The Role of Financial Institutions in Protecting Delicate Brazilian Ecosystems

Environmental

Financial Services


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- ***Equator Principles***. Some financial institutions have adopted these credit-granting and risk-management guidelines.
- ***ISO 1400 series***. Recommended by the International Organization for Standardization, these best practices set out measures for sustainable corporate management from an environmental standpoint.
- ***National Monetary Council***. With the recent amendment to Resolution 4327, Brazilian institutions are required to comply with specific provisions to endeavors that pose social and environmental risks.
- ***National Environmental Council, Law 6931/81***. This law provides for criminal and administrative penalties applicable to those deemed responsible for activities detrimental to the environment.

Nowadays, social and environmental issues undeniably take a privileged position on the agendas of

countless individuals, including those writing academic studies and making political decisions. These issues require the government to take a stand and develop public policies to implement and be supervised by competent agencies, including the judiciary.

Social and environmental issues are of considerable relevance and economic importance, as shown by the current shortage of water in some of the greatest urban centers of Brazil. Therefore, means and mechanisms that allow for a balance between national, social and economic development and preservation of natural resources have to be thoroughly examined. The target is balance among society, market and environment, creating a scenario of social and environmental justice. Policies that lead to a sustainable economic system have to be developed and implemented.

Sustainability as a self-sufficiency concept reveals a concern with the development of technologies and relational methods that enable quick access to renewable resources in order to meet market demands and societal consumption. The combination of social and economic development and strict respect for human rights is an essential part of sustainability. This combination also promotes workforce qualification and eradication of serious problems related to urgent social issues, such as slavery, child labor and universal access to efficient public health systems such as basic sanitation. Sustainable social and economic development also promotes appreciation of life and human dignity.

There is absolutely no way social and environmental issues can be handled apart from the traditional production and consumption economy. Given that credit plays a very important role in this traditional economic model, financial institutions are naturally affected, as they are responsible for credit activities.

Social and environmental self-regulation in the financial system

Social and environmental issues became a concern for financial institutions when the International Finance Corporation, an entity bound to the World Bank, established a set of principles, called Equator Principles, which were adopted by some financial institutions on an international scale. Defined as guidelines, these principles aim to guide the operations of banks according to policies of credit granting and risk management in social and environmental matters that result from financing economic projects and activities that could damage the environment and social relations, including human rights.

By adopting and monitoring credit-granting criteria, financial institutions that adhere to the Equator Principles grant credit to finance projects only if the economic agents adopt practices that effectively offer the following: (i) biodiversity protection and pollution control; (ii) protection of health and cultural and ethnic diversity; (iii) assessment of social impacts, including impacts on the native population; (iv) compensation for the population affected by the project implementation; (v) efficiency related to water resources and use of renewable energy source; and (vi) respect for human rights and elimination of child labor.

It is incumbent on financial institutions, through their credit-risk selection, to adhere to the principles by suggesting that projects be adjusted to mitigate risks arising from their implementation. In practice, the principles are applied in accordance with social and environmental classification. The projects eligible for financing are classified as follows: Category A for high-risk projects, Category B for average-risk projects and Category C for low-risk ones. The categorization of risk from high to low considers the possibility of diverse, irreversible or unprecedented impact on the environment, society and human populations.

For Category A projects, an environmental management plan is developed and applied after careful monitoring by the financing institution. The Equator Principles are revised from time to time, and they provide as a criterion for project inclusion the financed amount, which must be at least US$10 million. However, adherence to such principles is not mandatory; the institution chooses whether to commit to a self-regulation program.

Signed in 2009, the Green Protocol (Protocolo Verde) nationalized the Equator Principles. Pursuant to the Protocol, financial institutions attempted to do the following: (i) offer credit facilities and programs that foster life quality and sustainable use of natural resources; (ii) consider the social and environmental impacts and costs in asset management and project analysis; (iii) promote consumption awareness; and (iv) inform, sensitize and engage interested parties in sustainable policies. Although this is a voluntary commitment, the Prosecution Office and the judiciary have demanded compliance with the terms of the Green Protocol and the Equator Principles. Another successful experience in the corporate self-regulation area comes from the widely disseminated management practices recommended by the International Organization for Standardization (ISO). In regard to environmental issues, the best practices are included in the ISO 14000 series, which sets out measures for sustainable corporate management from an environmental standpoint. Like other self-regulation programs, adoption of these measures is optional. The ISO may award the institution a certification stating that its environmental management is in compliance with the sustainability standards proposed by ISO 14001. Thus, the certified institution will abide by the applicable environmental legislation in its activities.

