

International Alert.

Conflict and Project Finance: exploring options for better management of conflict risk

Background paper

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Table of contents

Executive summary	i
Authors' note	iii
1. Introduction	1
2. Conflict	2
2.1 Understanding conflict	2
Box 1: Key terms	3
2.2 Causes and triggers	5
Table 1: Causes of conflict	5
3. Why project finance and conflict?	5
Box 2: Conflict risk in Guatemala – the Marlin gold project	7
Box 3: Financial services and conflict	8
4. Understanding the ‘two-way street’ between project finance and conflict	9
4.1 Costs of conflict on projects	9
Table 2: Costs of conflict	10
4.2 The impact of projects on conflict	10
5. Assessing non-commercial risks: current practice	11
5.1 Environmental and Social Impact Assessments (ESIAs)	11
Box 4: IFC's environmental and social standards	12
5.2 Country risk ratings	13
5.3 Political risk analysis (PRA)	13
6. Conflict risk mitigation: current practice	14
6.1 Political risk insurance (PRI)	14
Box 5: PRI in Democratic Republic of Congo	15
6.2 Covenants and warranties	17
6.3 ‘Political umbrellas’	17
7. Elements of a conflict-sensitive approach to project finance	18
7.1 Enhanced due diligence	18
Box 6: Sample screening questions	19
Box 7: Human rights compliance and impact assessment tools	19
7.2 ‘No-go’ criteria	21
7.3 Encouraging better conflict risk management by project sponsors	21
7.4 IFC Performance Standards, Common Approaches, Equator Principles: opportunity to raise standards	22
7.5 Tightening policy coherence	23
7.6 Strengthening the regulatory environment	24
References	26
List of institutions and organisations contacted (May – November 2005)	30
Annex 1: Conflict impacts at the project level	31
Annex 2: IFC draft Performance Standard 4	33
Annex 3: Voluntary Principles on Security and Human Rights	35

Executive summary

Investment projects in politically unstable countries present considerable risk management challenges to project sponsors, as well as their financiers and insurers. In particular, conflict risk – the risk that a project's development, construction or operations may be adversely affected by the outbreak of violent conflict - can be a major threat to a project's creditworthiness. Demonstrations and blockades by local communities; sabotage of project installations or facilities; kidnapping or assault to staff; outbreak of violent clashes between armed groups; demanding of payments by armed groups to project sponsors – all of these expressions of violence can impose direct costs to an investment, including reputational and even legal challenges arising from proximity to these factors.

At the same time, no project located in a politically unstable, conflict-prone area will be neutral. That is, just as a project may be adversely affected by violent conflict at the project or national levels, the project itself will have an impact on the conflict context within which it is located. The project and its context thus must be understood to have a two-way relationship.

This background paper focuses on the linkages between project finance and conflict. Project finance is frequently used to fund investments in higher-risk developing countries – particularly for large infrastructure and natural resource extraction projects. These investments are often linked to violent conflict at local and national levels due to interactions with certain structural and proximate causes of conflict, including economic underdevelopment and natural resource dependence. Even where conflict appears to be geographically far from a project, it is possible that investments, in contexts where resources are scarce, will soon become part of the conflict dynamic, boosting government access to revenue that can be used to prosecute conflict; attracting attention and demands from conflict actors; bringing migrant workers into a locality; and becoming a source of heightened competition locally.

Project financiers are particularly exposed to conflict risk due to the non-recourse and limited recourse nature of the financing structure. Hence, financiers need to be specifically concerned about managing their exposure to conflict-related credit risks. Business interruptions can lead to project downtime; legal injunctions can lead to expensive delays; and larger compensation packages can create cost overruns. All these developments can directly affect a project's ability to repay debt in a timely manner. And as project finance is very specific to a particular activity, a clear line of responsibility connects financiers with social impacts caused by a project, thus exposing the financier to reputational risks.

Despite the strong case for closer thinking on the appropriate assessment and management of conflict risk on the part of project financiers, there has been limited attention to this issue to date. Lenders and insurers currently employ advanced risk management processes to deal with a range of commercial and non-commercial risks associated with projects in higher risk markets. Most financial institutions rely on a combination of techniques to assess environmental, social and political risks: country level risk indices, political risk assessments, as well as social and environmental impact assessments are all helpful to varying degrees. However, these are inadequate in terms of conflict risk: they fail to systematically examine the two-way interactions between projects and the conflict context in which they are developed and operated.

The weaknesses of current conflict risk assessment practices are reflected in the existing strategies employed to manage conflict risk. In particular, reliance on political risk insurance (PRI) to mitigate risk is problematic. While PRI insurance or hedging instruments do provide cover for political violence and other events, cover is expensive, and may not extend to sub-state conflict risks faced by clients. Nor is PRI a risk management tool in the sense of ensuring a project will not aggravate existing tensions throughout development, operation and closure. Further, from a conflict prevention perspective, PRI is problematic as it may create a moral hazard whereby the provision of the insurance itself may act as a disincentive for sponsors to take steps to avoid exacerbating conflict.

Despite current gaps in conflict risk assessment and mitigation processes, the project finance community is well-placed to improve its understanding and management of conflict risk. This may be done through adopting what this paper terms a 'conflict-sensitive' approach to project finance. This encourages enhanced due diligence by financial institutions to better understand the conflict context in which a project is developed; to identify the interactions between the project activities and that context; and to act to prevent any negative impacts that may be the result of that interaction. A conflict-sensitive approach would also require encouraging improved conflict risk mitigation by project sponsors in line with international best practice. This approach also advocates that public sector lenders and insurers work to ensure cross-institution and inter-departmental coherence on poverty reduction, private sector investment and conflict prevention policies.

Enhanced understanding of conflict risk may bring a number of benefits to project financiers. For commercial lenders, enhanced understanding of the two-way nature of conflict risk facing a project may give a competitive advantage in that a bank may reduce the risk of certain projects, thus either improving the risk-reward tradeoff they face or opening up opportunities to lend to projects with which they would not otherwise become involved. More indirectly, reducing the potential for negative impact on risk from projects contributes to an enhanced and more sustainable global economy. Improved understanding of conflict risk may also assist those financial institutions with a 'footprint' in conflict-prone areas, as conflict-sensitive approach to lending could contribute to more informed and sustainable business relationships with governments, business partners and other stakeholders, as well as to a more stable operating environment.

A conflict-sensitive approach to project finance should also appeal to public sector lenders and insurers. While multinational development banks and export credit agencies may be brought into higher-risk projects due to the level of political protection afforded by them or home governments, conflict may also reduce MDB and ECA scope for business by foreclosing areas from consideration for lending. Improved conflict risk assessment and management may open up new investment opportunities, as well as assisting institutions pursue international development goals. At the same time it will alert organisations to situations where the risk of violent conflict is so high that proceeding with investment may not be viable.

Until now the financial sector has had limited involvement in international debates on business and conflict. This background paper seeks to stimulate greater consideration of conflict risk and a more constructive path for project finance backed investments in conflict-prone regions.

Authors' note

International Alert (Alert) is a UK-based peacebuilding NGO committed to the just and peaceful transformation of violent conflict. It has 20 years' experience of conflict transformation work from field programmes in a number of conflict situations around the world, including the Great Lakes region of Africa, West Africa, Sri Lanka, the Caucasus and Colombia. To complement its field programmes, Alert analyses issues relating to the root causes of conflict, influencing decision-makers in government, international organisations and the private sector.

Alert has been working to promote a more constructive role for business in conflict-prone societies, by engaging business both in-country and at headquarter level, through dialogue, capacity building, awareness-raising and policy research, since 1999. In 2005, we published *Conflict-Sensitive Business Practice: Guidance for Extractive Industries*, a series of tools for companies in the oil, mining and gas sectors that was developed in consultation with industry representatives. The purpose of these tools is to assist companies in assessing and mitigating the conflict risks associated with doing business in unstable countries, in the interests of the long-term stability of those societies at local and national levels.

The present paper is part of a new project which builds on earlier stages of work through seeking to determine better practice for the assessment and mitigation of conflict risk by project financiers. It is intended to serve as an input to a process of exchange and dialogue with the finance sector and other interested stakeholders on this topic that will run throughout 2006. It is designed to complement the work of other NGOs, such as BankTrack and ECA Watch, who advocate for wider human rights reforms in the ECA and broader financial services sector.

1. Introduction

Violent conflict is a persistent feature of the international landscape and presents a serious challenge for foreign businesses investing in unstable societies throughout the world, especially parts of Africa, Asia and Latin America. There is a large body of evidence that shows that investments in unstable areas interact with the dynamics of violent conflict at both local and national levels. These interactions have become the focus of activism and research by civil society groups, academics and think-tanks around the globe.¹

Some companies have responded with active engagement in the debate on business and conflict, participating in multi-stakeholder processes such as the Kimberley Process Certification Scheme, the Extractive Industry Transparency Initiative (EITI), the UN Global Compact and the Voluntary Principles on Security and Human Rights (VPs) in order to seek out shared solutions to problems. To date, however, the financial sector has had limited involvement in these discussions and processes.

Since the 1980s, political risk analysis and environmental and social impact (ESIA) standards have been in a state of evolution, complemented by increasingly sophisticated understandings of the appropriate relationship between business and host societies, and of 'corporate social responsibility' (CSR). Despite this, understanding of the interrelationship between particular investments and violent conflict has been limited. In particular, major gaps exist in:

- 1) The capacity to understand accurately any existing or potential conflict in a country, its actors and their perspectives, and its causes and consequences; and
- 2) The ability to appreciate the spectrum of influence that a project can have on such conflict, directly, indirectly and at varying levels.

Conflict risk – the risk that a project's development, construction or operations may be adversely affected by the outbreak of violent conflict - can be a major threat to a project's creditworthiness. Demonstrations and blockades by local communities; sabotage of project installations or facilities; kidnapping or assault to staff; outbreak of violent clashes between armed groups; demanding of payments by armed groups to project sponsors – all of these expressions of violence can impose direct costs to an investment, including reputational and even legal challenges arising from proximity to these factors.

At the same time, no project located in a conflict-prone area will be neutral. That is, just as a project may be adversely affected by violent conflict at the project or national levels, the project itself will have an impact on the conflict context within which it is located. The project and its context thus must be understood to have a two-way relationship. Even where conflict appears to be geographically far from a project, it is possible that investments, in contexts where resources are scarce, will soon become part of the conflict dynamic, boosting government access to revenue that can be used to prosecute conflict; attracting attention and demands from conflict actors; bringing migrant workers into a locality; and becoming a source of heightened competition locally. Decisions that sponsors take regarding project location, design and management have the potential to impact and distort conflict levels and dynamics. Decisions on the distribution of employment opportunities, security arrangements, relationships with political actors; environmental usage and impact; location of installation; and even social investment and community relations activities often providing the trigger which sparks pre-existing structural and proximate conflict factors into violence, to the detriment of the project itself (International Alert:

¹ Organisations including Amnesty International, Global Witness, and Human Rights Watch have campaigns focusing on links between natural resource exploitation and violent conflict. This is complimented by research into the economic dimensions of armed conflict by think tanks including the International Peace Academy, Fafo AIS, as well as public policy and government agencies such as the World Bank and the United Nations.

2005).² Understanding pre-existing tensions, and how a project may impact upon them, is thus central to improved conflict risk assessment.

This paper focuses on the field of project finance, which, it asserts, is well-placed for the development of new, innovative approaches to assessing and managing risks associated with investing in conflict-prone countries. The paper proposes a new approach to project finance that it terms 'conflict-sensitive'. As will be explored in greater detail, a conflict-sensitive approach to project finance requires financial institutions and other actors involved in a project finance investment to understand the conflict context in which a project is developed; to recognize the interactions between the project activities and that context; and from there to act to prevent any negative impacts that may be the result of that interaction. As such, a conflict-sensitive approach requires financial institutions to improve assessment of conflict-risk by analysing projects and conflict through a 'two-way street' perspective that recognizes the dynamic interaction between investment and conflict issues during due diligence; promoting better conflict risk mitigation by project sponsors; and making decisions not to invest where a project meets 'no-go' criteria (for example, where egregious human rights violations occur). A conflict-sensitive approach also requires public sector lenders and insurers to work to tighten policy coherence to ensure project finance is provided in line with international sustainable development goals and commitments to human rights. Commercial lenders, in turn, should consider the possible benefits of improved conflict risk assessment practices under existing and proposed financial regulations.

The paper takes as its hypothesis that adopting a conflict-sensitive approach to project finance could contribute in a small but significant way to a less uneven and unstable globalised economy. At the same time, a conflict-sensitive approach to lending and insuring may provide project sponsors and investors with increased confidence that cash flow, reputation and relations with host country actors will not be negatively affected by violent conflict. In turn, this approach may also assist multinational development banks (MDBs) and others to improve their track record of supporting those projects that further developmental goals, as well as projects which 'do no harm' and contribute to the building of peace.

