

”Key Elements of an ESMS for Financial Institutions

NOTE: This brief introduction spells out the key elements of a potential Environmental and Social Management System (ESMS) within a Financial Institution (FI). It intends to provide guidance on what should be considered as satisfactory to meet the contractual requirements of KfW.

What is an Environmental and Social Management System (ESMS)

An ESMS states a financial institution's **commitment to environmental and social (E&S) management** incl. **Health and Safety**, explains its **procedures** for identifying, **assessing and managing E&S risks** of financial transactions, defines the **decision-making process**, describes the **roles, responsibilities and capacity** needs of staff for doing so, and states the **documentation and recordkeeping requirements**. It also provides guidance on how to **screen** transactions, **categorize** transactions based on their E&S risk, conduct **Environmental and Social Due Diligence (ESDD)** and **monitor** the **borrower's E&S performance**.

The scope of financing activities of different types of financial institutions varies greatly, and so do the associated E&S risks. The **management of these risks should also be tailored to the individual institutional characteristics** of each financial institution, which are different for banking institutions, leasing companies, microfinance institutions, and private equity funds.

The supporting **policies and procedures** of the ESMS should be **well documented, made available** to all staff with responsibilities for implementation and can be compiled into a stand-alone operations manual to formally document the process. This manual should be

updated regularly through a simple but effective revision process to ensure **continuous improvement** of the tailored processes.

Because the procedures and decision-making process of the ESMS are systematically incorporated at each stage of transaction appraisal and monitoring, the ESMS cannot function as a stand-alone system. The process for developing an ESMS needs to consider a financial institution's existing risk management framework and transaction cycle.

Last but not least, if required, **E&S appraisal results** shall be considered in the loan contract as **covenants**.

Key Elements of an ESMS

E&S Policy	The E&S Policy is a brief declaration of an organization's commitment to sustainable development and management of E&S issues including health and safety requirements. It is communicated at least internally and mostly disclosed publicly. The Policy - as frame of the ESMS - needs the full support of the management and shall be launched by them.
E&S Procedures	<p>The Procedures detail how the organization addresses E&S and sustainability issues as part of its investment operations. They are normally step by step instructions focusing on what needs to be done and by whom at various stages of the investment cycle (including supervision). Reference is often made to guidelines (s. below).</p> <p>Procedures may be stand-alone or constitute part of the Credit or other Operational procedures of the institution. They should be documented and communicated to ensure that all existing and new staff are aware of the process. Regular trainings shall be performed to make responsible staff familiar with the respective procedures.</p>
E&S Guidelines	These provide guidance to responsible staff on how to carry out the various steps outlined in the E&S Procedures and on what to look for when conducting an E&S review. They might encompass useful tools, e.g. Checklists or Questionnaires. The guidelines can be simple for low risk investments and more sophisticated for high risk investments.
Record Keeping	This is a vital aspect of an ESMS that ensures that the review and analysis conducted and the required mitigation or corrective measures as applicable according to the Procedure are recorded in the credit decision documents.
Capacity and resources and Training	Additional responsibilities for E&S risk management should be assigned to existing staff or new staff should be hired as required by the ESMS. A financial institution's staff with designated responsibilities under the ESMS shall be trained, and is then required to follow the necessary procedures in their day-to-day tasks related to risk management at all stages of the transaction appraisal and monitoring process.

Review and Continuous Improvement	<p>Throughout implementation and subsequent operation of the ESMS, the ESMS should be reviewed periodically to ensure that its procedures remain relevant to the level of E&S risk associated with the institution's portfolio. This will ensure that new and emerging E&S risks are detected and identified during the environmental and social due diligence (ESDD) process.</p> <p>Any potential difficulties and opportunities for improvement should be identified by staff and addressed in a timely manner by the ESMS Officer and concerned staff to ensure a smooth implementation and efficient operation.</p> <p>The operations manual (Procedures) for the ESMS should be updated regularly to reflect any changes and new requirements in the E&S regulations and/or international best practices that affect the business operations of an institution's clients/investees.</p>
Categorization	<p>To ensure that the extent of the review is commensurate with the nature of risk, categorization is a useful step in procedures: Based on basic information about a project such as sector and scale, the level of the project's possible E&S risk is determined. This also enables the bank/fund to determine the extent and sophistication of the subsequent E&S review. Examples of categorization are High, Medium, and Low risk for Projects.</p>
Exclusion List	<p>The Exclusion List provides a list of activities that cannot be financed by KfW. Therefore, as part of its procedures, institutions are required to verify that the activities of a commercial client are not on the Exclusion List.</p>

For additional information please also refer to Section III of IFC Interpretation Note on Financial Intermediaries (2012)
http://www.ifc.org/wps/wcm/connect/38d1a68049ddf966af3cbfda80c2ddf3/InterpretationNote_FIs_2012.pdf?MOD=AJPERES