.

One must note that positive reforms like GST and the IBC law also induce uncertainty because these affect future project viabilities leading to a wait-and-watch attitude. Others, like demonetisation, tax coercion, state intrusion, and inertia in addressing banking sector, regulatory and NPA issues are downright negative. But why do we call this a 'hidden' uncertainty? We call it 'hidden' because it is submerged under the bright sunshine of strong GDP growth—growth that is averaging 7.7% in the past four years if you will; an exceptional 8% and 8.2% in FY16 and FY17. This positive growth narrative submerges the doubts lurking beneath and prevents their eruption to the surface. However, it manifests in the absence of animal spirit—the confidence that drives businessmen to invest.

But for the two conflicting yet parallel growth stories observed from official GDP statistics and other lead indicators, the zest to invest is no better or much the same as in 2012-13. The statistically visible investment-growth slump at that time had haunted the UPA government. The question is, if a different set of concerns this time around will simply wilt under the strong sunshine of an optimistic growth story.

All industries: Real credit growth

(y-o-y, %)

Jan 1, 2012 Oct 1, 2018

New project announcements

(₹ crore)

Jun 2013 Dec 2018

Source: RBI database with author's calculations, CMIE

Facebook too big to care about privacy

Facebook's 'like' and 'share' buttons enable the company to collect information as people roam non-Facebook websites—whether or not people click them

SHIRA OVIDE

Bloomberg

TWO YEARS AGO, a Yale Law School student published what became an influential paper about how antitrust law should apply to one of America's superstar technology companies, which don't fit the conventional mould of Standard Oil monopolists. Now, another academic paper from a former advertising technology executive and Yale law graduate is arguing that Facebook Inc. abuses its power. Titled in part, *The Antitrust Case Against Facebook*, its author, Dina Srinivasan, offers a deeply researched analysis of Facebook's pattern of backtracking on the user data collection that allowed the company to become a star. Once Facebook was powerful and popular, Srinivasan says, it was able to overrun objections about its data-harvesting practices.

The core of Srinivasan's argument is to treat two anxieties about Facebook—potential abuses of monopoly power and violations of users' privacy—not as separate but as two sides of the same coin. It is a relatively novel idea that has echoes in a recent order from Germany's antitrust authority. (Facebook has said the German regulator was wrong to link enforcement of privacy law and antitrust, and the company said it is appealing the decision).

The paper was published this week in the Berkeley Business Law Journal from the University of California, and I read a version that has been online for two weeks. I'll leave it to legal experts to assess the validity of Srinivasan's antitrust analysis. I was drawn in by her selective, although not inaccurate, reading of Facebook's history of increasing boldness in harvesting information for the purpose of tailoring ads.

In Facebook's early years, Srinivasan says, Facebook competed against once-popular social networks like MySpace in part by pitching itself as protective of people's privacy. But once Facebook became an indispensable tool of digital life, it gained the power to reverse promises it had made not to gather certain types of information on people's online activity.

Her piece is a reminder that Facebook's practice of gathering digital dossiers for commercial purposes didn't happen at all once but as a slow creep that overwhelmed—or waited out—objections that Facebook was misleading the public or undermining people's privacy. This history remains relevant as Facebook is working on linking its multiple internet hangouts in a way that is likely to generate yet more user data for itself.

In one particularly compelling example from Srinivasan, she focuses on Facebook's 'like' and 'share' buttons. The company started to introduce the features in 2010, and now they're on millions of websites. Many Facebook users don't know it, but those bits of software code enable the company to collect information as people roam non-Facebook websites—whether or not people click them.

Initially, Facebook told partners and the public that it wasn't tracking people's web surfing, nor would it use that information for personalised advertising. The company's initial statements about what information it was collecting, and when, were not entirely correct, but Srinivasan argues that Facebook was at least cautious about such practices. There were enough competitive social network alternatives that there was blowback each time the company overreached in the types of information it wanted to gather or how it would broadcast people's actions online.

Then, in 2014, Facebook changed its policy to allow for use of web activity data in ad targeting. The company, Srinivasan writes, "would do precisely what it had spent seven years promising it did not and would not do, and finally accomplished what the previous competitive market had restrained it from doing".

To Srinivasan, this was part of Facebook's pattern of bait-and-switch tactics surrounding data harvesting. It grew so popular, she says, the company could eventually change the rules.