ISO establishes requirements for quality management systems of companies and organizations. In Brazil, the Brazilian Standards Institute [Associação Brasileira de Normas Técnicas - ABNT] prepares Brazilian versions of the most recurring ISO standards, among which is ISO 14001, whose official version in Brazil is provided by ABNT through the NBR ISO 14001. Brazilian Institute of Metrology, Standardization and Quality Control - INMETRO.

The ISO 14001 certification does not exempt the certified institution from the effects of inspection by environmental agencies, nor does it ensure that no environmental drawbacks or irregularities will occur during the performance of the certified institution’s activities. Therefore, ISO 14001 is not able to keep the certified institution safe from liability for environmental damage.

It is worth mentioning: the Corporate Sustainability Index of BM&FBovespa reflects the return on a stock portfolio of companies that adopt social and environmental responsibility practices in the Brazilian market. A company is admitted to the list of share issuers of ISE Bovespa only upon joint resolution by BM&FBovespa, environmental nongovernmental organizations (NGOs), Fundação Getúlio Vargas (FGV) and the Prosecution Office. Company selection is annual and takes into consideration the organization’s relationship with the community and its employees as well as its corporate governance program and the environmental impact of its activities.

The ISE maintains a specific group (Group IF) for financial institutions and insurers. The creation of a specific group for financial institutions in ISE reflects investors’ concerns over environmental liabilities of institutions that may finance potentially polluting activities. The sustainability of companies listed on the ISE is controlled by the ISE board, which monitors the technical management of corporate actions aimed at the environment, and also by the community, which participates through public hearings where the population can evaluate the companies listed on ISE.

It is known that the judiciary and the Prosecution Office often reference the Green Protocol and the Declaration of Principles for Sustainable Development when referring to voluntary protocols. The

effective implementation of the measures and principles set out in those documents could meet the conditions of Law No. 6938/81. It is possible that the government might consider adoption of parameters and principles set forth by the Green Protocol and the Declaration of Principles for Sustainable Development a way of complying with the principles and obligations of the National Environmental Policy.

Although discussions about the adhesion of financial institutions to voluntary protocols are fairly recent, there are examples of the judiciary seeking to force financial institutions to uphold the principles of voluntary protocols they agreed to, especially with regard to the Green Protocol and the Declaration of Principles for Sustainable Development. Still, there is no statutory provision determining the adherence of financial institutions to these protocols.

The judiciary has been considering the development of protocols in compliance with the obligations imposed by Article 12 of Law No. 6938/1981. Voluntary protocols and commitments that establish parameters and criteria to grant credit to companies duly licensed and in compliance with environmental legislation would be linked to the statutory obligation imposed on financial institutions. The adherence to voluntary protocols may be understood as a preventive measure to protect the environment. Financial institutions that effectively serve the purposes of the Green Protocol, for instance, would end up confirming that their activities are performed in compliance with Article 12 of Law No. 6938/1981.

Indeed, even if a financial institution does not directly perform the polluting activities of the company to which it grants credit, it would not be released from adopting measures to prevent environmental damages. Although the adherence to voluntary protocols and compliance with their targets and principles fulfills the obligation imposed on financial institutions, they could not be considered mitigating factors in determining penalties imposed due to environmental damages in the civil, administrative and criminal levels.

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Implementation of the social and environment responsibility policy by financial institutions

Despite the initiative of self-regulation of financial institutions through the Equator Principles, with the amendment to Resolution 4327 of the National Monetary Council, on April 25, 2014, Brazilian institutions were required to comply with the specific provisions on their involvement in situations that could pose social and environmental risks.

The recently amended Resolution establishes that while performing their activities, institutions are required to create and apply operating principles related to social and environmental issues that must be integrated with the list of governance procedures and measures. These principles are then part of the measures for risk control and management of Brazilian financial institutions.

