# Environmental and social risk management guidance for SME lending

European Bank
for Reconstruction and Development

**Financial intermediaries (FIs) are required to comply with Performance Requirements (PRs) 2, 4 and 9 of the EBRD Environmental and Social Policy (ESP). This guidance note aims to provide further explanation of how the EBRD expects FIs to manage environmental and social risks in relation to small and medium-sized enterprise (SME) lending financed by the Bank.**

The EBRD uses the European Union (EU) definition of SME, which is based on a combination of turnover, employees and total assets, as shown in Figure 1. It acknowledges that FIs may use other definitions of SME, in line with national standards and/or corporate needs.

**Figure 1: EU definition of SMEs adopted by the EBRD**

| Enterprise category | Headcount: annual work unit (AWU) | Annual turnover | | Annual balance sheet total |
|---|---|---|---|---|
| Medium-sized | < 250 | ≤ €50 million | ↔ or | ≤ €43 million |
| Small | < 50 | ≤ €10 million | ↔ or | ≤ €10 million |
| Micro | < 10 | ≤ €2 million | ↔ or | ≤ €2 million |

Source: European Union (2020), User guide to the SME Definition, Luxembourg (2020).

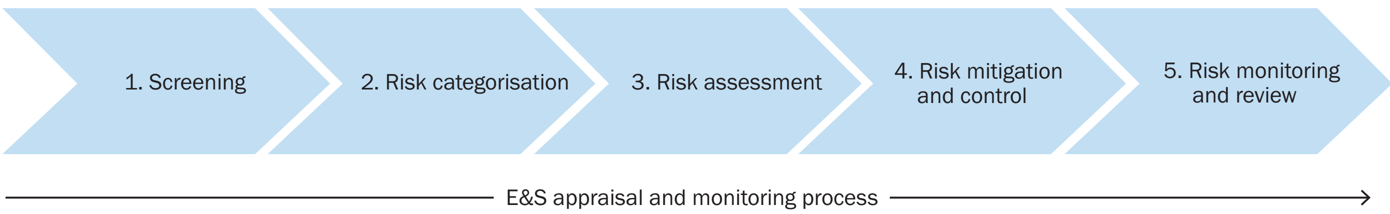
## Tailoring an ESMS to SME lending

PR9 and its associated guidance note, together with other guidance on environmental and social (E&S) risk management for FIs, provide comprehensive information on the EBRD's E&S risk management requirements and best practice for all types of FI.

In summary, FIs must put in place suitable procedures for E&S due diligence and the monitoring of sub-projects financed with the proceeds of EBRD funding, in accordance with the generic concept illustrated below.

In addition, such procedures must be embedded in an overall E&S management system (ESMS) that also includes an E&S policy (supplemented, if appropriate, by additional policies on specific industries or E&S themes), resources for implementation, arrangements for internal and external reporting as well as reporting to the EBRD, and periodic review for continuous improvement purposes.

**Figure 2: E&S appraisal and monitoring process for FIs**



FIs should consider the following general recommendations when tailoring an ESMS to the context of SME lending, as this typically involves the rapid processing of large numbers of relatively small loan transactions that are usually originated at branch level, without access to specialist E&S expertise:

- E&S procedures, tools and workflow integration should be as simple and standardised as possible to enable consistent decision-making by lending officers who may not be E&S specialists. This needs to be based on clear and objective criteria that can be easily applied using relatively basic E&S information on the sub-borrower and sub-loan.
- Escalation of proposed SME loan transactions for review by the FI's E&S specialists should be reserved for cases posing medium to higher levels of potential E&S risk, again based on clear and objective criteria as outlined in the EBRD risk categorisation guidance.
- E&S assessment of sub-projects categorised as medium or high E&S risk may establish that the actual risks are not as significant as anticipated, thanks to the sub-borrower's capacity to manage them in an effective manner. However, in some cases, E&S assessment may identify significant risks that would require relatively complex E&S risk mitigation methods, such as the use of external E&S consultants, the preparation of ESAPs and/or customised E&S terms and conditions in the loan agreement. In an SME lending context, such sub-projects are not common due to the excessive time and effort needed for on-boarding and monitoring. Such sub-projects would be accepted if there were an exceptional business case for persevering with a sub-borrower, project or sector.
- Decision-making will, therefore, typically be based on "go/no go" criteria linked to the EBRD's E&S requirements and a clear articulation of the FI's own E&S risk appetite.
- It is rare for SME lending to produce the kind of sub-project that would need to be designated "Category A". In some cases, the loan agreement between the FI and the EBRD may even explicitly prohibit the financing of such sub-projects. However, if Category A SME loans come under consideration, they should be subject to the type of more rigorous E&S due diligence procedures as outlined in PR9 of the ESP.

The EBRD's E&S requirements for SME sub-projects will be set out clearly in the relevant loan agreement between the Bank and the FI, but at a minimum will almost always consist of the following:

- EBRD financing shall not be used to lend to any sub-project that falls under Bank-wide exclusions, the E&S exclusion list and GET exclusions (for GET-eligible sub-projects).
- Sub-projects financed by EBRD funds must meet national E&S standards and regulations.