2. Conflict

2.1 Understanding conflict

Conflict occurs when two or more parties believe their interests to be incompatible, express hostile attitudes, or take actions that damage the other's ability to pursue its interest. 'Violence' is often used interchangeably with 'conflict,' but violence is only one means among many that parties choose to address a given conflict. Non-violent conflict is essential to social change and development at both the personal and group level, and a necessary component of human interaction. Conflict becomes violent when parties no longer seek to attain their goals peacefully, but instead resort to violence in one form or another. When violence erupts, it signifies a profound breakdown in social relationships that is likely to have long-term and far-reaching destructive effects. 'Conflict' is also sometimes erroneously confused with macro-political violence between two warring parties (as with a civil war between a national government and a non-state actor – this is 'armed' or 'civil'). Violent conflict, of concern to investors, can also occur at more localised levels, and at the same time always has the potential to escalate. Conflict is a dynamic process with complex causes, and may take differing forms and runs through various stages of escalation and de-escalation.

Since the end of the Cold War, civil conflict has been a persistent feature of the international political landscape. While the demise of the Soviet Union brought with it a rise in expectations of a new, peaceful world, such hopes were short-lived: the global, annual number of armed conflicts rose sharply in the early 1990s, from 56 in 1990 to 68 in 1992. Between 1990 and 1999 there were 118 armed conflicts, 100 of which were largely, primarily or exclusively internal conflicts (Smith 2004: 112). While some of the conflicts that erupted in the early 1990s have ostensibly

² See also Collaborative for Development Action Inc. www.cdainc.com; and Ballentine and Haufler (2005).

been 'ended' with peace agreements, the incidence of intrastate violent conflict overall has continued to increase (UNDP 2005: 12). This can in part be explained by the fact that half of all countries coming out of violent conflict revert to war within five years: peace agreements do not necessarily alter the factors that led to conflict in the first place (Smith 2004).

Today's landscape of persistent violent conflict throughout much of the developing world is complicated by the security threat posed by terrorism. Al Qaeda's attacks in the United States in 2001 brought terrorism to the forefront of political leaders' agendas throughout the world, leading to US-led military campaigns in Afghanistan and Iraq as well as increasingly strong legislative measures to support the 'war on terror'.

While an emphasis on hard security over human security is now once again apparent in the international system as a result of these developments, it is also accepted that terrorism may be symptomatic of a wide range of social, economic and political stresses experienced in different parts of the world. Globalisation has not brought a balanced increase in access to economic, political and social opportunities in all countries. The UN Secretary-General's annual report for 2005, *In Larger Freedom* argues that we live in an age when the lethal interaction of poverty and violent conflict poses grave threats not just to the immediate victims but also to the collective security of the international community. Endemic poverty, inequality and high unemployment, combined with political disenfranchisement, poor governance, growing competition over access to land and natural resources, and an insufficient access to justice, along with other factors, are known correlates of violent conflict and terrorism alike. Taking account of root causes and conducting meaningful analysis of conflict dynamics on the part of all actors engaged in either development-oriented or private sector activities in developing countries becomes all the more pertinent in today's world.

Box 1: Key terms

Actors are individuals, groups or institutions who contribute to conflict; and/or are affected by conflict (in a positive or negative manner); and/or are engaged in dealing with conflict.

Conflict sensitivity refers to the ability of any organisation to: understand the context in which it operates; understand the interaction between its own activities and the context; and act upon the understanding of this interaction, in order to avoid negative impacts and maximise positive impacts.

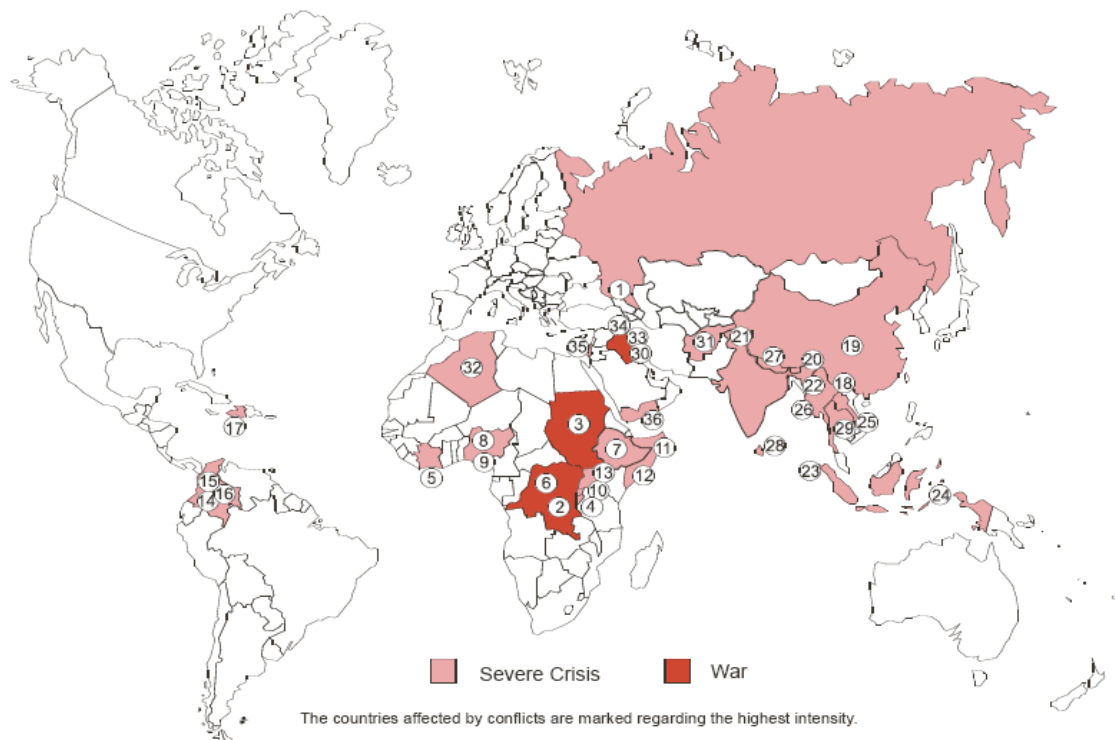
Context refers to the political, economic and social operating environment, which ranges from the project level to the macro level (e.g. community, district/province, region(s), country and neighbouring countries).

Development refers to long-term efforts aimed at bringing improvements in the economic, political and social status, environmental stability and the quality of life of all segments of the population.

Impacts (positive or negative) describe an interaction in terms of its contribution to exacerbating or mitigating violence or the potential for violence.

Peacebuilding is those measures designed to consolidate peaceful relations and strengthen viable political, socio-economic and cultural institutions capable of mediating conflict, and to strengthen other mechanisms that will either create or support the necessary conditions for sustained peace.

Worldmap: Violent Conflicts of High Intensity 2004



Legend

No.	Name of Conflict and most important Conflict Item	No.	Name of Conflict and most important Conflict Item
Europe - severe crises		Asia and Oceania - severe crises	
1	Russia (Chechnya) - secession	18	Bhutan (Indian separatist rebels) - territory
Africa - wars		19	China (Hui) - other
2	DR Congo (Rebels) - national power, resources	20	India (Assam) - secession, resources
3	Sudan (SLM/A - JEM) - regional predominance	21	India (Kashmir) - secession
Africa - severe crises		22	India (Nagaland) - secession, regional predominance
4	Burundi (Hutu) - national power	23	Indonesia (Aceh) - secession, resources
5	Côte d'Ivoire (Rebels) - national power	24	Indonesia (Moluccans) - regional predominance
6	DR Congo (Hema - Lendu) - regional predominance	25	Laos (LCMD, CIDL) - ideology / system, autonomy, national power
7	Ethiopia (Anyuak - Nuer) - regional predominance	26	Myanmar (minorities) - secession
8	Nigeria (Christians - Muslims) - ideology / system	27	Nepal (Maoist rebels) - ideology / system, national power
9	Nigeria (Nigerdelta - Ijaw) - resources	28	Sri Lanka (LTTE-East - LTTE) - regional predominance
10	Rwanda (Hutu) - national power	29	Thailand (Southern Border Provinces) - secession
11	Somalia (Somaliland) - secession	Middle East and Maghreb - wars	
12	Somalia (various groups) - national power	30	Iraq (insurgents) - national power, ideology / system
13	Uganda (LRA) - national power	Middle East and Maghreb - severe crises	
Americas - severe crises		31	Afghanistan (Taleban) - regional predominance, national power
14	Colombia (ELN) - national power, ideology / system	32	Algeria (Islamist groups) - national power, ideology / system
15	Colombia (FARC) - national power, ideology / system	33	Iraq (al-Sadr group) - ideology / system
16	Colombia (paramilitias) - regional predominance, system	34	Iraq (CPA - resistance groups) - ideology / system, resources
17	Haiti (opposition) - national power	35	Israel (Palestinians) - autonomy, ideology / system, resources
		36	Yemen (Islamists) - national power

Map: Heidelberg Institute on International Conflict Research, *Conflict Barometer 2004*, p.4

2.2 Causes and triggers

Conflict is sometimes viewed in the corporate world as a separate ‘issue’ that can be addressed in isolation from other ‘issues’ such as human rights, the environment or sustainable development. However, conflict is a cross-cutting theme or context – a violent manifestation of tensions that may have arisen for a variety of reasons (e.g. human rights abuses, environmental scarcity or degradation, unjust governance, economic insecurity).

Research institutions, international organisations and others have made attempts at modeling individual risk factors that lead to the break out of violent conflict.³ To begin to understand conflict, and how infrastructure, resource extraction and other projects may interact with conflict, it is useful to structure thinking about violent conflict in terms of structural and proximate causes, and triggers.

Table 1: Causes of conflict

	Description	Correlates of conflict - examples
Structural/root causes	Pervasive factors that have become built into the policies, structures and fabric of a society. Structural causes of conflict are inevitably the most complex and long-term but constitute an ever-present threat.	<ul style="list-style-type: none"> • <i>Poor governance and corruption</i>: related to government’s responsiveness to citizen’s concerns; • <i>Poverty</i>: proxy for weak government and correlated with incidence of intra-state violence due to absence/inequality in distribution of economic benefits; • <i>Uneven spread of ethno-nationalist groups across different regions</i>: conflict can correlate where population distribution significantly skewed.
Proximate causes	Factors that are symptomatic of the root causes and may heighten the risk of violent conflict, or exacerbate and perpetuate existing conflict. Proximate causes take on a particular importance at the local level.	<ul style="list-style-type: none"> • <i>Availability of light weapons</i>: even when easy access to weapons does not lead to conflict, it increases the risk of violence and suggests weak or corrupt security structures; • <i>Human rights abuses</i>: a history of violations can leave a legacy that fuels conflict and indicates poor governance or repressive regime; and • <i>Objectives of political actors</i>: armed groups and others may seek violent solutions to long-term historical grievances.
Triggers	Single acts, events or their anticipation that may set off or escalate violent conflict.	<ul style="list-style-type: none"> • Elections • Increased food scarcity • Environmental disasters • Security arrangements of companies • Project resettlement and compensation policies

It should not be assumed that violent conflict is inevitable where the correlates listed above are present in a particular country. Equally, a conflict may break out where some or most of these correlates do not exist. However, a good overview of a country’s conflict correlates (and hence its ‘conflict context’) can assist in understanding the overall level of conflict risk.

3. Why project finance and conflict?

While there are a number of aspects of the activities of the financial services industry as a whole which may be linked to incidences of violent conflict (see box 3, below), this paper focuses on the linkages between project finance and conflict because it seems timely and realistic to do so; because doing so builds on current Alert work with extractive industries; and for the reasons that relate to the characteristics of project finance itself which are set out below. At the same time,

³ For example see Collier and Hoeffler (2001); Ballentine and Sherman (Eds.) (2003); Nathan (2004); and the Correlates of War Project www.correlatesofwar.org.

given the industry-wide links that can be drawn between financial services and violent conflict that are discussed in box 3, over time a more comprehensive inquiry and reflection on the part of industry leaders into minimizing activities that can exacerbate, facilitate or otherwise support the prosecution of violent conflict is likely to climb advocacy agendas.

First, it is apparent that since the 1980s there has been increased interest in project finance, particularly in emerging market countries in Latin America and Asia: project finance is now commonly used to fund investments in developing countries. In these higher-risk economies, project finance is attractive as it can increase the availability of finance, and tends to reduce the overall risk for major project participants. Indeed, project financing is more likely to be used where there is high political risk in the host country (for example, in countries where institutions and law enforcement are weak), often through project finance syndicates which will act to discourage default on loans (Hainz and Kleimeier 2004: 4). Often these syndicates will include international lending organisations such as IFC, EBRD or export credit agencies which offer political influence to deter host governments from making decisions that will adversely affect the project.