In other words, institutions authorized to operate by the Brazilian Central Bank are added to the chain of liability with regard to damages and impacts in the form of degradation — irrespective of the level and quality of the social and environmental relationships — caused by the economic activity.

The Resolution provides financial institutions guidelines to follow to establish and implement the Social and environmental Responsibility Policy (PRSA), which sets out “relevance proportionality” as the standard to determine the scope and complexity the PRSA must have with regard to the financial institution.

The PRSA must be conceived and implemented in accordance with the nature of the institution, the complexity of its activities, and the products and services offered to the market. In addition, the PRSA must be applied with the appropriate level of exposure to social and environmental risk. Once these are defined, the teleological purpose of the PRSA to assess and control the social and environmental risk will be ensured.

The Resolution establishes that the PRSA will have principles and guidelines that will guide the strategic actions of the financial institution as it concludes business deals and establishes relationships with clients and users of its products and services. In this process, the Resolution provides that the institution must encourage the effective involvement of the interested parties in the development of the PRSA itself. In practice, the purposes of the PRSA, as developed by the institution, should be synchronized with the real needs, concerns and interests of the market and society. That synchronization should be constantly monitored to measure its effectiveness.

As the PRSA is developed and implemented, it must be revised and have its adequacy revaluated every 15 days, with full involvement and coordination of the institution’s management, either its executive board or board of directors. The PRSA, as an instrument to manage the compliance of the institution’s social and environmental actions, should be fully included in the governance structure to guarantee the effectiveness of its implementation. Further, the new Resolution determines the possibility of the financial institution establishing an advisory committee, which may have parties that are not from the institution. The advisory committee should accomplish two of the missions provided in the institution’s governance structure: monitoring and evaluating the effectiveness of the actions carried out under the PRSA.

The Resolution provides an approach to social and environmental risk focused on the possibility of financial losses to the company as a result of social and environmental damages in any level and extension. The Resolution does not have any provision on the financial institution’s liability for action or omission that may directly or indirectly give rise to damages. However, financial institutions often find themselves in the middle of litigation in this regard.

It seems that the implementation of a PRSA in line with the characteristics of the institution’s activities will lead to gradual and constant reduction in the occurrence of social and environmental damages, and that alone should cause a reduction of the effects detrimental to the institution’s activities. On the other hand, the Resolution further requires the institution to ensure that the social and environmental risk is treated as an additional and considerable component of the risk management matrix. With this requirement, institutions are then tied to minimum parameters to establish methods for social and environmental risk management. Thus, in addition to the clear need for increasing technical training for individuals who perform management tasks of this new risk modality, the institutions must develop routines guided by systemically monitored procedures. Such systems, applied to operations, products and services of the institution, should allow that the social and environmental risk be part of a cycle that begins with its identification and classification, according to its source, nature and dimension, which are assessed by standards defined by the institution. After measuring the social and environmental risk, the institution must monitor it and, in case it is materialized, mitigate its effects, thus ending the control cycle.

The standard for social and environmental risk assessment must be shaped by the damage potential of the economic activity with which the operation, product or financial service is associated. Financial institutions must define specific criteria and methods to assess the social and environmental risk of financial transactions and deals, such as financing industrial projects or infrastructure works. Once this cycle is completed, it should have its information and observation results registered and stored by the institution, especially any effective financial losses resulting from social and environmental damages and drawbacks.

All of these actions inherent in the management process of this risk type and led by the institution's governance guidelines should enable the administration to previously assess potential negative social and environmental effects resulting from new products and services that, in a worst-case scenario, could be detrimental to the reputation of the financial institution. The concern with recycling and updating the systematic routines is also part of the financial institution's agenda, which should establish procedures for effectively monitoring changes in the market and in the applicable legislation and regulation.

The introduction of the PRSA requires institutions to define targets and actions to adjust the operating and organizational structures, their routines and procedures, following a schedule approved by the administration. By the end of implementation, they must be fully integrated with the financial institution's other governance policies, especially the risk management policy, but also including credit management and human resources policies.