I was struck by the common thread between Facebook's recent data privacy scandals, Srinivasan's reading of Facebook history and the conclusions from Germany's antitrust authority. People wary of Facebook now face an unappealing choice between pervasive surveillance by a powerful company or pulling out of a bedrock tool of modern life. And it didn't get that way by accident.

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LETTERS TO THE EDITOR

Mentorship in the workplace

It is important to establish policies which are enforceable on the ground, build a conducive work environment, and facilitate a natural discipline at the workplace. Leveraging one's status/fame to gain advantage in the short-term berates the overall consumer sentiment and undermines the importance of social responsibility, thus defeating the very purpose of the industry/sector and the values endorsed by it. Role models with a significant following ought to lead by example and render a strong message delivery—that of self-confidence, motivation to do the right thing and proactive whistle-blowing at the appropriate forum

— Girish Lalwani, Delhi

Another election gimmick

The Employees' Provident Fund Organisation (EPFO) decision to hike the interest rate by 10 bps to 8.65% for 2018-19 is probably a poll gimmick resorted to by the BJP-led NDA government. The move comes on the back of RBI lowering the repo rate and its top brass urging bank CEOs to lower lending rates. However, most of the bankers were reluctant to toe the RBI line. With the Lok Sabha elections looming over the horizon, don't be too surprised if the government springs more pleasant surprises on the middle-class and the *aam aadmi* as it nears the finish line

— Ravi Chander, Bengaluru

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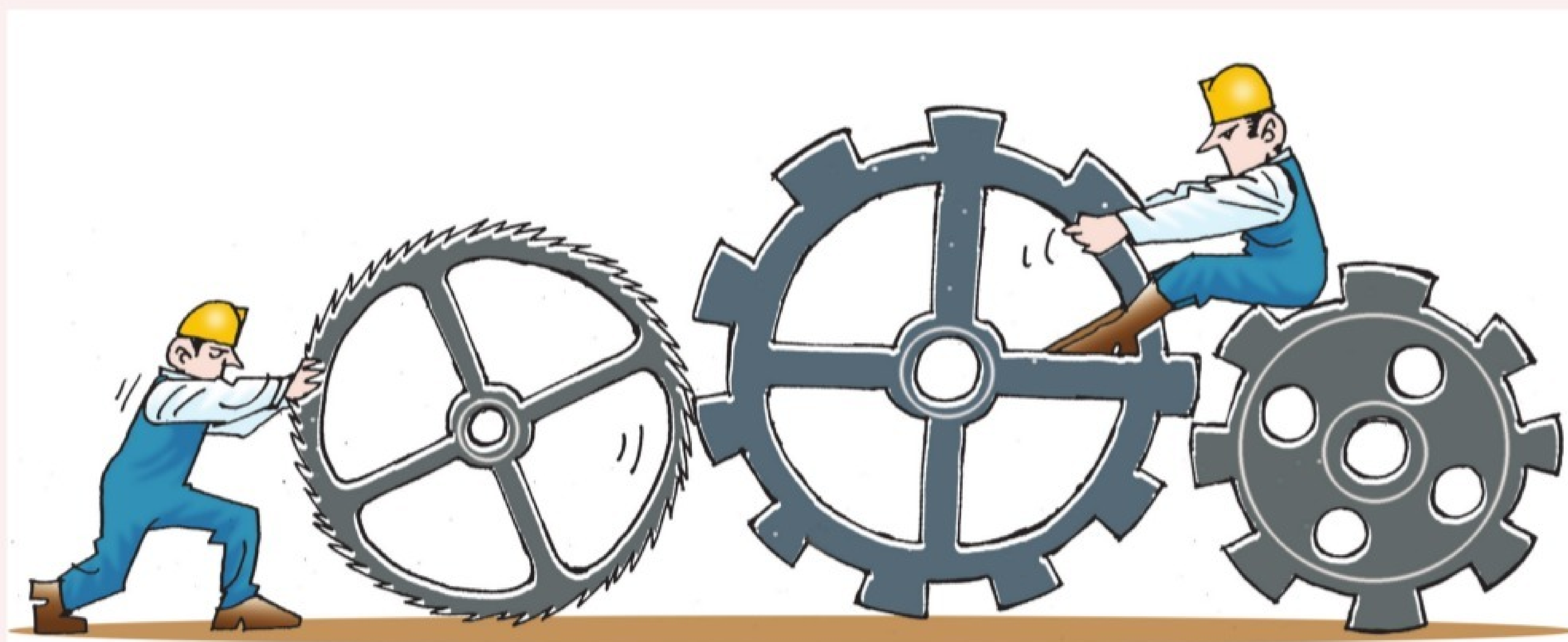

