# E&S risk management guidance for leasing companies

European Bank
for Reconstruction and Development

## Introduction

**Financial intermediaries (FIs) are required to comply with Performance Requirements (PRs) 2, 4 and 9 of the European Bank for Reconstruction and Development's (EBRD) Environmental and social Policy (ESP). This guidance note aims to explain how the Bank expects FIs to manage environmental and social risks in relation to non-retail leasing financed by the EBRD.**

## Leasing overview

The EBRD supports leasing companies that specialise in providing operating leases and/or finance leases as asset financing solutions for businesses that require equipment or vehicle fleets. Other leasing companies that the EBRD supports have real estate assets in their portfolios.

An operating lease is a contract that permits the use of an asset without transferring the ownership rights of that asset. A finance lease is a contract that permits the use of an asset and transfers ownership after the lease period has finished, and the lessee has met all other contractual obligations.

The key features of the two main types of lease are summarised in the table below:

**Table 1. Key features of the two main types of lease**

| | Finance lease | Operating lease |
|---|---|---|
| **Who owns the asset?** | Leasing company | Leasing company |
| **Who takes the risks and rewards of ownership?**[1] | Lessee | Leasing company |
| **Who is responsible for maintenance and repairs?** | Lessee | Leasing company if contract includes maintenance |
| **Usual length of lease** | Most of useful lifespan | Part of useful lifespan |
| **Balance sheet treatment** | On balance sheet | On or off balance sheet depending on accounting standards used |

Industries that tend to use leasing for asset finance include (but not limited to):

- agriculture
- construction
- education
- transportation
- green energy
- manufacturing
- waste disposal
- retail
- medical
- organisations that require vehicle fleets.

The leasing companies the EBRD works with typically focus on leasing "hard" assets (namely, durable physical equipment with high intrinsic open-market resale value). Examples include:

- buses
- trucks
- materials handling equipment
- printing presses
- cars
- tractors and other agricultural equipment
- manufacturing equipment.

In some cases, leasing companies may also lease "soft" assets (with a lower intrinsic open-market resale value), such as:

- IT and communications equipment
- security systems
- catering equipment
- vending machines
- software
- gym equipment.

## Key environmental and social issues

The key environmental and social (E&S) risks and issues that leasing companies need to manage relate to:

- the physical asset itself
- the E&S implications of the function for which that asset is employed
- the lessee's ability to use and maintain the asset in a safe and responsible manner.

1 The "risks" in this context are mainly commercial, but may also include environmental and social (E&S) and health, safety and security (HSS) risks that could have financial implications for the leasing company

### E&S risks associated with the asset itself

In all cases, the leasing company must ensure that the leased equipment meets applicable environmental, health and safety (EHS) standards at the time of delivery to the lessee.

In some cases, the leasing company may also need to consider whether the equipment includes components or materials from a supply chain that may not be compliant with international conventions on critical E&S issues, such as forced labour, child labour, or the protection of biodiversity. If so, it may need to question whether the primary supplier is able to provide satisfactory evidence of supply-chain code of conduct policies and due diligence procedures. Examples may include (but are not limited to):

- leasing of electric vehicle (EV) fleets that use batteries that contain cobalt from countries on the US Department of Labor list of goods produced by child or forced labour and biodiversity risks associated with artisanal and small-scale mining
- leasing of solar photovoltaic (PV) equipment containing polysilicon sourced from certain regions allegedly associated with forced labour risks.

In the case of operating leases where the leasing company is responsible for maintenance, the lessor must ensure that leased equipment is maintained (including via preventive maintenance), so that it continues to meet applicable EHS standards during the lifetime of the lease.

Leasing companies that provide operating leases may also be responsible (either directly or via contractors or agents) for the storage, re-use or end-of-life disposal of used equipment or vehicles on expiry of the lease, and must ensure this is done in accordance with national E&S regulations, including those promoting circular economy principles.

### E&S risks associated with the function of the asset

Leasing companies shall not use EBRD funding to provide leased equipment, the specialised design or intended function of which directly conflicts with business activities cited in the EBRD's E&S Exclusion List, or among Bank-wide exclusions and Green Economy Transition (GET) exclusions for GET-eligible sub-projects. Examples of non-permitted activities include (but are not limited to):

- leasing of fishing vessels that conduct drift-net fishing in the marine environment in excess of 2.5 km in length
- leasing of sea tankers for the bulk transport of oil or other hazardous substances that are not in compliance with International Maritime Organization requirements
- leasing of specialised manufacturing equipment for the production of unbonded asbestos fibres or asbestos-containing products (other than bonded asbestos cement sheeting where the asbestos content is less than 20 per cent)
- leasing of specialised manufacturing equipment for the production of pharmaceuticals, pesticides/herbicide or other hazardous substances, where the products being manufactured are subject to international phase-outs or bans
- leasing of specialised manufacturing equipment for the production of ozone-depleting substances that are subject to international phase-out (for example, certain types of hydrofluorocarbon [HFC]) or used to produce equipment (such as industrial air-conditioning systems) that contain such ozone-depleting substances
- leasing of specialised equipment for the production of arms or military equipment, tobacco products or hard liquor.