Finally, the approval of the PRSA and the action plan for its implementation must take place by June 31, 2015, upon assignment of execution responsibility to an officer of the institution. However, this period is shorter for financial institutions subject to the internal process of determination of capital compliance, referred to in Resolution 3988 of June 30, 2011, in its articles 4, VI, and 6. As a result, it is imperative that institutions subject to Resolution 4327/14 be fully aware of the set of rules, manuals and regulations that govern social and environmental issues in our system of laws. In this regard, we will now consider the legislation that provides for aspects connected with environment protection. This matter is provided for in Law 9605 of February 12, 1998 and in Law 6931 of August 31, 1981. Therefore, it is relevant to review them.

Said Resolution 3988 provides for the implementation, by the financial institutions authorized to operate by the Brazilian Central Bank, of a capital management structure. Art. 4, VI, establishes that such structure should provide for, among other measures, the Internal Process for Evaluation of Capital Compliance - ICAAP, which must be implemented by institutions whose total assets exceed 100 billion reais and which were authorized to use internal models of market risk, credit risk or operational risk, or which are members of a financial conglomerate whose assets exceed 100 billion reais, and which is composed of at least one full-service bank, commercial bank, investment bank, development bank, exchange bank or savings and loan bank. The credit unions, credit cooperatives, mortgage loan companies, brokerage firms, currency exchange companies, distributors and leasing companies, among others, are released from implementing such processes.

In addition to establishing the National Environmental Council, Law 6931/81 provides for the purpose, mechanisms and application of the National Environmental Policy (PNMA), which features systematic purposes and instruments for implementation and environmental controls. This law provides for criminal and administrative penalties applicable to active agents and co-agents deemed responsible for conduct and activities detrimental to the environment. The range of environmental values comprised in this law is broad, and it categorizes conduct deemed threatening to flora and fauna, urban planning and cultural heritage. Failure to comply with the environmental rules imposes on the

agent three levels of liability: administrative, civil and criminal. Thus, pursuant to Article 14 of Law No. 6938/81, failure to adopt the measures necessary to protect the environment or repair the damages caused by degradation of environmental quality that will subject the offenders to administrative penalties, without prejudice to criminal penalties and the obligation to repair the damage.

Even though the current legislation establishes provisions applicable to financial institutions, there is no provision that expressly holds the financer strictly liable to repair environmental damage or face an environmental administrative penalty resulting from an undertaking or activity performed by third parties. However, under Article 12 of Law No. 6938/1981, the governmental financial institutions are required to authorize the financing of projects only upon evidence of prior environmental licensing and compliance with rules, criteria and standards set by the National Environmental Council. It seems possible to conclude that such institutions are not required to effectively monitor the progress of the financed project implementation.

Although there is no rule holding the financer strictly liable, there are cases of financial institutions held indirectly liable for acts that led to environmental damage, and they were classified as the agent that gave rise to damages to the environment. This liability of financial institutions is backed by the interpretation of the rule that the legal entity, governed by either public or private law, may be held directly or indirectly liable for an activity that causes environmental degradation under Article 14 of Law No. 6938/1981.

There are precedents holding financers liable, even if indirectly, for activities that caused environmental damages. According to such precedents, we may conclude that there is the possibility of extending and applying the concept of financial institutions' liability for environmental damages as a result of commissive and omissive conduct due to failure to comply with specific regulatory obligations of the institution.

Special Appeal No. 650728 - SC, of the Second Panel of the Superior Court of Justice, reported by Justice Antônio Herman V. Benjamin, published on 12/2/2009, concludes that "In order to determine the causal connection of the environmental damage, the following parties are made equivalent: the one that does something, the one that does not do something when it should have done it, the one that fails to do it, the one that does not care that anyone does it, the one that provides financing for others to do it, and the one that benefits from what others do."

Thus, it seems that it is precisely because of this concept of indirect liability of the institution, in either a commissive or omissive manner, that financial institutions should devote even more attention to compliance with the rules established in Resolution 4327/14. It is considerably important that preventive measures in policies, routines and operating procedures of the institutions be adjusted to reduce, even if slightly, the amount of misconduct when granting credit and financing projects and activities with environmental damage potential.