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Industrial policy for India

Indian policymakers just do not seem able to make a clear enough assessment of where growth will occur, where India's opportunities are, and how to create a playing field in which the most dynamic and well-run Indian firms can grow and prosper

THE NOTION OF INDUSTRIAL policy is one that has been around for decades. Some economists think it is an idea that never worked, whereas others still see merit in the concept. India certainly had an industrial policy, conceptualised in terms of developing heavy industry through state-led efforts. It was the nature and quality of this implementation, rather than the idea of industrial policy itself, that let India down. Economists now often shy away from the idea that governments can "pick winners," in crafting industrial policy. But again, the reality is not one-sided.

It still seems reasonable to argue that Japan got things right in developing its automobile industry almost seven decades ago. Apparently, this was considered unrealistic and foolhardy by some observers at the time, and it took Japan's automobile firms over two decades and some luck (two oil price spikes in the 1970s) to make their presence felt in global markets. Whatever the challenges of implementation, the economic logic was clear: automobiles were a product with a high income elasticity of demand, and significant knowledge spillovers in production. As the consumer good with the most complexity in terms of production, if Japan could make them successfully, it was more than likely that it could also make a range of other manufactured products that required engineering expertise.

By contrast, India treated automobiles as a luxury good for its own population, and did not consider exports as an option, and churned out a few obsolete models for decades. Perhaps automobiles were not the place for India to start its industrialisation path just after Independence, but there was little else where India's policymakers charted a strategic vision and mapped out a supportive policy framework for industrial growth and dynamism. Even more labour-intensive products, with lower engineering complexity, did not become categories where India established world-class quality and globally-efficient scale.

There have been some successes after the economic reform process began, but almost three decades later, India is still struggling with upgrading and expanding its manufacturing sector, and that seems to be an obvious reason why it has not achieved double-digit growth rates to match those of the Japanese miracle or China's later economic ascent. What is missing? One argument is a new version of the export pessimism that constrained economic policy thinking at the time of Independence, in India and many other developing countries. Now, the suggestion is that India missed that boat, and neither the global trading environment nor the pace of economic growth in advanced economies is as favourable as when Japan and China raced ahead.

But this seems to be a self-fulfilling form of pessimism, just as it was seven decades ago. Global growth is strong, just not necessarily distributed as it was in the past. Tariffs are not that high, despite short-run hiccups due to Brexit and the Donald Trump administration's nationalist approach to international trade. Indian policymakers just do not seem able to make a clear enough assessment of where growth will occur, where India's opportunities are, and how to create a playing field in which the most dynamic and well-run Indian firms can grow and prosper.

In terms of physical needs, India is going too slowly in creating the logistical infrastructure to allow India to connect to global—and especially regional—production networks. There are financing constraints as well as constraints in terms of expertise, but there seems to be little sense of urgency or strategic intent in this respect. Relaxing the constraints by tapping global capital and multinational expertise seems to be proceeding only fitfully, nor does Indian policymaking seem to think carefully enough about complementarities in various kinds of infrastructure for supporting industrial innovation and growth.

In terms of the technologies and the products and services that will matter over the next few decades, the candidates are obvious. Digital technologies matter everywhere, for making products and for delivering services. India's software industry has proved its resilience and dynamism many times over, completely belying the pessimists who derided its start at the lower end of the digital value chain, and even called its employees "techno-coolies." But India desperately needs to upgrade and extend its digital infrastructure, and increase the numbers and skill levels of those who will maintain this infrastructure, and those who will use it to deliver a continuing stream of new digital products and services.

> **Effective industrial policy will mean listening to innovators, and also providing them with the conditions they need to serve new markets. India's policymakers still seem to lack a full understanding of the private enterprise**

There are other obvious areas of global growth. Technologies and products that combat global warming, and those that serve the needs of rapidly ageing populations in many countries, will be the opportunities for growth. Effective industrial policy will mean listening to innovators, and providing them with the conditions they need to serve new markets. India's policymakers still seem to lack a full understanding of the private enterprise and how to encourage it. Continuing examples of corruption and incompetence among India's corporate giants make matters even more difficult, but illegality has to be distinguished from honest mistakes and failures.