Private financiers that may not otherwise invest in certain developing countries may in fact consider being involved in projects located in such markets where such syndicates are involved. For example, a financier that may normally limit its exposure in Peru might consider financing the Camisea gas development project, which is based in Peru but whose risks are mitigated by project finance loan arrangements. The sharing of risk by numerous parties to a project finance deal lowers the exposure to risk of an individual financier. Developing country governments can also find project finance deals appealing, in that they facilitate the entry of big foreign investors (Esty 2004: 48). This can provide opportunities for avoiding more public debt whilst at the same time delivering large-scale development projects (Valahu 2005: 27-30).⁴

Second, project finance is a widely used method for financing large infrastructure projects and certain types of natural resource extraction activities: power plants, oil and gas pipelines and hydroelectric dams, for example. These activities are often linked to violent conflict at local and national levels due to their strategic significance; their large environmental, social and revenue 'footprint'; and the need to protect such assets with security forces (International Alert 2005; Bannon and Collier 2003; Switzer 2001). Large projects may require resettlement, alienate communities from their land, or otherwise affect socio-cultural groups whose needs are not addressed by the government or the project. In addition, natural resource extraction projects can in and of themselves be associated with the phenomenon known as the 'resource curse', which describes the structural link that has been demonstrated to exist between dependence on natural resources and underdevelopment or conflict (Lynn Carl 1997; Ross 1999 and 2003).

Thus, project finance often occurs in the context of developing countries and socially/environmentally sensitive large projects. In addition, project financiers are particularly exposed to conflict risk due to the non-recourse/limited recourse nature of the financing structure (meaning that loans and bonds are repaid based on the revenues generated by the project itself: creditors do not have 'recourse' to the project sponsors if the project is not successful or if difficulties in debt repayment are encountered). Hence, project financiers need to be especially concerned about managing their exposure to conflict-related credit risks. Business interruptions can lead to project downtime; legal injunctions can lead to expensive delays; and larger compensation packages can create cost-overruns. All these developments, which are explored in this paper, can directly affect a project's ability to repay debt in a timely manner.

At the same time, project finance is very specific to a particular activity, which draws a clear line of responsibility connecting financiers with the social impacts caused by a particular project. For example, a bank that arranges a project loan for a controversial dam can run the risk of being held publicly accountable for capitalizing that project and for the conflict that might ensue as a

⁴ In particular, project financed public-private partnerships (PPPs) are increasingly the vehicle of choice of developing country governments, particularly for large infrastructure projects.

result.⁵ This contrasts, for example, with the practice of an investment bank that underwrites a general obligation bond for a dam construction company. While some businesses and their financiers operate to a 'high-risk/ high-reward' model of doing business, it is not therefore in the business interest of a large project finance agency, whether public or private, to invite such exposure.

Public sector lenders such as IFC have the added consideration of operating consistently with the wider international objectives and mandate of their institution. They are especially likely to come under criticism where projects get caught up in conflict dynamics precisely because these trends are seen to undermine the development, poverty reduction and global security concerns of many tax-payers, reflected in government policy.⁶ The IFC-supported Marlin gold project in Guatemala is an illustration of the need for public sector lenders to ensure conflict risk is properly assessed and mitigated in order to fulfill institutional mandates and goals of promoting sustainable private sector development.

Box 2: Conflict risk in Guatemala – the Marlin gold project

From 1960 to 1996 Guatemala was the site of a civil war between Mayan insurgents and the US-backed national army. It is estimated that over 200,000 people were killed or went missing during the war. Since then, the government has been criticized for a failure to uphold human rights and implement key components of the Peace Accords (Amnesty International 2005). Guatemala's rural peoples are very poor, and the country is plagued by organized crime. The Western Highlands of Guatemala have historically seen violent clashes between the government and Mayan communities.

In June 2004, IFC approved a \$45 million loan in support of the \$261 million Marlin gold project in Guatemala's Western highlands, to be developed by Glamis Gold (via its subsidiary Montana Exploradora de Guatemala S.A), a Canadian mining company. In addition to providing the loan, IFC assisted in 'effective planning and implementation of... environmental and social programs by working closely with the company, NGOs, local municipalities, and community members' (IFC November 2004).

In January 2005, local communities protesting against the mine clashed with security forces, resulting in one death and several injuries. Later, in March 2005, an off-duty employee of the company providing security to Glamis shot and killed one local villager. The same month, local anti-mine activists received death threats.

In February 2005, a formal complaint was lodged with IFC's Compliance Advisor Ombudsman (CAO) by a Guatemalan environmental NGO. The organization alleged, inter alia, that the mine was environmentally damaging, that local indigenous peoples had not been adequately consulted about the mine, and that the mine's existence exacerbated social tensions, violence and insecurity.

Investigations carried out by the CAO in May 2005 led to criticisms of IFC's assessment of the government's capacity to effectively mitigate conflict and regulate the project and for insufficient meaningful consultation with local groups (CAO 2005(1)). Significantly, the CAO found that IFC and the company had no policy on conflict assessment, and failed to take into formal consideration of security concerns and the potential for local violent conflict related to the project. The report stated: 'IFC should have considered more systematically the potential risk to human rights at the project level, should have taken appropriate measures to mitigate these risks, and should have provided clearer directives to the company with respect to both issues' (CAO 2005(2)).

⁵ For example, Barclays Bank's advisory role in the Omkareshwar Dam project in India has been criticised by Friends of the Earth as the project fails to meet IFC standards in relation to indigenous people, resettlement and compensation – problems that are linked to incidences of violent conflict elsewhere (FoE 2004, 2005). Similarly, the role of the World Bank, Asian Development Bank along with commercial banks including BNP Paribas, Societe General, Standard Chartered, ANZ, ING and others in the Nam Thuen 2 hydroelectric dam project in Laos has been criticised for flawed stakeholder engagement processes and a failure to address detrimental effects on the environment, human rights and livelihoods (BIC 2005). ECA-backed dams have been criticised for aggravating ethnic tensions in Sri Lanka and Senegal (Hildyard in Ballentine and Nitzsche (2005: 243-244).

⁶ See N. Hildyard in Ballentine and Nitzschke (Eds.) (2005). Numerous advocacy campaigns and official complaints have been made by civil society groups in relation to ECA, IFC and EBRD involvement in projects such as the Baku-Tbilisi-Ceyhan (BTC) pipeline which runs through a region beset by a number of violent and 'frozen' conflicts. See also CEE Bankwatch Network (2004) and WWF (2003).

While there are thus a cluster of factors that point to project financiers' particular exposure to conflict risk, the project finance community is at the same time well-placed to take remedial steps, to both protect their own investments and ensure that their business is not impacting negatively on those affected by violent conflict or the wider objectives of their own institutions. Project finance transactions involve numerous parties and have a relatively long lead time; allowing many financiers the opportunity to perform conflict-related due diligence. The project financing cycle often lasts over a year, and lending syndicates can involve over a dozen creditors, all of whom scrutinise the transaction. Thus, the level of conflict-related due diligence performed by financiers may be much higher and subject to more cross-verification compared with other transactions. The longer timeframe and complex legal arrangements also allows lenders to specify particular conflict-related performance requirements in loan covenants, whereas such conditionalities may be more difficult to levy in other financial arrangements. Naturally, the degree of influence a financial institution will have over a project's design will be tied to the type of financial product and services provided to the sponsor, the type of institution, the structure and other parties to the finance agreement, and at which stage of the project cycle the institution becomes involved.

Despite what seems to be a strong case for closer thinking on the appropriate assessment and management of conflict risk on the part of project financiers, there has been limited attention to this issue to date.

Box 3: Financial services and conflict

This paper focuses on how financial actors involved in the field of project finance may be able to improve practice in order to better understand and mitigate conflict risks associated with infrastructure, extractive and other projects in conflict-prone areas. However, it is apparent that other financial services are also connected with violent conflict, and while some attention has gone into tightening standards regarding some relevant areas, further research and industry-wide attention to violent conflict is needed. Some of the links between financial services and conflict are listed below.

(1) Facilitating the enrichment of corrupt and repressive regimes

- *Capital flight and money laundering:* every corrupt dictator that has transferred money offshore for personal enrichment has done so with the aid of correspondent and/or private banking services. In 2005 US-based Riggs bank was fined \$41 million for its failure to scrutinize suspicious transactions by former Chilean dictator Augusto Pinochet and President Obiang of Equatorial Guinea (O'Hara 2005). Such grand-scale corruption is often a correlate with violent conflict.
- *Financial advising:* financial advising is an important service offered to sovereign governments, but sometimes this advice is employed for dubious ends. In 1997, a Jardine Fleming banker was sacked for providing financial advisory services to the Papua New Guinea government. The government had sought assistance to source and finance mercenaries in an attempt to suppress a separatist uprising and protests against the Bougainville copper mine, operated by Rio Tinto (Ridding 1997).
- *Sovereign loans:* financiers provide loans to sovereign governments that may engage in human rights abuses or war-mongering activities. Perhaps the best known case involves banks that were active in apartheid South Africa, such as UK-based Barclays which is said to have made US\$725.4 million in loans to the apartheid regime.⁷
- *Sovereign bonds:* bond offerings may also be used by repressive governments to raise capital. In the context of the government of Guatemala's links to human rights abuses and political repression, Morgan Stanley led a sovereign bond offering by the Republic of Guatemala in November of 2001, while Citigroup served as the bookrunner for Guatemala's 330 million 30-year sovereign bond issue in 2004 (Latin Finance 2001 and 2004).
- *Financing state-owned enterprises:* in countries where revenues from natural resource extraction bankroll state-sponsored repression or civil war, state-owned companies can play a key link between the financial sector and violent conflict. For example, in 1996 the Angolan state-owned oil company, Sonangol, borrowed US\$310 million from a sixteen-member international bank syndicate led by UBS. The next year, UBS arranged another US\$400 million syndicated bank loan for the company. In 1997 and 1998, Swiss oil trading company Glencore, which was also an Angolan oil offtaker, arranged a series of oil-backed loans worth \$900m from institutions like Banque Paribas. According to the NGO Global Witness, 'much of the money from these [Glencore-arranged] loans was used to purchase weapons' (2000).

⁷. See Jubilee South Africa press release, <http://www.nu.ac.za/ccs/default.asp?3,69,3,702> . Viewed 12 August 2005.

(2) Providing financial facilities for the trade in weapons

- *Trade facilities:* merchant banks can provide trade facilities that enable governments to import weapons, communications equipment, and other articles of war. On the other side of the transaction, financiers may also support the manufacture of these items. For instance, AXA, Dexia, Fortis, ING and KBC have been linked to the financing of cluster bombs, landmines, nuclear weapons and depleted uranium weapons (Netwerk Vlaanderen 2004).
- *Export credits and support of arms sales:* a significant proportion of export credit guarantees awarded by ECAs in the European Union are in support of the defence industry. While it is argued that the controls on such exports ensure that weapons are only sold to recognised sovereign governments and in line with international regulation, experience has shown that this is not always the case (Ingram and Davis 2001; and Mephram and Eavis 2002).⁸

(3) Conflict commodities

- *Natural resources:* timber, cobalt, tin, diamonds, gold and oil may generate hard currency for tyrannical regimes, civil war or violent conflict, as has been the case in countries such as Liberia and Angola. Links between international financial markets and conflict commodities are well documented, including some cases where the commodities themselves are used as a form of payment. For instance, ING, UBS and HSBC have all extended loans or revolving cash facilities to the Angolan government that were repaid in crude oil cargoes, rather than cash (Global Witness 2005, 2000).
- *Support to extractive industries involved in conflict zones:* Sudan's conflict between North and South was linked with the exploitation of oil. Some estimates indicate that Khartoum's war cost the Sudanese government \$1 million per day, with almost all of that revenue generated from oil development with the assistance of foreign companies such as PetroChina (Christian Aid 2001). In 2001, PetroChina spun itself off from parent company China National Petroleum Corporation, in an effort to separate itself from Sudan investments and to prepare itself for an initial public offering (IPO) on the New York Stock Exchange. However, the company's ties with Sudanese activities, along with its doubtful environmental management capacity, and its plans to develop natural gas near Tibet and layoff over a million workers, sparked an unprecedented activist campaign to derail the offering. An investor boycott was launched, which garnered the support of investors with \$1 trillion of assets under management. After claiming that it would raise \$10 billion in a Goldman Sachs-led IPO, PetroChina ultimately only raised \$2.89 billion, even after underwriters supported the offering by purchasing shares on the first day.