## Specific guidance on E&S risk management for SME loans

### Screening

The FI should screen the potential beneficiary's business activity against the EBRD's E&S exclusion list. See the screening note for further guidance.

### Categorisation

Box 1 provides an indicative example of an E&S risk categorisation methodology suitable for SME lending. See the note on categorisation for further guidance.

**Box 1: Example of E&S categorisation methodology for SME lending**

In this example, the E&S risk category is determined using only two factors, as illustrated in the matrix below, both of which can be applied simply and quickly.

- the level of E&S typically associated with the borrower's business sector (the EBRD's E&S sectoral risk categorisation list can be used as a suitable look-up reference tool)
- the amount and tenor of the proposed loan.

| Loan size and tenor | Low | Medium | High |
|---|---|---|---|
| Loan between €2,000 and €100,000 with tenor of 36 months or longer | **Medium** | **High** | **High** |
| Loan between €2,000 and €100,000 with tenor of 18–35 months | **Low** | **Medium** | **High** |
| Loan < €2,000 plus tenor > 18 months | **Low** | **Medium** | **Medium** |

Overall E&S risk rating for the sector

## Assessment

Table 1 summarises the recommended E&S risk assessment activities to carry out for transactions of low, medium and high E&S risk levels.

**Table 1. Recommended E&S assessment activities for low-, medium- and high-risk transactions**

| | E&S risk category | | |
|---|---|---|---|
| **E&S risk assessment activity** | Low | Medium | High |
| Regulatory compliance check | Confirm compliance by the beneficiary through warranties and covenants | Confirm compliance by the beneficiary through warranties<br>If concerned, check compliance, for example, review permits/licences, speak to regulator and so on | Confirm compliance by the beneficiary through warranties and check compliance, for example, review permits/ licences, speak to regulator and so on |
| Evaluate beneficiary's management of E&S risk | | Engage beneficiary to assess commitment, capacity and track record in managing E&S risk | Engage beneficiary to assess commitment, capacity and track record in managing E&S risk |
| Conduct an operational site visit | | | Conduct an operational site visit to check areas of concern |

Regulatory compliance check:

- Carry out a regulatory compliance check to confirm that the beneficiary is meeting relevant laws, regulations and standards, such as environmental and health and safety regulations, planning permissions, operating licences and permits.
- In low-risk transactions, it is sufficient to confirm compliance through warranties and covenants.
- For medium- and high-risk transactions, further evidence is required, per Table 1.

Engage in discussions with the sub-borrower's management team to assess:

- Commitment to managing E&S issues relevant to the business.
- Presence of effective systems to manage E&S issues, including accountability.
- Past record of regulatory breaches, fines, lawsuits, negative media or stakeholder protests/complaints that demonstrate how well the beneficiary has been managing E&S issues. An FI can also investigate a track record through an online search of publicly available information, such as media reports, social media and non-governmental organisation websites.

Conduct an operational site visit:

- Conduct a site visit to the beneficiary's operations to further evaluate E&S risks identified during management discussions and investigate how the beneficiary's E&S management systems are applied in practice.
- If appropriate, speak to site managers and other employees on how E&S risks are managed.
- FIs can conduct site visits themselves or commission an E&S expert to do so on their behalf.
- If the FI has access to previously commissioned E&S due diligence reports on the beneficiary's operations, the FI may choose to rely on these instead of carrying out a new site visit, if the report can be considered credible and appropriate.

Document the results from the E&S risk assessment:

- The FI should document findings and recommendations in the E&S due diligence (ESDD) report to help make an informed decision about the acceptability of the E&S risks associated with a proposed transaction.

If the FI is not satisfied with the findings or is concerned about E&S risks, it may choose to carry out additional E&S risk-assessment activities beyond the required actions outlined above. Additional E&S risk-assessment activities should be considered as appropriate to the concerns and risks identified.

## Mitigation

As a general rule, SME sub-loans should only be approved if E&S risks can be mitigated through simple and easily actionable methods, such as the use of standard E&S representations and warranties in the loan agreement or minor adjustments to the design of the sub-project to be financed.

As mentioned, more complex E&S risk mitigation methods (such as the use of external E&S consultants, preparation of environmental and social action plans [ESAPs] and/or customised E&S terms and conditions in the loan agreement) are atypical in SME lending. SME sub-loans with the kind of significant E&S issues that require such mitigation should generally be avoided, other than in exceptional cases. If such measures are warranted (for example, because of the strategic importance or positive development impact potential of the sub-loan), the FI should follow the guidance provided in the mitigation guidance note.

## Monitoring

The E&S monitoring of SME loans should follow the approach summarised in the monitoring guidance note using a risk-based approach to focus efforts more on SME sub-loans categorised as high risk.

## Reporting

E&S reporting to the EBRD on SME sub-loans should follow the approach summarised in the reporting guidance note focusing on the provision of aggregate portfolio data, together with summary details on any sub-loans with unusually complex E&S features and/or where there is evidence of significant E&S non-compliance.

June 2024



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