None of the above means a neglect of basic education and health, including sanitation infrastructure. India remains very unequal in these respects, and denying basic needs to all the citizens is as big a scandal as corruption among politicians and capitalists. But even after decades of economic planning, India's policymakers still struggle to put all the pieces together, including industrial policy, for sustained growth at levels shown possible by Japan and China.

SBO Rules need more clarity

BHARAT VARADACHARI

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IDENTIFICATION OF THE 'beneficial owners' behind legal entities remains a tricky yet crucial endeavour in the global fight against money laundering and terrorist financing. Despite well-intentioned efforts, country-level initiatives targeted at improving transparency have often lacked clarity and incisiveness.

Drafting the original Companies (Significant Beneficial Owners) Rules, 2018, would have entailed a complex exercise given the government was faced with multiple choices for key design elements like applicability, exemptions, definition of compliances and penalties. Countries like the UK, Singapore and Hong Kong introduced nuanced guidelines to demystify the concepts when they embarked on similar journeys. The Rules prescribed in June 2018 stirred much debate due to several open and interpretative issues. While the latest amendments, no doubt, address many of these issues, they could have covered further ground.

A question that merits discussion is the extent to which the amended provisions may help promote the identification of the real ownership, influence or control of businesses operating in the country, where needed.

1. In certain cases, the Rules issued by the ministry of corporate affairs (MCA) in 2018 required the senior managing official (SMO) of a company to be treated as the significant beneficial owner (SBO), where no SBO was identified. Several EU countries treat SMOs or equivalents as the 'ultimate beneficial owner' where the qualifying criteria are not met or cannot be verified (Denmark, Ireland, Hungary, Italy). Countries like the UK, Singapore and Hong Kong do not require a default treatment of one or more executives as SBO-equivalent, if the prescribed conditions are not satisfied. A specific entry in the prescribed register to the effect that there is no person who meets the qualifying criteria is the only requirement. Arguably, this approach is suitable for countries with stronger monitoring and enforcement mechanisms and relatedly higher levels of compliance and self-governance.

> **With the amended Rules and revised forms notified, speedy issuance of FAQs will go a long way in ensuring that corporate India is better equipped to fulfil its compliance obligations**

While the amended Rules in India have dispensed with the approach of identifying SMO, the new definition of the term 'significant influence' treats any person with the power to 'participate' in the operating and financial policy decisions of the company as an SBO. Identifying persons who are visibly essaying their assigned roles in an organisation or whose details are available with the government (for example, directors), as SBOs, may not serve any useful purpose. But given the potential risks, the MCA is possibly seeking maximum information from senior executives occupying positions of influence in a company to assign greater accountability over the conduct of its financial and operating affairs.

2. The amended Rules explicitly provide that the reporting responsibilities with respect to SBOs only apply to companies incorporated in India. Potential misuse of legal forms of presence is not restricted to companies and given that the (MCA) is also the administrative ministry for LLPs and partnership firms in India, the SBO reporting requirements may be extended to these legal forms in due course.

3. Borrowing a page from the widely followed global approach and the AML/KYC guidelines issued by SEBI/RBI, companies whose shares are listed on a stock exchange in India or outside India or subsidiaries of such listed companies could have also been exempted from SBO regulations, given their existing stringent disclosure requirements.

4. The amended Rules place strong emphasis on a company's investigative process but prescribe no penalties for failure to issue the mandated enquiry notices or refer matters to the NCLT where it receives unsatisfactory or no responses. Given the sheer volume of compliance across the country, effective monitoring/audit mechanisms will be needed for verification and enforcement of the compliances in identified high-risk cases.

With the amended Rules and revised forms now notified, speedy issuance of supplementary guidance/FAQs would go a long way in ensuring that corporate India is better equipped to fulfil its compliance obligations.

Equator Principles in project financing

Implementing the Equator Principles has enhanced the role of project financing; sustainable development has become key

VIDYA HATTANGADI

The author is a management thinker and blogger

THE EQUATOR PRINCIPLES is a risk-management framework, adopted by financial institutions, for determining, assessing and managing environmental and social risk in project financing, and is intended to provide a minimum standard for due diligence and monitoring to support responsible risk decision-making prior to lending for projects. The Equator Principles were formally launched in Washington, DC, on June 4, 2003.