4. Understanding the 'two-way street' between project finance and conflict

As discussed in the introduction to this paper, the relationship between project finance and conflict is best understood as a 'two-way street' whereby each influences the other. This section expands on this point by setting out some of the likely interactions in both directions.

4.1 Costs of conflict on projects

There are numerous recent examples of projects that have incurred direct and indirect costs as a result of conflict. For instance, in 2001 attacks on Colombia's Caño Limón-Coveñas oil pipeline by insurgent groups resulted in a direct loss of earnings of approximately US \$500 million in that year alone (GAO 2005). Similarly, guerilla groups opposed to foreign companies have routinely sabotaged the Ocesa pipeline in Colombia, with state security forces being accused of serious human rights abuses in attempting to secure the pipeline. The attacks themselves have led to operational delays and reputational damage to project sponsor BP. Enron's Dabhol power plant in India faced a series of construction delays as a result of vehement local opposition, demonstrations and the filing of a legal injunction by affected populations who believed the plant was being built in a way that violated their rights (Human Rights Watch 1999). Similarly, in Brazil, lenders have come under scrutiny for their role in a dam project which as seen demands for better compensation packages (Bank Information Centre 2005).

While project sponsors will introduce a range of measures to reduce the risk of delays, project risk assessment and mitigation may not include a thorough analysis of two-way conflict risk

⁸ The current EU Code of Conduct on the export of military technology and equipment is only politically, not legally, binding. However, the Code is currently under review and it is expected that a revised Code will be adopted as legislation by mid-2006, and stipulates that States must deny an export licence for military technology or equipment which would provoke or prolong armed conflicts or aggravate existing tensions or conflicts in the country of final destination.

impacts, and as such the risk of delays caused by conflict may not be adequately dealt with. This in part may be due to the current lack of standardised financial models that accurately quantify and estimate the likely costs a project may incur as a result of conflict. While the pricing of political risk insurance is frequently referred to as a proxy for determining the likely cost of the adverse impacts of political events such as civil disturbances, this may not accurately reflect specific direct and indirect costs that a project may incur as a result of violent conflict impacts during discrete project stages. Table 2 (below) summarises some potential direct and indirect costs of conflict to projects throughout various project stages.

Table 2: Costs of conflict

Direct costs	Example	Project stage
Security	Higher payments to state/private security firms; staff/contractor time spent on security management.	All.
Risk management	Insurance, loss of coverage, reduced mobility and higher transport costs.	All, especially construction and operation.
Material	Destruction of property or infrastructure.	Construction, operation.
Opportunity	Disruption of production, delays on imports.	Operation.
Personnel	Kidnapping, killing and injury; recruitment difficulties; higher wages to offset risk.	All.
Reputation	Consumer campaigns, risk-rating, share-price, competitive loss.	All.
Litigation	Expensive and damaging law suits.	All.
Indirect costs		
Human	Loss of life, health, intellectual and physical capacity.	All.
Social	Weakening of social, political and economic capital – thus making operating environment difficult to work in.	All.
Economic	Damage to financial and physical infrastructure, loss of markets.	Construction, operation, closure.
Environment	Pollution, degradation, resource depletion.	Construction, operation, closure.
Political	Weakening of institutions, rule of law, governance.	All.

The direct costs caused by the outbreak conflict may affect a project's creditworthiness, which in turn will expose investors to a higher degree of risk - which is currently mitigated mainly through transferring risk to insurers (see section 5). However, indirect costs will also affect investors, particularly in regard to reputation. For example, a bank that arranges a project loan for a controversial pipeline can run the risk of being held publicly accountable for capitalising that project and for the conflict that might ensue as a result.⁹

4.2 The impact of projects on conflict

Few major greenfield projects are developed in areas of actual violent conflict, precisely because of the risks entailed. More commonly, violence at the local level will follow the start of operations. As major investments inevitably alter traditional systems and, even in relatively peaceful environments, they can easily lead to a heightening of tensions and possibly violence. In areas of pre-existing social tension, the odds on such an outcome increase. In short, the absence of violence in a project area is no guarantee of what might happen in the future.

Just as conflict can impose a range of direct and indirect costs on a project throughout the project life-cycle, so too will projects have an impact on the local environmental, economic, political and social context in which they are developed. For example, at the project level, a natural resource extraction project will have an impact on local land-use. The project may require the resettlement of local communities which may be a source of resentment and protest against the project by

⁹ For instance, community representatives from Thailand and Malaysia with international NGOs including Friends of the Earth, Corner House and Platform have recently campaigned against Barclays Bank financial backing of the Trans Thai-Malaysia gas pipeline project. The project has been criticised for its security arrangements: it is associated with the continued use of state violence, with reports of over 500 police personnel guarding a proposed gas separation plant site (Friends of the Earth 2004, 2005).

those communities. In addition, resettlement may have a secondary conflict impact of putting strains on relations between relocated and host communities – and compensation provided to resettled communities will not necessarily solve the problem. Rather, the payment of cash compensation would mean an influx of money into the local subsistence economy which, in turn, may lead to compensated individuals becoming the targets of extortion. The project sponsor itself may face demands for increased compensation from both resettled communities and other actors.

At the macro-level level, the sponsor's activities will also interact with some of the structural correlates of conflict outlined above. For instance, a project sponsor may pay fees, taxes or shares production revenues with the national government of an underdeveloped country with a track record of corruption. If that government does not ensure the economic benefits of the project are equally distributed, a perceived inadequate share of revenue to the project locality can increase alienation and tensions. Where the government is overly dependent on the project, this may also lead to an increased state security presence in the project's vicinity, as well as a clampdown on dissent.

Annex 1 provides a further breakdown of the range of impacts a project can have on a particular conflict context.

5. Assessing non-commercial risks: current practice

Financial institutions have advanced risk management processes designed to determine the risk/reward trade-off for a wide variety of commercial and non-commercial risks. In relation to non-commercial risks such as conflict risk, banks, ECAs and MDBs currently have access to a variety of techniques and standards to measure and assess the non-commercial risks associated with supporting projects in politically unstable environments. In terms of a qualitative assessment of conflict risks, most lending institutions rely on a combination of environmental and social impact assessments (ESIA), country-level risk indices and political risk analysis to identify and assess potential problems. While these assessments do draw attention to some areas related to conflict, they fall far short of the systematic two-way conflict risk and impact assessments necessary to pinpoint conflict risks and design suitable conflict mitigation strategies for projects.

5.1 Environmental and Social Impact Assessments (ESIAs)

Environmental Impact Assessments are frequently required under law by host governments and as a pre-condition for certain project lending by the majority of commercial and multilateral financial institutions. Social Impact Assessments (SIAs) are also increasingly required by lenders in order to identify potential social risks and opportunities, and particularly for projects in developing countries.

While the ultimate objective of an EIA may be to maximise the positive impact of a development project on environmental sustainability, the practical application of EIAs is normally limited to preventing or minimising a large project's adverse effects (UNEP 2002: 105). Even though EIA methodologies are well developed, particularly in comparison with nascent SIA techniques, they are widely criticised. Common concerns about the effectiveness of EIAs include: flawed engagement processes with stakeholders, as a result of unequal power, expertise and resources; inadequate consideration of cumulative effects and other factors, such as social and health impacts and risks; and a failure to consider indirect effects on systems and communities outside of project 'space frame' (Goldwyn and Switzer 2004; International Association for Impact Assessment 1998).

In contrast to EIAs, SIAs remain under-developed and varied in approach, generally consisting of some combination of scoping studies, baseline data generation, impact prediction, evaluation of significant issues, and recommended mitigation strategies. As is the case with EIAs, the influence of SIAs on project design and operation management plans is dependent on the level of commitment and obligations on the part of project sponsors to taking findings into account. While

the results of an SIA may be used to inform resettlement and compensation plans, it is unlikely that assessment outcomes will influence wider project management strategies.

While SIAs may highlight conflict-related issues such as resettlement and compensation, this often falls far short of what is required under conflict-impact risk assessments (Goldwyn and Switzer 2004). In both EIAs and SIAs, perceptions of causality and risk are weak. These assessments tend to rely on simple models of 'cause and effect' and 'impact and mitigation' which are frequently inadequate to deal with the complexities of project-induced social change, particularly in conflict areas. The process by which they are conducted is a further constraint on their ability to understand conflict – which requires meaningful stakeholder consultation and mapping in order to understand different groups' perceptions and interests accurately. They may obscure the complexity of a situation, and interlinkages between variables (De Zeeuw 2002: 13). Furthermore, as ESIAs are public documents, they are less likely to contain conflict-risk related data (such as the human rights records of state security forces) that may put sponsors at risk of political recriminations.

The weaknesses of ESIAs in relation to systematically identifying conflict-risks and providing guidance on conflict risk mitigation are amplified by widespread failures of financial institutions to take social and environmental risks seriously. There has been growing public scrutiny since the 1990s of the negative role played by some ECAs with regard to environmental degradation, human rights abuses and conflict abroad, and there are numerous case examples of ECA-backed projects that have had negative social and environmental impacts.¹⁰

Social impact issues are slowly gaining attention within OECD-based ECAs: some OECD ECAs now consider social risks as part of screening processes, and some have incorporated select issues with human rights implications into their policies and EIA procedures, such as resettlement.¹¹ Overall, critics see the steps that have been taken as weak and unsatisfactory.

Less tied to immediate national interest in terms of investment promotion, MDBs have proved themselves more progressive in setting standards relating to managing the 'footprint' of projects. The IFC Safeguard Policies were created to address social and environmental risks in co-financed development projects in high-risk settings, and have become internationally-recognised benchmarks echoed both in the Equator Principles adopted by over 30 banks and one ECA, as well as the OECD Common Approaches for ECAs. There are signs that these benchmarks are themselves gradually shifting to include recognition of conflict risk and human rights issues. For instance, IFC's new draft Performance Standards now contain guidance on the use of security personnel at project sites – an indication that violent conflict is an issue that should be taken seriously by lenders and sponsors alike (see box 5 and Annex 2).

Box 4: IFC's environmental and social standards

At the time of writing, the IFC Safeguard framework was in the final stages of an extensive review, which in turn has prompted reviews of the Equator Principles and the OECD Common Approaches.¹² The review has resulted in renaming the standards as IFC's 'Policy and Performance Standards on Social and Environmental Sustainability.' The aim of the revised set of policies is to further IFC's commitment to sustainable private sector development in developing countries and reducing poverty – in a manner that 'does no harm' to people or the environment.

¹⁰ In 2000, over 300 NGOs signed the Jakarta Declaration for ECA reform, which included calls for greater transparency, binding common environmental and social guidelines for finance, the adoption of explicit human rights criteria, guidelines on corruption, the cessation of investments into military exports, and the cancellation of ECA debt for poor countries. See www.eca-watch.org/goals/jakartadec.html

¹¹ For example, following a 2005 revision of export credit legislation, Switzerland's ERG is explicitly mandated to 'respect and realise' Swiss policy on foreign aid and sustainable development - including policies related to human rights and conflict. However, the ERG does not yet have a mechanism for assessing conflict impacts of transactions, or mitigating them where they are likely.

¹² In June 2003, the Equator Principles were launched by ten leading commercial banks to support sustainable project finance. The Equator Principles are voluntary guidelines drafted by four banks (ABN Amro, Barclays, Citigroup and West LB) based on the World Bank and IFC's safeguard policies and apply to loans for projects with a capital cost of US\$50 million or more. See www.equatorprinciples.org.

Under the current draft, IFC clients will be required to meet eight Performance Standards that cover issues including social and environment assessment and management, community health and safety, and land acquisition and involuntary resettlement (IFC 22 September 2005). The Performance Standards are to be read in conjunction with a set of Guidance Notes designed to provide more detailed information on the Performance Standards. It is worth noting that IFC is given considerably more discretion on the implementation of the new Standards in comparison with the implantation of the former Safeguard Policies, and the Guidance Notes are not enforceable.

While falling far short of providing comprehensive guidance on understanding and managing risk related to violent conflict, the latest draft Performance Standards do include guidance on the use of security personnel at the project level – indicating IFC's recognition of the need to address conflict risk at the project level (see Annex 2). Guidance Note 4 builds on this and advises that where there is social unrest or conflict in a project's area of influence: *the client should understand not only the risks posed to its operations and personnel but also whether its operations could create or exacerbate conflict and what measures it can take to avoid or mitigate adverse impacts on the situation and contribute to long-term stability* (IFC 22 September 2005).