Conducting environmental audits of the financed activities, establishing contractual conditions for termination or penalties in case of violation of environmental standards, and implementing routines to monitor strategic projects and ensure compliance with environment-related contractual obligations are examples of measures that may set conduct guidelines for financial institutions in relation to environmental risk management.

Financial institutions will have to take basic operating precautions, which are highly relevant, to determine the conformity of the undertaking or activity that may pose any degree of risk of environmental degradation to rule out their inclusion, as financer agents, in the chain of liability. It is

lawful that financial institutions demand that those requesting credit and financing from them prove that they are in full environmental compliance. It is only after they prove it that the institutions will grant the requested credit.

The financer agent's duty of diligence is evident, be such agent public or private, while conducting evaluation studies prior to granting the credit sought by parties that could potentially cause degradation to the environment in the performance of their financed activities. Therefore, such duty does not rely on the source of credits granted to the entrepreneur.

Policy for Environmental Responsibility of Financial Institutions

In 2012, the Commission for Social Responsibility and Sustainability of the Federação Brasileira de Bancos (FEBRABAN), which congregates 20 associated banks, established some assumptions that should guide their activities in order to avoid possible environmental risk arising from financing operations. The assumptions consider the current legislation, mainly in view of two decisions rendered by the 2nd Panel of the Superior Court of Justice,[1] and are as follows:

(i) It is up to the entrepreneur to request the necessary environmental permits and comply with the technical requirements laid down by an environmental agency.

(ii) The environmental agency, due to its power to do so, oversees the project, grants environmental permits and imposes penalties for noncompliance with the law.

(iii) Banks are recommended to work expeditiously on the analysis of the proposed funding request and verify all documents obtained from the environmental and supervisory bodies attesting the correctness of the funded project.

(iv) The bank may be held accountable if it fails to comply with the rules set by the Environmental Authority, which legitimizes, empowers and supervises the project(s) under the current legislation.

(v) The bank has to demonstrate its environmental diligence in funding projects, which will provide certainty that its non-characterization as an indirect polluter (as defined in the current legislation), due to the absence of a causal relationship between the conduct of the bank and the environmentally harmful result.

(vi) Banks should follow up on the enterprise to remain in compliance throughout the period of disbursement. In any event, banks should retain the ability to paralyze disbursements if it finds irregularities.

On August 28, FEBRABAN approved the Self-Regulation of Normative FEBRABAN 14, which formalizes the fundamental guidelines and procedures for the environmental practices of its signatories.

This Normative 14 establishes the self-regulation program for the development and implementation of policy and environmental responsibility by the signatories, with the objectives of (i) formalizing fundamental guidelines and procedures for the incorporation of practices for assessing and managing social and environmental risk in business and relationship with stakeholders; (ii) demonstrating diligence and commitment of banks in the evaluation of social and environmental impacts of its operations and activities; (iii) defining the minimum level of procedures and practices in avoiding disparities competition between banks; and (iv) setting up the parameters and criteria for audits and

creating exculpatory evidence in lawsuits.

The signatory banks shall do the following:

(i) Develop and implement environmental responsibility policy (“PRSA”);

(ii) Possess a governance structure robust enough to enable them to give proper treatment to environmental issues, in proportion to the risk exposure of each institution, and ensure the integration of their policies,

(iii) Establish criteria and procedures to periodically check out the adherence of its internal rules to the areas defined in PRSA;

(iv) Consider the analysis of the environmental aspects of new products and services; and

(v) Verify financial transactions subject to the analysis of environmental aspects of legal requirements and adopt a method that considers their ability to identify in advance the borrower’s purpose for resource use.

According to the normative, certain operations that create significant exposure to environmental risks will be subject to evaluation based on consistent and verifiable criteria, such as the environmental license issued by a member agency of the National Environmental System (SISNAMA) or equivalent document.

While financing clients dealing with research and/or biosafety projects that obtain genetically modified organisms and their derivatives or assess the biosafety of these organisms, regardless of the degree of exposure to related environmental risks, the signatory banks shall verify the Biosafety Quality Certificate issued by the National Biosafety Technical Commission. The certified conditions include the construction, cultivation, production, handling, transportation, transfer, import, export, storage, research, marketing, consumption, environmental release and disposal of such organisms and derivatives, as provided for in Federal Law No. 11.105/2005 and Decree 5.591/2005.