They were formed as a guideline to financial institutions before lending to infrastructure projects. Since the inception of the Equator Principles in 2003, the energy and extractives industry has been a major focus of the environmental and social risk reviews conducted by nearly 80 member banks. For example, Bank of Tokyo-Mitsubishi, a leader in project finance, put 225 projects through its Equator Principles review process between 2006 and 2012. Of these, 60% were in the mining, oil, gas and energy sectors.

Financial institutions are accountable to screening when lending to projects that are hazardous environmentally and socially. Their investment decisions increasingly include an assessment of E&S risks and impacts. This rule is not only applicable to MDBs (multilateral development banks) and international financial institutions, but also to commercial banks and private equity funds. In many developing countries, international players require compliance with both national laws and international E&S standards developed by MDBs, which are sometimes more stringent than those inscribed in national legislation.

In the 1980s, the Sardar Sarovar project, which involved construction of a dam on the Narmada river in Gujarat, got harshly criticised worldwide for its adverse environmental and social impacts. It was built to provide electricity and irrigation water to downstream regions, and the construction of this dam resulted in forced dislocation of more than 2 lakh native people living along upstream districts, without provisions of sufficient compensation or means of livelihood reinstatement. To ensure justice to the people displaced, international NGOs undertook Narmada relief campaign, due to which the financial assistance to the project, provided by the World Bank and official development assistance (ODA) of the Japanese government, got terminated.

In the late 1990s, when the world started seriously thinking about safeguarding environment and social welfare above all, multilateral development financial organisations such as the World Bank and export credit agencies of OECD member countries came up with environmental and social guidelines to properly manage environmental and social risks associated with large-scale projects. But only a handful of private financial institutions in the world were implementing environmental and social reviews before lending for projects. Therefore, environmental NGOs started demanding that private financial institutions must be held responsible for neglecting environmental and social risks; attention must be given to CSR in terms of environmental issues.

To address these demands and concerns, in October 2002, ABN AMRO and the International Finance Corporation (the IFC is in charge of private projects for the World Bank Group) invited major global financial institutions engaged in project finance activities to assemble in London with the intention to come up with environmental and social risks management guidelines for private financial institutions. As a result of this meeting, Citigroup, ABN AMRO, Barclays and WestLB, in collaboration with the IFC, created a framework for managing environmental and social risks. The Equator Principles were thus formulated in June 2003.

The founders of the Equator Principles wanted their adoption to be a globally applicable to financial institutions in the northern and southern hemispheres, and the equator seemed to represent that balance perfectly, hence were named thus.

The Equator Principles were first revised in July 2006, to align it with the IFC Performance Standards. Further revision of the IFC Performance Standards took place in 2012 and the need to strengthen environmental and social risks management resulted in the launch of the third version of the Equator Principles in June 2013. The fourth round of revision is under review and will be finalised by August 2019.

The key thematic areas of this round include social impact and human rights, climate change, designated countries and applicable standards and scope of applicability of each principle. So far, 94 financial institutions from 37 countries have officially adopted the Equator Principles, which covers the majority of international project finance debt in emerging and developed markets.

Pursuant to the finalisation of principles of EPFIs (Equator Principles Financial Institutions), the lender needs to categorise a new project according to its level of probable environmental and social risks based on the screening criteria of the IFC. The three categories are as follows:

Category A: Projects with potential significant adverse social and environmental impacts those are diverse, permanent and exceptional;

Category B: Projects with potential limited adverse social or environmental impacts, largely reversible and addressable through mitigation measures;

Category C: Projects with minimal or no social or environmental impacts. The standards have consequently been periodically updated into what is commonly known as the IFC Performance Standards on social and environmental sustainability and on the World Bank Group Environmental, Health, and Safety Guidelines.

Benefits of the Equator Principles: Borrowers don't like banks telling them how to behave; they want their loans to be sanctioned and that's about it. With so many monetary scams and money laundering taking place, the credibility of the global financial institutions is under heavy scrutiny today, especially in markets where social and environmental standards for business are less stringent. Another fact is that companies with little or no experience in applying mitigation measures often require additional support and advice from their lenders. Implementing the Equator Principles has enhanced the role of project financing; sustainable development has become key issue.