5.2 Country risk ratings

Measuring exposure to risk at the country-level in volatile emerging market economies has become a critical task for international investors looking for business opportunities (Linder and Santiso 2002: 2). Frequently, banks rely on country-risk analysis conducted by service providers such as Fitch Ratings, the Economist Intelligence Unit¹³, the Business Environment Risk Intelligence (BERI), Institutional Investor, or Moody's Investor Services. Economic, political, financial and social factors are examined; and risks associated with violent conflict may be further highlighted by political risk analysis (see section 5.3 below). Banks also generate internal country-level risk numeric indicators which condense the results of internal analysis of (generally retrospective numerical) data on a range market and non-market risks.

While country-level risk ratings are a useful guide to gauging levels of market risk, it is recognised that they are not specific about the nature of political risks that face a particular investment or project (Linder and Santiso 2002: 7). For instance, the *International Country Risk Guide* (ICRG) database of the Political Risks Service (PRS) Group's political risk model includes numeric indicators of government stability, external and internal conflicts, corruption, socioeconomic conditions, ethnic tensions, and the influence of the military on politics. While these may be a useful broad indicator for looking at the potential for conflict in a specific country, it will not provide the specific qualitative information necessary to understand the 'two-way' dynamics between macro-level social, economic and political conditions and a particular project. Nor will country-level risk indicators necessarily reflect the level of conflict risk at the project level.

5.3 Political risk analysis (PRA)

Political risk is the 'threat that politics or political players will have a negative impact on a firm's asset values, costs, or revenues' (Wilkin in Elgar 2002: 5). Project sponsors seeking to develop projects in emerging markets will frequently commission or conduct political risk analysis to pinpoint likely sources of threats, opportunities and risk management strategies. These risks are commonly understood to include cronyism, organized crime and fraud, unfair competition, corruption and poor legal standards. Unlike some ESIA's, the results of political risk analysis are usually confidential.

Traditional political risk measures relied on either macroeconomic accounting indicators or investor perceptions of risk (Elgar 2002: 8-9). In the wake of the 1997-98 East Asian and more recent Argentinean financial crises, these methods have been under review. A major problem with traditional quantitative political risk methodologies is over-reliance on retrospective data which may reflect speculative trends and therefore be unable to account for other or new sources

¹³ The EIU's Country Risk Services (CRS) provides ratings for seven categories of risk, including political risk. The political risk category is divided into two components: political stability (which examines whether the political scene is free of internal or external threats to security); and political effectiveness (which assesses the quality of governance).

of risk in a country (Elgar 2002). And, social relationships are complex, and cannot necessarily be modelled in the same way as more technical considerations (Goldwyn and Switzer 2004).

Public financial institutions such as ECAs combine political risk assessment with qualitative country-level risk analysis as part of due diligence. As public entities, ECAs benefit from access to the services and information of foreign policy, trade, industry and international development agencies within their national governments. For instance, Canada's EDC project due diligence risk assessment includes consideration of socio-economic inequality, government attitude to foreign investment, government interference in transactions, levels of corruption, regime stability and the existence of democratic institutions (Hussels and Switzer 2004: 22; Doyle/EDC 2004). Political risks such as the potential for political violence, currency transfer and expropriation are also considered. This is then combined with project-level risk analysis to determine the level of risk facing a particular project. The higher the risk, the less likely the project will receive support (NGO Working Group on EDC 2004: 10). While this approach can highlight possible causal factors that may lead to conflict, assessment falls short of considering 'two-way' conflict-project interactions that may highlight how project actions may adversely impact upon the context in a particular project is developed and operated.

Sponsors, as well as some commercial financial institutions, also may contract specialist political risk consultants to conduct qualitative political risk assessments for projects. These consultants employ a variety of methods to determine the level of political risk facing a project, including assessing the drivers and constraints to conflict-related events, as well as stakeholder mapping, scenario planning and horizon scanning. However, despite advances made by some specialist political risk consultancies, including the ability to highlight conflict risk issues facing a particular project, the approach suffers from the following limitations:

- PRA provided by specialist political risk consultants tends not to be linked to project cash flows, and as such tends to be treated as a separate activity rather than being integrated into the wider risk assessment process conducted during project finance transactions;
- There is often a failure to link the results of PRA to the prevention or mitigation strategies elaborated in the SIA;
- Conflict-prone environments are unstable and can change rapidly, while PRA, often contracted out and conducted at a particular moment of project history, may fail to ensure continual monitoring and revision throughout the project cycle;
- PRA is generally relied on as a measurement tool to determine levels of risk – not a management tool to actively reduce that risk; and
- Stakeholder perceptions of risk may differ significantly from those gleaned from official sources, and yet perceptions do not tend to be particularly valued through PRA (Goldwyn and Switzer 2004).

6. Conflict risk mitigation: current practice

In order to mitigate the range of risks facing projects in risky emerging markets, financial institutions have access to a variety of mitigation strategies, including insisting on substantial commitments from sponsors in the form of equity to ensure the project is adequately covered. The very use of project finance itself is a risk mitigation tool as it allows risks to be shared amongst the numerous parties to a transaction. However, in general, 'softer' non-commercial risks such as environmental and social risks are usually considered mitigated through ESIA's and the inclusion of covenants in lending agreements that require adherence to environmental management plans. Political risks are, in turn, generally mitigated by transferring the risk to insurers. This section examines whether these and other non-commercial risk mitigation strategies are adequate to deal with conflict risk.

6.1 Political risk insurance (PRI)

Sponsors and lenders will often transfer political risk to insurers, this being set down by banks as a pre-requisite for lending and the provision of credit guarantees by ECAs. Political risk insurance

(PRI) traditionally provides investments with cover for expropriation, currency inconvertibility or non-transfer and political violence (covering physical damage to an asset as a result of politically motivated strikes, riots, civil commotion, terrorism, sabotage, war, and/or civil war). In addition, coverage for business interruption may be available for net profit lost, and compensates for defaults caused by political violence (Wagner 2000).

While PRI cover may at first glance appear to cover costs that may arise from conflict risk, the extent of this is limited. PRI premiums are high, coverage capacity in the insurance market is limited, and cover provided is generally bound to restrictive terms and conditions (Swiss Re 1999). This being so, it is in the interests of project sponsors, lenders and insurance providers to align insurance with improved conflict-risk mitigation and management practices at project level.

Second, ECAs and private insurers that offer PRI will typically cover specified events and reasons for project losses rather than offering a comprehensive policy. Unforeseen problems can therefore leave project developers and financiers exposed to losses (Red Listed.com 2002: 2). Further, political risk insurance or hedging instruments are available only for limited terms, and rarely reach beyond the replacement value of assets to encompass cash flows (Henisz and Zelner in Moran 2004: 164).

Third, PRI does not cover many of the sub-state risks that projects in conflict-prone areas are likely to face. PRI tends to focus on primarily covering political risks that emanate from national governments (such as currency inconvertibility) and as such can overlook conflict risks faced by projects that may emerge from the structural and proximate causes of conflict outlined above, such as poor governance and corruption, or ethno-nationalist tensions.

Fourth, from a conflict-risk prevention perspective, PRI is problematic: the provision of PRI may create a moral hazard whereby the provision of PRI itself may result in sponsors not having an incentive to take steps necessary to avoid exacerbating conflict in the project's sphere of influence. That is, the presence of PRI may perversely promote a lack of consideration of potential conflict impacts of the two-way relationship between a project and the surrounding conflict context. In this vein, PRI provider MIGA has been criticised for failing to consider the interconnections between different components of political risk, and assessing whether a client's business activities will aggravate these risks:

'[Civil] unrest or violent protest may in extreme cases manifest itself in attacks on project personnel or acts of sabotage. Alternatively,... [it can] trigger abuses of the rights of project affected people. Such events can have profound impacts on the communities in the vicinity of projects and on the reputation of a project operator, with potential ripple effects for the providers of finance or insurance. This also holds true for environmental hazards or incidents, which can cause environmental, reputational and financial damages' (CAO 2002: 15).

Recently, MIGA's support of a mining project in conflict-ridden Democratic Republic of Congo (DRC) has exposed the weaknesses in its approach (see box 6).

Box 5: PRI in Democratic Republic of Congo

Like IFC, the Multilateral Investment Guarantee Agency (MIGA) is part of the private sector arm of the World Bank Group and promotes private foreign direct investment into developing and emerging markets through the provision of insurance, guarantees and technical assistance services to the private sector. Through these services and products, MIGA seeks to attract foreign direct investment to developing and post-conflict countries to speed up recovery and reconstruction. Post-conflict support makes up approximately 13% of MIGA's portfolio, and between 1988 and 2003 it issued 56 guarantees worth \$1.5 billion for investments in 16 conflict-affected countries. For the year ending 30 June 2005, MIGA supported 12 projects in conflict-affected countries, including its first project in the Democratic Republic of Congo (DRC) (MIGA 2005).

The southern province of Katanga in the DRC has some of the world's largest deposits of copper, cobalt and silver. While Katanga is comparatively more stable than parts of Eastern DRC, it is still politically volatile. In

recent years, militia groups including Mai-Mai rebels have become increasingly active, especially in northern Katanga. Despite the controversy surrounding the links between extractive industries and conflict and corruption in DRC, numerous mining companies believe that potential lucrative rewards outweigh the risks of operating in this resource-rich yet unstable country.

In 2002, the Australian-owned, Toronto-listed mining company Anvil Mining secured funding and began a three stage programme to develop the Dikulushi copper and silver mine situated in north-eastern Katanga.¹⁴ According to Shares Magazine, Dikulushi was developed without the benefit of a bankable feasibility study. This unusual step was taken because the deposit was so rich and no-one knew how long the DRC's favorable political climate would last (Lawrence quoting Shares Magazine 2003).

Anvil was provided a \$4.5 million project finance loan facility by RMB Resources Ltd, part of the Rand Merchant Bank of South Africa, with the balance of the remaining development costs paid for by Anvil's own funds. Stage I of development was completed in 2002, with Stage II being completed in September 2004. At the time of writing, Anvil plans to carry out further Stage III developments.

On 15 October, a rebel group called the *Mouvement Revolutionaire pour la libération du Katanga* (MRLK) seized control of the town of Kilwa, roughly 30 kilometers south of Dikulushi. The leader of the group aimed to proclaim the independence of Katanga, and knew that he could manipulate some of the frustrations within the local community with regard to Anvil Mining's activities in the town. Anvil was accused by certain sectors of the population of hiring 'non-natives' and of not contributing sufficiently to improving the living standards of the local community. In response the heightened security risk, Anvil evacuated non-essential personnel from Dikulushi. Shortly afterward, the Congolese Armed Forces (FARDC) moved in to quell the uprising. The army was reported to have killed around 100 people, as well as torturing civilians, looting possessions and carrying out illegal detentions (MONUC 2005).

In June 2005, an Australian documentary television programme was aired suggesting Anvil's complicity in the 15 October incident. It alleged that Anvil airplanes were used to fly in FARDC soldiers from Lumumbashi (Katanga's capital city). Claims were also made that Anvil provided vehicles to assist the army's assault on the town, and to transport those arbitrarily arrested as well as corpses and looted goods.¹⁵ Anvil confirmed that it supplied vehicles, but denied that they were used to transport corpses or looted goods (MONUC 2005). NGOs such as the UK-based NGO Rights and Accountability in Development (RAID) have urged the Australian Federal Police to investigate the incident (RAID 2005).

In May 2005, some seven months *after* the killings and Anvil's provision of logistical support to the FARDC, MIGA approved a \$13.3 million political risk guarantee for the Dikulushi mine, covering transfer restriction, expropriation, breach of contract, war and civil disturbance. This guarantee covered both equity investment from Anvil Mining as well as loans from Rand Merchant Bank. Half of the MIGA guarantee featured cover from insurance groups Beazley and Chubb. (The cover replaced political risk insurance previously supplied by two private underwriters). According to MIGA, the underwriting process took over two years to complete and entailed extensive due diligence. MIGA also indicated that it received representations from Anvil that it would adhere to the Voluntary Principles on Human Rights and Security as part of efforts to mitigate risks associated with operating in a conflict-prone country. Anvil informed MIGA that this was being discussed at board level, and that the company was looking at incorporating the Principles as part of wider protocols with the assistance of a North American NGO (Valahu (MIGA) 2005).

This example seriously calls into question whether MIGA has adequate due diligence and monitoring systems in place to appraise the support of a project in a conflict-prone country (RAID 2005). It seems that MIGA failed to fully consider the two-way interactions between Anvil's business activities and security and political context in which it was operating, with grievous results. At the time of writing, an audit by the CAO of the incident had been completed and publication of its report was pending.

Similarly, the provision of PRI has been criticised by NGOs for benefiting only the project companies who may suffer losses as a result of political events, and not the host communities

¹⁴ Anvil retains a number of other mining interests elsewhere in Katanga province at Mutoshi and Kinsevere as well as outside the DRC in Zambia, Vietnam and Australia.