The contractual instruments applicable to transactions the banks take part in, with the potential to generate significant adverse environmental exposure, shall contain the provisions addressing the following topics:

a) The obligation of the borrower to observe the applicable legislation;

b) An obligation on the borrower to observe labor, particularly the rules relating to occupational health and safety and the lack of slave labor or child labor laws;

c) The right of a party to accelerate the maturity of the operation in cases of cancelation of the environmental license, where applicable, and any other final conviction due to practice of acts that involve child and or slavery employment, criminal advantage of prostitution or damage to the environment;

d) The obligation of the borrower to monitor its activities in order to identify and mitigate environmental impacts unanticipated at the time of hiring credit; and

e) The obligation of the borrower to monitor its direct suppliers with regard to environmental impacts,

observance of social and labor laws, standards of occupational health and safety and the lack of slave labor or child labor.

In the case of new shareholding investments the signatory banks resolve to enter into that give rise to their enjoying shareholding rights or a position to prevail in corporate decisions — as well as the power to elect or remove a majority of directors and officers — effective operational control or controlling interest must be preceded by assessment to ascertain the adherence degree of the invested legal entity to social and environmental laws, as well as compliance with the invested entity's policies. Additionally, at the discretion of the banks, it will be considered, among others, the existence of certifications by the standards ISO 14001 and 26000, respectively Environmental Management System and Environmental Responsibility Management System.

Another important point has to do with rural properties given as collateral in certain project financings. In such cases, the expert must observe the registration of the legal reserve and the enrollment of the rural property or the Rural Environmental Registry (CAR) or document executed with the appropriate body, in accordance with current legislation. The bank in such cases may require or make a statement included in the contract that the property subjected to the collateral does classify as inserted into any area of archaeological or environmental preservation, and, therefore, should bear any restriction.

The banks may exert themselves to adopt any method of identifying risk-contamination areas at the property given as collateral and consider this variable in the decision-making process.

Brazil already has an environmental regulatory and legal framework that demonstrates that financial institutions (i) adopt an increasing understanding of the importance of sustainable development in Brazil's economic, social and environmental pillars; (ii) recognize the importance of prevention systems and demand for wide remedying of environmental damage; and (iii) envision the opportunity to build understandings and solutions to mitigate and recover environmental degradation.

Indeed, it is clear that the Brazilian financial institutions play a leading role in the field of environmental responsibility and effectively contribute to the full implementation of the constitutional principle inserted in Section VI of Art. 170 of the Brazilian Federal Constitution, which considers the defense of environment one of the pillars of the economic and financial order of the country.

NOTES
1 Recurso Especial nº 650.728-SC – 02.12.2009 e Recurso Especial nº 1.071.741-SP – 26.03.2009.

Conclusion

The social and environmental issues currently point in the sustainability direction and involve financial institutions as they conduct transactions that may be related to economic activities that, to some extent, have environmental impact. Thus, financial institutions must constantly identify and address the risks associated with their operations. With the National Monetary Council's implementation of Resolution 4327/14, financial institutions are required to devote even more attention to situations that may pose a social and environmental risk. These situations do not refer to financing only but also to the acceptance of the corresponding guarantees

Antonio Carlos de Toledo Negrão

General Counsel

Brazilian Banking Federation

Antonio Carlos de Toledo Negrão, general counsel of the Brazilian Banking Federation (Febraban), was previously president of the Comité Latinoamericano de Derecho Financiero da Federación Latinoamericana de Bancos. He completed his graduate and postgraduate degrees at Pontifícia Universidade Católica de São Paulo (PUC/SP) and received his master of laws degree from the Universidade de São Paulo (USP), and his MBA from Fundação Getúlio Vargas Rio de Janeiro (FGV/RJ).

Fabio De Almeida Braga

Member of the Corporate Finance Team

Demarest Advogados

Fabio De Almeida Braga is a member of the corporate finance team of Demarest Advogados. He conducts activities and projects related to different areas of the Brazilian financial market, with special focus on transactions intended to meet specific financial needs of the automotive industry, in all the phases and sectors of its chain.