E&S risks in other end-use scenarios (and the EBRD's E&S requirements in such circumstances) must also be considered on a case-by-case basis. For example:

- Logging equipment shall not be leased to a company where it is reasonably foreseeable that the asset may be used to undertake illegal logging.
- Construction equipment shall not be leased to a company where it is reasonably foreseeable that the asset will be deployed in the construction of a project that involves significant adverse impacts on biodiversity or indigenous peoples, contrary to the objectives of the EBRD's PRs.
- Agricultural equipment shall not be leased to a company that is known to have significant exposure to forced labour or child labour in its workforce of farm labourers.

### E&S risks associated with the lessee's E&S management capacity

Leasing companies should also be able to identify (and act accordingly) in situations where it is relevant (and feasible, given limited leverage) to consider or influence the lessee's E&S management capacity. This may be particularly important in cases where potential E&S-related problems or failures could impair the security value of "hard" assets. Relevant aspects of E&S management that can be material in this context may include:

- pollution prevention and control
- occupational health and safety
- industrial hazard and risk control
- consumer safety and product traceability
- vehicle fleet maintenance and safe driving training.

Where the lease is for "soft" assets, with credit risk depending on the overall financial health of the lessee rather than the market value of the physical assets, the leasing company may, on occasion, need to identify whether there are any critical E&S issues (such as community opposition, labour disputes, loss of environmental permits, water-scarcity constraints and so on) that could affect the client's business continuity and/or profitability, or that could pose an environmental impairment risk to other physical assets (such as land) used as security.

## E&S risk management systems for leasing companies

To comply with PR9, leasing companies should establish and maintain an E&S management system (ESMS) focusing on the key issues and objectives summarised above.
The leasing sector has not yet developed industry-led good-practice frameworks for such E&S management systems in the same way as the banking or private equity sectors. Leasing companies, therefore, have a greater degree of flexibility in demonstrating how they meet PR9. In general terms, however, the EBRD expects an ESMS for a leasing company to be aligned with the basic procedural building blocks outlined in PR9, customised for leasing applications in accordance with the advice provided in the following table.

**Table 2. Customising an ESMS for leasing applications**

| Procedural step | Advice on customisation to the leasing context |
|---|---|
| **General** | Leasing companies that tend to specialise in a small range of technologies or industry sectors (such as agricultural machinery and construction equipment, or electric vehicle fleets) should consider developing end-to-end E&S procedures and decision-making guidance specific to those individual asset classes. Specific E&S procedures may also need to be customised for:<br>• operating leases versus finance leases<br>• "hard" assets versus "soft" assets<br>• large numbers of low E&S risk leases versus a small number of high-value leases with potentially moderate to high E&S risk. |
| **Screening** | E&S screening procedures in leasing companies should focus on ensuring that the function (end use) of the asset does not breach the EBRD Exclusion List, as discussed earlier in this guidance note. Screening criteria should focus on filtering specific types of asset (such as fishing vessels, sea tankers, pharma equipment or cooling equipment) for additional "red flag" screening checks. Additional screening (for example, for forced labour risks) may be needed for specific types of client (such as agricultural producers). |
| **Categorisation** | As explained in other EBRD E&S guidance notes for FIs, the main purpose of E&S categorisation is to provide an indication of the likely time, resources and expertise required to conduct further E&S assessment of a potential transaction. Basic E&S categorisation procedures that rely only on "low", "medium" or "high" E&S risk classifications of the client's industry sector are, therefore, unlikely to be sufficient for leasing companies, who should also triage new leasing transactions based on asset type (including "hard" versus "soft") and lease type (operating versus financial), as well as transaction size. |
| **Assessment** | In all cases, E&S assessment procedures in leasing companies should include minimum checks to verify that the leased equipment meets applicable E&S and HSS standards. The procedures should also clearly define what additional desktop or site-visit due-diligence steps may be required in certain situations. For example:<br>Hard assets provided through finance leases to clients in industry sectors classified as "high E&S risk": confirm that the client's business does not involve E&S risks that could impair the value of the leased assets.<br>Soft assets leased to clients in industry sectors classified as "high E&S risk": confirm that the client's business does not involve E&S risks that could impact on credit risk. |
| **Mitigation** | E&S risk mitigation measures specific to the leasing sector may include:<br>• contractual requirements on the permitted location(s) of mobile equipment (such as construction vehicles) to ensure that they are not utilised in projects that have adverse E&S impacts<br>• an explicit focus on E&S risks in preventative maintenance contracts<br>• notification requirements in the event of major accidents or incidents involving leased assets<br>• E&S action plans and/or special underwriting conditions to protect leased assets from environmental and social risks and impacts. |
| **Monitoring** | E&S monitoring procedures in leasing companies should take a risk-based approach in order to focus monitoring efforts (including annual plant condition reports and site visits) on those leases where factors such as transaction size, equipment type, lease type and client industry sector combine to create the highest level of potential E&S risk. |
| **Reporting** | Annual E&S reports from leasing companies to the EBRD in relation to the use of proceeds from EBRD financing should include: (a) aggregate data on low- and medium-E&S-risk leases; (b) individual summary information on the E&S compliance status of each lease classified in the highest E&S category; and (c) updates on the leasing company's overall ESMS, including continuous improvements. |

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