¹⁵ In response, in a statement issued on 7 July 2005, Anvil stated: "The DRC military requested access to Anvil's air services and vehicles, to facilitate troop movements in response to the rebel activity. Anvil had no option but to agree to the request, made by the military of the lawful Government of DRC, as any other company would have done in similar circumstances. Anvil had no knowledge of what was planned for the military operation, and was not involved in the military operation in any way." See www.anvil.com.au.

which may also be adversely affected, potentially as a result of conflict exacerbated by the project itself. As PRI may be seen purely as a tool to protect a project's creditors, PRI providers are also criticised for failing to encourage project sponsors to adhere to basic social and environmental safeguards (Moody 2005: 7).

6.2 Covenants and warranties

Non-commercial risks (including environmental and social risks) may be mitigated through the inclusion of covenants and warranties into credit and insurance agreements requiring the project company to ensure risks are managed appropriately at the project level. These may include requirements that environmental management plans and community support mechanisms be implemented. Limited information is in the public arena on the type of covenants and warranties used by financial institutions (F&C and KPMG 2004: 19). In particular, because of the confidential and deal-specific nature of commercial agreements, it is unclear how effective such warranties are in ensuring sponsor compliance with international best practice in environmental and social risk management.

Furthermore, it should be noted that even in cases where compliance with best practice on social risks is included as a lending requirement, this will not necessarily be sufficient to ensure *conflict* risk is adequately mitigated by the project sponsor. This is partly a consequence of the lack of systematic assessment of conflict risks in ESIA methodologies.

Monitoring and compliance are important issues to consider in the context of covenants and warranties. While project lenders will employ independent consultants to conduct compliance-oriented due diligence tests of the project prior to releasing funds to the project, they may lack the capacity or willingness to monitor compliance with covenants throughout the life of a project effectively. Nor do financial institutions routinely determine whether project sponsors also have the capacity to comply with conditions and warranties. For instance, the Environmental and Social Review Procedures (ESRP) followed by MIGA require the institution's clients to provide warranties and assurances that environmental and social issues will be managed effectively. However, as pointed out by the CAO's 2002 report *Insuring Responsible Investments?*, MIGA does not systematically assess client capacity to adhere to such warranties.

6.3 'Political umbrellas'

The involvement of IFC or any other MDB in a project is important for sponsors looking for the multinational 'stamp of approval', and the political risk mitigation influence that the involvement of a multilateral financial institution such as the World Bank is perceived to bring. The 'political umbrella' concept posits that host governments will be far less likely to take certain actions – e.g. expropriate foreign investor assets, exacerbate violent conflicts and riots that would disrupt foreign business – given the power of an MDB over a developing country's macroeconomic affairs, and the involvement of influential governments in the MDB.

However, this perception needs to be balanced with consideration of the ability of MDBs to work adequately with sponsors to assess and mitigate conflict risk. While MDBs have considerable influence in developing countries, and the majority of MDBs do consider a range of social, environmental and political issues as a part of due diligence, none have adopted a coherent framework to analyse conflict risk. For instance, the project sponsors of the Chad-Cameroon pipeline actively sought the involvement of IFC and other MDBs to mitigate the high political risks of developing the project through two underdeveloped, conflict-prone countries. While MDB involvement and an extensive environmental impact assessment may have lowered the risks facing the pipeline, as there was no comprehensive conflict risk impact assessment conducted, it is perhaps not surprising that the risk of violent conflict adversely affecting the project remains an ongoing concern (Amnesty International 2005; Gary and Reisch 2005).

The 'political umbrella' offered by MDBs through their syndication programmes is meant to encourage private sector involvement in riskier markets, but is no guarantee that projects covered by the umbrella will be conflict-risk free. Without MDBs themselves ensuring that conflict risk is

adequately assessed and mitigated, investors, creditors and insurers themselves may not be protected by the umbrella. Only when MDBs finance projects that provide conflict-sensitive, sustainable contributions in riskier markets, in line with commitments to promoting peaceful markets, will the political protection offered by the presence of a multilateral agency be assured.¹⁶

7. Elements of a conflict-sensitive approach to project finance

This paper has set out a range of arguments to encourage project financiers and insurers to lower their exposure to conflict risk through adopting a 'conflict-sensitive' approach to project finance. Conceptually, this requires putting a greater emphasis on assessing conflict risk by including a 'two-way' perspective, and developing mitigation strategies that ensure that projects 'do no harm' and contribute to peacebuilding.

What might such an approach look like in practice? How can project financiers help ensure projects in conflict-prone countries will 'do no harm' and potentially contribute to peaceful, sustainable development? The paper will now set out potential areas for action on the part of financial institutions, which could be taken with a view to improving the management of conflict risk and the overall impact of projects on global stability and prosperity.

7.1 Enhanced due diligence

As a first essential step, improved practice regarding conflict risk requires project financiers to include conflict risk and impact assessment as part of standard due diligence procedures. By assessing the two-way relationship between a project and the context in which it is developed, project financiers will be in a better position to understand the nature of conflict risk that may affect a project – with far greater sophistication than is currently standard practice. Conflict risk analysis from this two-way perspective will also enable financiers to identify particular weaknesses and strengths in a project's design and management strategy, which in turn will allow more informed risk mitigation strategy dialogue with a project sponsor.

Due diligence may be enhanced in several ways. This paper does not attempt to provide a complete tool but offers early ideas based on the development of conflict risk and impact assessment tools for the extractive industries already undertaken by Alert. This envisages project sponsors in the extractive industry undertaking a three-tier process of conflict risk and impact assessment: initial screening, macro-level and project-level, which identifies conflict issues *and* promotes understanding of the two-way interaction between these and the project.¹⁷ The methodology is designed to accompany the entire lifecycle of a project, being constantly updated to reflect a dynamic external context and internal project development. It is also important to note that at their core the Alert tools involve participatory analysis to draw on the perspectives of those living in affected areas to provide richer analysis of context. As such, the assessment involves developing strong stakeholder relationships in order to ensure that decision-making processes of the project sponsor are shared with stakeholders. This in itself is a conflict risk mitigation strategy, as shared decision-making invites transparency and trust, fosters legitimacy and relieves tensions. While the in-depth and dynamic approach may not suit the needs of project financiers, it seems logical to assume that aspects can usefully be built into due diligence procedures in order to give a fuller picture of this dimension of risk.¹⁸

¹⁶ For commitment to mainstreaming conflict prevention see: Canada's DFAIT Human Security Programme; Germany's 'Comprehensive Concept of the Federal Government on Civilian Crisis Prevention, Conflict Resolution and Post-Conflict Peacebuilding' (2000); Sweden's 'Preventing Violent Conflict: Swedish Policy for the 21st Century' (2001); UK DFID's 'Eliminating World Poverty – Making Globalisation Work for the Poor' (2000); the EU's 'Programme for the Prevention of Violent Conflicts' (2001); the World Bank's 'Operational Policy 2.30 Development Co-operation and Conflict' (2001); and the UN Secretary-General's 'Report on the Prevention of Armed Conflict' (2001).

¹⁷ Together with Engineers Against Poverty, Alert is in the process of adapting this approach to the engineering sector, leading to publication in 2006/7.

¹⁸ Adaptation of this methodology into a practical guide of project financiers is one possible outcome of Alert's current work in this area.

Lenders and insurers should thus conduct an initial conflict risk screening process at an early stage that can help identify key conflict risk issues facing a particular project. Sample screening questions can focus on identifying any potential correlates of conflict that exist at the local, national or regional levels (see box 7).

Box 6: Sample screening questions

- (1) *Governance issues:*
- Is the country an autocracy or democracy?
 - If the country a 'democracy,' has there been any violence been associated with election or political party activities or problems related to the credibility of election results in the last five years?
 - Where is the country ranked on corruption indexes?
 - Has there been political instability in the past three years?
 - Has the government been accused of involvement in major human rights abuses in the past 12 months? Does the country prevent freedom of expression?
- (2) *Economic issues:*
- Has there been a recent economic crisis or decline?
 - What is the country's ranking on the Human Poverty Index?
 - Is one identifiable group (e.g. ethnic, cultural) at a serious economic disadvantage over another?
- (3) *Socio-cultural issues:*
- How large is the country's population and growth rate, and is there a significant urban/rural divide?
 - Are there different ethno-nationalist groups spread unevenly in different regions?
 - Have large populations relocated to or within the country or region due to violence?
- (4) *Security issues:*
- Is annual government military expenditure high as a percentage of GDP?
 - Does the government have difficulty in controlling state security forces, including military, police, intelligence and militia groups, or the activities of private security companies?
 - Are state opposition groups armed?
 - Has there been a history of violent conflict, and is there currently violence in the country?
 - Are there any incidences of group violence in a neighbouring country?

This could then be followed by a more comprehensive conflict risk and impact assessment focused at both the project and macro levels, which may be combined with existing environmental and social impact assessments in order to coordinate and streamline assessment processes. Alert's methodology seeks to overcome some of the shortfalls in approach and implementation of standards ESIA methodologies, integrating a more thorough understanding of the nature of violent conflict throughout. In addition to assessing the conflict impact on the operation (including the ability to import required inputs, to export product etc.), the assessment would also identify potential remedies to problems.

Adoption of enhanced due diligence assessments of the conflict risk faced by projects in unstable countries should of interest to both commercial and public sector lenders as greater knowledge about the types of risk facing a project may provide opportunities for a lowering of the risk/reward trade-off institutions must make when deciding to invest in a project.

As conflict risk and impact assessment entails examining the social, political and economic context in which a project will be developed, this will include consideration of human rights issues – especially given that the worst forms of human rights abuses are more often than not a feature of contemporary conflict. In order to fully appreciate human rights dimensions of projects, specialist human rights assessment tools are currently being developed (see box below).

Box 7: Human rights compliance and impact assessment tools

A rise in the awareness of links between businesses and human rights obligations has led to a demand for practical guidance for companies, governments, and local communities that will assist their understanding of the links between investments and human rights. As such, there are a number of human rights-focused

assessment tools currently available and under development by civil society and research institutions.

- *Danish Institute for Human Rights*¹⁹ - *Human Rights Compliance Assessment (HRCA) tool*: The HRCA is an on-line diagnostic tool designed to promote better corporate performance by companies by helping them to detect potential human rights violations caused by the effect of their operations on employees, local residents and all other stakeholders. The tool aims to provide companies with useful information about how to deal with human rights issues relevant for their particular operations, and runs on a database containing over 350 questions and 1000 corresponding human rights indicators, developed from the Universal Declaration of Human Rights, the 1966 Dual Covenants and over 80 other major human rights treaties and conventions.

The HRCA web-based interface allows each company to select questions in the database to suit their type of business and area of operations. When a questionnaire is complete, the computer programme generates a final report identifying areas of compliance and non-compliance in the company's operations. Numeric scores are included in the report to help the company report, improve and track its performance from year to year. The standards and indicators in the database are updated on an annual basis, based on feedback from both company users and human rights groups. This ensures that the tool continuously addresses the real life problems faced by companies and reflects the changes and developments in international human rights law.

- *Rights & Democracy*²⁰ - *Human Rights Impact Assessment (HRIA) tool*: the Canada-based organisation Rights & Democracy is developing a human rights impact assessment for use by both policy makers and communities to increase corporate accountability and ensure that investment and project financing do not undermine international human rights laws and norms. The draft tool, currently being tested on five projects is composed of a number of human rights indicators in the form of questions that will enable communities to document an investment project's positive or negative impact on human rights. The tool is based on the UN Norms for Business and includes civil, political, social, economic and cultural rights.

Rights & Democracy advocates that both host government and states involved in financing investments through export credit agencies and multilateral development banks should require HRIAs. A human rights impact assessment should be a requirement if a company is to benefit from the investor protections offered under bilateral or multilateral investment treaties. Rights & Democracy sees the essential goal of a human rights impact assessment as ensuring that risks and violations of human rights are minimized and positive rights outcomes are maximized. This tool will be refined during 2006 and will be published in 2007.

- *International Business Leaders Forum (IBLF)*²¹ – *Human Rights Impact Assessment tool*: UK-based IBLF is currently coordinating the development of a human rights impact assessment guide for operational managers of companies on the process of implementing human rights impacts within their commercial projects. This will aim to link into other social and environmental impact assessment processes that companies are developing and using. The guide will be designed to identify the practical impact of human rights challenges throughout the lifetime of a commercial project. It should therefore assist in the management of risks and provide a framework for monitoring and responding to evolving human rights issues. It is anticipated that the guide will be ready for testing and further consultation in the spring of 2006 and for final completion by the end of 2006.

- In addition, the Business Leaders Initiative on Human Rights (BLIHR)²² have developed a *Human Rights Matrix* which sets out minimum expected and desirable company practice for fulfilling the obligations set out in the UN Norms. This is supporting BLIHR companies efforts to road test the Norms during 2003 – 6.

These tools are complimentary in that they focus on different needs and audiences. The Danish Institute for Human Rights HRCA and the IBLF tools, as well as the BLIHR matrix, are designed for companies: the IBLF tool provides guidance on the process needed to carry out a human right impact assessment before companies start operations, while the HRCA focuses on the substance of human rights compliance of ongoing company operations. Similarly, the Rights & Democracy Tool covers both procedural and substantive aspects of the HRIA but from a different perspective – the perspective of communities rather than companies. All tools emphasize states' obligations to respect, protect and fulfil human rights including in their policies related to investment.

These human rights-focused tools compliment Alert's own *Conflict-Sensitive Business Practice: Guidance for Extractive Industries* tool. *CSBP Guidance* allows companies to better understand the two-way impacts of their business activities on the macro and project-level conflict context in which they operate. Examination

¹⁹ <http://www.humanrightsbusiness.org/>

²⁰ www.dd-rd.ca

²¹ www.iblf.org

²² www.blihr.org

of the human rights setting of a particular country is incorporated as part of assessing this conflict context in *CSBP Guidance*. In addition to this, however, it is advisable for companies also develop a full understanding of the human rights impacts of business activities, and to measure their compliance with human rights standards. This is where the above-mentioned tools can be used to compliment conflict risk impact assessments.

Enhanced due diligence procedure on the part both of banks and insurers could also include consideration of the project sponsor(s) track record in managing conflict risk. This would entail extending routine consideration of a project sponsor's past performance on social and environmental issues to include consideration of whether the sponsor has been involved in projects located in conflict-prone countries, and how it dealt with security and human rights issues. A financial institution may also enquire into the project sponsors' policies on corruption, business ethics, environmental issues, and project security (Henisz and Zelner in Moran 2004: 154).

7.2 'No-go' criteria

In some countries, the probability of conflict risk affecting a particular project may be so high that from the conflict-sensitive perspective it would be unwise for an investment to proceed. Due diligence screening should alert project financiers and insurers to this possibility. Wherever a project is located in an area where egregious human rights abuses are currently, or have been, committed in the recent past, financiers should seriously consider not investing in that project. This is because experience shows that a large-scale investment occurring in a context where such abuses are being committed is unlikely to escape involvement in the local power struggle around which abuses are occurring, whether through security forces, payment to armed groups, use of company infrastructure and hardware for political ends on the part of conflict actors, etc.

At the same time, such proximity to egregious human rights abuses has associated legal risks that project financier and sponsors should consider. A number of national jurisdictions permit criminal or civil prosecutions of business entities on certain grave breaches of international law (International Peace Academy/Fafo AIS 2004). In the past, individual officers and managers of business entities have been held accountable in civil or criminal courts for violations of international criminal law, including genocide, crimes against humanity and war crimes. Such cases have most recently stood in US courts under the Alien Torts Claims Act and often relate to subsidiaries or joint venture partners.

Most recently a Dutch businessman was found guilty of complicity in war crimes over a 1988 chemical attack that killed more than 5,000 people after supplying chemical weapons to Saddam Hussein (BBC 2005). The doctrine of complicity has developed to address the way in which companies are unlikely to be the direct perpetrators of crimes, but rather accomplices to (or 'aiding and abetting') the violence through their relationship with state or non-state armed groups. The most frequent violations of international humanitarian and criminal law in which companies can be found complicit are: use of forced labour/enslavement, pillage and plunder, the deployment of child soldiers, and the use land mines (International Peace Academy/Fafo AIS 2004).

7.3 Encouraging better conflict risk management by project sponsors

If conflict risks and potential impacts are comprehensively assessed during due diligence, the logical next step is to identify and implement conflict risk mitigation measures. One option is for lenders to work with sponsors to ensure projects are developed and operated in a conflict-sensitive manner. This may lead to the incorporation of warranties and covenants in loan agreements. For instance, an agreement may include a warranty that the project sponsor(s) has conducted a project-level risk assessment, as well as with covenants requiring that the sponsor comply with conflict-sensitive business practices (for instance, by demonstrating adherence to the Voluntary Principles on Human Rights and Security – see Annex 3).

One challenge for including such warranties or covenants will be the need for lenders to monitor and assess compliance with those terms. As is the case with warranties and covenants stipulating actions to be completed in respect of environmental management plans, monitoring compliance requires focused attention for it to be meaningful and effective as a response to the risks identified.

A further challenge will be the degree of leverage a financial institution will have in terms of requiring a sponsor to undertake a series of actions to avoid negative conflict risks or impacts. Leverage will depend on the type of financial product offered (loan, guarantee or security underwriting), as well how the institution is situated within the financing structure, and at what stage in the project cycle the institution becomes involved.

Whereas lenders may have a degree of leverage to encourage the uptake of conflict-sensitive approaches during the financing stages of a transaction, political risk insurers also have a degree of leverage both in terms of negotiating terms and conditions of insurance and when deciding to pay out any future insurance claims. In order to reduce the likelihood of a claim after a project is adversely affected by violent conflict, it is in the interests of insurers to work with project sponsors to gain improved awareness of the two-way relationship between their project and the conflict context.

An inherent problem in the use of PRI to mitigate risk is that where as political risk management is an ongoing, active process, insurance cover is usually taken out at the outset of a project (Heinsz and Zelner in Moran 2004: 168). At this stage it is too easy to consider that conflict-risk is 'transferred.' The management of risks associated with developing and operating projects in conflict-prone areas needs to be sustained and fluid in order to adapt to changing social, economic and political realities. Where possible, insurance providers should encourage the uptake of a conflict-sensitive business approach to projects in order to ensure risks are appropriately assessed and managed throughout the life of a project.

One option for political risk insurers may be to include carve-out clauses in contracts that specify particular circumstances where the provider will not pay out a claim after the outbreak of violent conflict, where, for instance, the project sponsor itself was responsible for the increase in violence or failed to adopt conflict risk management strategies. This would cover cases like that of Anvil Mining in DRC, where the insured company is alleged to have provided logistical support to the Congolese military. This may also be a way of alleviating the moral hazard inherent in the provision of PRI: sponsors should be encouraged to take steps to avoid conflict risk rather than potentially exacerbating conflict through failures to adopt conflict-sensitive business practices.

7.4 IFC Performance Standards, Common Approaches, Equator Principles: opportunity to raise standards

The revision of IFC's Performance Standards, along with the upcoming revision of the Common Approaches and Equator Principles, offers an opportunity for financial actors to explore ways of promoting higher standards, as well as encouraging greater harmony of approaches in relation to assessing and mitigating conflict risk.

As discussed in Box 5, the draft IFC Performance Standards do not provide sufficient guidance in relation to sponsors' assessment and mitigation of conflict risk. Alert has recommended that IFC should work more closely with clients to ensure improved understanding of the two-way relationship between investment and conflict, through incorporating the concept of 'conflict-sensitivity' into the new Performance Standards.

IFC has implicitly acknowledged the importance of conflict risk by including guidance on project security arrangements in Performance Standard 4 and offering some explanation of the nature of conflict risk in Guidance Note 4 (see Annex 2). This guidance reflects the general spirit of the Voluntary Principles on Security and Human Rights (VPs) (see Annex 3). However, it should be

noted that Standard 4 falls short of capturing best practice outlined by the VPs in not requiring full risk assessment and consultation with local communities on security arrangements.

The upcoming reviews of both the Equator Principles and the OECD Common Approaches will need to take account of the revised format and content of IFC's standards, especially in relation to the inclusion of reference to security arrangements in Standard 4. Financial institutions and other actors outside the Equator Principle framework which look to IFC for guidance on social and environmental risks will also need to consider the implications of IFC's inclusion of conflict and security issues on their own due diligence practices. IFC in turn must give this issue greater priority in future reviews, particularly as IFC and MIGA projects themselves are some of those which have shown themselves to be least able to understand and manage conflict issues effectively in the recent past.

7.5 Tightening policy coherence

MDBs such as the World Bank (specifically through IFC and MIGA)), as well as regional development banks, such as Asian Development Bank (ADB), offer a variety of financial products associated with project finance. While MDBs and RDBs are accountable to government shareholders, and disburse a large part of their funding to public sector projects, there is an increasing focus on private sector-related activities, reflecting the growing trend among development institutions of looking toward the private sector as a strategic partner for the realisation of development goals.

As discussed in Section 2, violent conflict is more common societies with weak institutions and chronic poverty. Of the 32 countries in the low human development section of the HDI table, 22 have experienced conflict at some point since 1990 and five of these experienced human development reversals over the decade (UNDP 2005: 154). Furthermore, conflict gives rise to chain reactions that perpetuate and extend economic losses: a slowing economy, weak rule of law, corruption and an uncertain security setting represent powerful disincentives for investment (Asiedu 2005; UNDP 2005).

MDBs and RDBs have in recent years begun to develop a role in conflict prevention, peacebuilding and post-conflict reconstruction work. This effort has included the introduction of new analysis tools for use by country desk staff; the option of formulating development projects designed to address the root causes of conflict; as well brokering projects to rebuild infrastructure and institutional capacity in the aftermath of conflict. To date, however, most MDB and RDB conflict-related analysis and work has focused on the public sector and has not been extended to their dealings with the private sector, although some, such as MIGA, are beginning to define a niche as providers of finance in such contexts.

The World Bank Group has come under particular scrutiny for the role IFC and MIGA have played in the support of extractive industry projects linked with social disruption, increased vulnerabilities, social hostility and conflict. The *Extractive Industries Review* (EIR) commissioned by the World Bank in 2003 recommended that WBG institutions (including IFC and MIGA) mainstream human rights into all areas of policy and support project sponsors to adopt human rights policies. The EIR also recommended an end to WBG support for extractive industry investments in countries prone to or affected by violent conflict, given that the overall developmental benefits of such investments in such conditions are far from positive. While this recommendation was not adopted in the WB's management response to the EIR, using conflict-sensitive lending practice - not only for extractive industry but for all private sector projects conflict prone regions - would be one step towards addressing the concerns relating to the relationship between projects and violent conflict that were voiced by stakeholders during the EIR process. Further, adopting a conflict-sensitive approach to project finance would also be in line with internal Bank policy on conflict: Operation Policy 2.30 on Development Cooperation and Conflict offers guidance to Bank activity in conflict-affected countries, recognising the need to promote and protect human security and to understand and work to minimise the causes of conflict.

Given the correlation between poverty and conflict, then, it is in the interests of MDBs and RDBs to consider new ways of encouraging greater private sector investment in developing countries while at the same time working to ensure such investments do not exacerbate conflict. Adopting a conflict-sensitive approach to providing financial products and services in project finance transactions would be a good first step at improving coherence between global poverty reduction goals and the need to augment the number of private sector investments that to 'do no harm.'

If private sector development is key to economic growth and poverty reduction, then other public financial institutions such as ECAs also have a role to play in supporting sustainable, conflict-sensitive projects that further national government's commitments to poverty reduction. Indeed, as ECAs rely on public funds to support private sector investments and exports, there should be an obligation to ensure that ECAs business activities is coherent with other public policy commitments – including development and conflict prevention goals (Harron et al 2005).²³

ECAs sit within governments that themselves are increasingly committed to conflict prevention and peacebuilding as part of development assistance and foreign policy. A coherent national policy approach requires reviewing investment promotion and trade policy from the perspective of security – both national and within the international system. At present however these arms of government tend to sit far from each other culturally and functionally, resulting in agencies such as ECAs having little linkage with wider international policy goals. The fact that some foreign ministries have begun to share country analyses with ECAs as an input to risk analysis is a small but important step in the right direction (MacDonald 2005).

Given the correlation between poor governance and the incidence of violent conflict, addressing corruption in ECA projects would be one way to begin moving agencies towards required levels of policy coherence (Lind and Sturman 2003). ECA-backed projects have been heavily criticised for reinforcing corruption in conflict-prone areas (Hawley 2003 and 2005; ECA Watch 2005; Goldzimer 2002).²⁴ While OECD ECAs have adopted an 'Action Statement on Bribery and Officially Supported Export Credits' (in line with the OECD's 1997 Convention on Combating Bribery of Foreign Public Officials), screening of companies' previous record with regard to bribery is not required by the Action Statement. Some individual ECAs have taken steps to improve transparency and address potential for corruption (for instance, the UK ECGD screening of companies through the World Bank corruption list). However these remain unilateral initiatives, and more needs to be done.

Increased efforts to improve harmony between MDB and other public financial institutions in policies on private sector investment promotion, development assistance and conflict prevention would help create the right environment for project finance to become a factor enabling peaceful and sustainable development in the global world economy.

7.6 Strengthening the regulatory environment

As conflict is a cross-cutting 'context', it is unsurprising that there is no internationally agreed overarching, legal or voluntary instrument on how to conduct business in unstable states in a way that minimises conflict risk. That being so, there are several initiatives underway to close the gap in international frameworks for addressing corporate operations in conflict zones. In relation to the activities of extractive industry actors, instances include the Voluntary Principles on Security and Human Rights, and the Extractive Industry Transparency Initiative (EITI). More broadly, the work of the UN Special Representative on Business and Human Rights over the next two years will focus on conflict and weak governance zones and could lead to useful further guidance and norm-setting. MDBs, ECAs and banks alike could do more to ensure that they actively promote meaningful adherence to these standards by clients, as well as existing standards such as the

²³ Note that this report encourages ECAs do adopt both a 'do no harm' approach to supporting exports as well as 'doing good.' This view has been criticised by ECA Watch, see www.ecawatch.org.

²⁴ Examples include ECA involvement in Indonesia during the corrupt presidency of Suharto, and the Lesotho Highlands Water Project.

OECD Guidelines for Multinational Enterprises, including through monitoring implementation as part of the financial relationship.²⁵

Developments in international financial regulations also point to possible measures to links between conflict and finance. International efforts to combat money laundering, such as the voluntary Wolfsberg Principles or the OCED's Financial Action Task Force 40 Recommendations (FATF 40 Recommendations), may offer some opportunities to promote conflict-sensitive finance practices. The FATF 40 recommendations are a series of 40 guidelines to prevent money laundering and terrorist financing. One set of recommendations focuses on national governments, and outlines ways to criminalize money laundering and terrorist finance (e.g. through confiscation of proceeds or property, national monitoring and analysis, law enforcement and prosecution). The other set of recommendations focuses on financial institutions, and outlines ways banks can perform due diligence on customers, especially in "high risk" categories (e.g. by Knowing Your Customer, monitoring accounts and transactions, record keeping, reporting suspicious transactions, establishing integrity standards, and creating internal enforcement mechanisms).

The FATF's designated "high risk" categories already include precious metals and stones, but should expanded to cover other areas, such as certain oil, forestry and even agribusiness activities, which also can be part of money laundering schemes and exacerbate violent conflict.²⁶

Perhaps the most significant new international banking regulation in the last several years is the new Basel Capital Accord (Basel II), which was developed by a committee of the Bank for International Settlements. Basel II focuses on capital adequacy requirements, this is, how much banks must keep in reserve compared to the volume of loans they extend. Basel II requires banks to analyse (either themselves or by relying others such as credit rating agencies or national ECAs) all their loans for risk, and set aside particular percentages of capital in reserve based on their risk analysis. So for example, banks would have to keep relatively high reserves for a loan to a company with an unproven track record, but keep lower reserves for a loan to well-established and well-managed company with solid business plan. In all likelihood, Basel II will have the effect of requiring banks to keep a significant amount in reserve for loans to countries engulfed in violent conflict. However, the Basel Committee and most commercial banks are probably not as sophisticated in analysing the links violent conflict and risk in corporate lending. Banks should have capital adequacy incentives (either through Basel II or through internal management systems) to bankroll conflict-sensitive business practices, and to analyse conflict risk in corporate and project finance lending.²⁷

Adopting a conflict-sensitive approach to project finance may also enhance the ability of banks to qualify for the Internal Ratings Based ('IRB') approach to capital requirements under the Basel II Framework Agreement. Currently Equator Banks may regard compliance with the Equator Principles as a 'discipline that will improve their internal risk assessment and management procedures and thus contribute to their qualifying for the entry criteria for the IRB' (Forster, Watchman and July 2005). So too, then, over time it may be that improved internal conflict risk assessment in project finance transactions may bolster the ability of a bank to satisfy IRB entry criteria.

²⁵ See OECD, Directorate for Financial and Enterprise Affairs

< http://www.oecd.org/departement/0,2688,en_2649_34889_1_1_1_1_1,00.html>. The OECD Investment Committee is currently developing a *Risk Management Tool for Investors in Weak Governance Zones* drawing on existing OECD instruments including the OECD Guidelines for Multinational Enterprises.

²⁶ The previous two paragraphs are largely based on a presentation of Michelle Chan-Fishel, Friends of the Earth, *The Role of Private Banks in Curbing Illegal Logging*, presented on September 5, 2003 at the Royal Institute of International Affairs in London. On file with Michelle Chan-Fishel (the author of these paragraphs).

²⁷ International Alert thanks Michelle Chan-Fishel of Friends of the Earth for writing the preceding four paragraphs.

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Amnesty International	Halifax Initiative
ABN Amro	HSBC
Asian Development Bank	International Business Leaders Forum
Barclays Bank plc	(IBLF)
BankTrack	International Finance Corporation (IFC)
Citigroup	Jardine Lloyd Thompson
Control Risks Group	KPMG
Corner House	MIGA
Credit Suisse First Boston	Novib
Danish Institute for Human Rights	OECD Export Credit Group
ECA Watch	OPIC
Environmental Defense	Oxfam International
ERM	Standard Chartered
European Bank for Reconstruction and Development (EBRD)	Swiss Re
Export Credit Guarantee Department (ECGD)	Rights & Democracy
Export Development Canada (EDC)	Royal Bank of Scotland
ERG (Switzerland)	Westpac
F & C Asset Management	UBS
Freshfields Bruckhaus Deringer	UNEP-FI
Friends of the Earth	UN Global Compact
	Independent consultants

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Annex 1: Conflict impacts at the project level

Impact Category	Action	Impact	Impacted stakeholders	Possible Secondary impacts	Additional impacted stakeholders	Conflict Risk level/impact on project
Primary & Secondary (Project)	Project land-use.	Resettlement of communities	<ul style="list-style-type: none"> Those living on land required for project. Armed groups. 	<ul style="list-style-type: none"> Relations between relocated & host communities. Influx of cash into subsistence economy. Compensated individuals become targets of extortion. 	Those affected by relocated communities.	<p>High.</p> <p>Potential for tension between sponsor & resettled communities; & within local communities. May lead to financial demands or increased security concerns for sponsor.</p>
	Pollution/environmental damage.	<ul style="list-style-type: none"> Destruction of farmland. Water in rivers/lakes made unfit for use. 	Those living on or from polluted land/rivers.	<ul style="list-style-type: none"> Oil spills. Air pollution. River life affected downstream from project. 	Potentially all communities within locality (& beyond).	<p>High.</p> <p>Failure to mitigate and manage environmental impacts can lead to conflict (e.g., violent protests, sabotage leading to delays or disruptions to operations; reputational damage).</p>
	Security arrangements for project.	<ul style="list-style-type: none"> Recruitment of locals. Influx of state or private security forces. 	<ul style="list-style-type: none"> Those living around/near project. Armed groups. 	<ul style="list-style-type: none"> Fence and walls alienate local communities. Abuse by security personnel. Employment of state security forces increases fear within community. Availability of weapons. 	Towns/villages frequented by security personnel.	<p>High.</p> <p>Disproportionate responses to demonstrations etc can trigger & inflame violence (e.g. further, more violent demonstrations which may disrupt construction; or sabotage). Exposure to potential complicity in human rights abuses.</p>

Impact Category	Action	Impact	Impacted stakeholders	Possible Secondary impacts	Additional impacted stakeholders	Conflict Risk level/impact on project
Indirect (context)	Revenue to government.	Perceived inadequate share of revenue to the locality increases alienation.	<ul style="list-style-type: none"> • Potentially all within locality. • Local government. 	<ul style="list-style-type: none"> • Corruption increases. • Gaps in living standards increased. • Government neglect exacerbates under-development. 	Indirect impacts can be felt more widely than any geographic boundary.	<p>High.</p> <p>Project sponsors blamed for the lack of benefits accruing to local communities. May lead to community demands for improved social service provision; in turn may lead to delays or cost overruns).</p>
	Project dominates local economy	<ul style="list-style-type: none"> • Distortion of traditional economic structure. • Neglect of existing industries/ livelihoods. 	All within locality.	<ul style="list-style-type: none"> • Unemployment. • Competition for employment with company. • Inflation. • Project becomes magnet for people from other regions. 	Neighbouring localities drained of productive labour.	<p>High.</p> <p>Intensified demand for jobs. Competition for employment and in-migration may increase local tensions and demands on sponsor.</p>
	Government dependency on project.	<ul style="list-style-type: none"> • Increased security presence. • Clampdown on dissent. • Greater incentive for government to remain in power. 	All within locality.	<ul style="list-style-type: none"> • Higher levels of human rights abuses. • Restrictions on freedom of speech. • Increase in detentions. • Electoral fraud. 	Country-wide.	<p>High.</p> <p>Sponsors/project associated with increasingly repressive regime. This may feed resentment against sponsor, leading to protests or other violent acts.</p>

Annex 2: IFC draft Performance Standard 4

The following text is contained in IFC's 22 September 2005 draft Performance Standards in *Performance Standard 4 – Community Health and Safety*:

Security Personnel

When the client uses employees or contractors to provide security to safeguard its personnel and property, it will assess risks to those within and outside the project site by its security arrangements. In making such arrangements, the client will be guided by the principles of proportionality and good international practices in terms of hiring, rules of conduct, training, equipping and monitoring of such personnel. The client will make reasonable inquiries to satisfy itself that those providing security are not implicated in past abuses and will ensure that those engaged to provide security are adequately trained in the use of force (and where applicable, firearms) and appropriate conduct towards workers and the local community, and require them to act within the law. The client will not sanction any use of force except when used for preventive and defensive purposes in proportion to the threat. The client will also investigate any credible allegations of unlawful or abusive acts of security personnel, take action (or urge appropriate parties to take action) to prevent recurrence, and report unlawful and abusive acts to public authorities when appropriate. A grievance procedure or mechanism should allow the affected community to express concerns about the security arrangements and acts of security personnel.

If government security personnel are deployed to provide security services for the client, the client will assess risks arising from such use, communicate its intent that the security personnel act in accordance with these requirements, and encourage the relevant public authorities to disclose the security arrangements for the client's facilities to the public, subject to overriding security concerns.

Draft *Guidance Note 4* (22 September 2005) accompanies Performance Standard 4. In relation to security personnel, the Note states:

25. Security arrangements to protect a client's personnel and property will typically depend in large part on security risks in the operating environment, though other factors such as company policy, the need to protect intellectual property or hygiene in production operations, etc. can also influence security decisions. In determining what security arrangements and equipment are necessary, clients should apply the principle of *proportionality*. In many circumstances, a night watchman may be all that is required, together with some basic security awareness training for staff, sign-posting or well-placed lighting and fences. In more complex security environments, the client may have to directly employ further security personnel or engage private security contractors or even work directly with public security forces.

26. It is important for clients to assess and understand the evolving risk environment of their operations, based on useful, reliable and regularly updated information. For clients with small operations in stable settings, a review of the operating environment can be relatively straightforward. For larger operations or those in unstable environments, the review will be more complex and may need to consider political, economic, law enforcement, military and social developments. If there is social unrest or conflict in the project's area of influence, the client should understand not only the risks posed to its operations and personnel but also whether its operations could create or exacerbate conflict and what measures it can take to avoid or mitigate adverse impacts on the situation and contribute to long-term stability. Clients should consider security risks associated with the entire range and all stages of their operational activities, including personnel, products and materials being transported. The assessment should also address negative impacts on workers and the surrounding communities, such as the potential for increased communal tensions due to the presence of security personnel or the risk of theft and circulation of firearms used by security personnel.

27. Community engagement is an important aspect of an appropriate security strategy, as good relations with workers and communities can be the most important guarantee of security. Clients should involve workers and surrounding communities in the security arrangements through implementation of the community engagement process described in Performance Standard 1, subject to overriding safety and security needs.

28. As an important step towards meeting the Performance Standard 4 objective of avoiding or minimizing risks to workers' and local communities' safety and security, clients should ensure the appropriate conduct of security personnel it employs or engages. Security personnel should have clear instructions on the objectives of their work and permissible actions. The level of detail of the instructions will depend on the scope of permitted actions (particularly if security personnel are permitted to use force and in exceptional circumstances, firearms) and the number of personnel. At a minimum, the instructions should be based on local law and professional standards to ensure that security personnel act within the law. If security personnel are permitted to use force, instructions must be clear on when and how force and firearms may be used, specifying that security personnel are permitted to use force only as a matter of last resort and only for preventive and defensive purposes in proportion to the threat, and in a manner that respect human rights (see paragraph 32). Security personnel should be instructed to exercise

restraint and caution, clearly prioritizing prevention of injuries or fatalities and peaceful resolution of disputes. The use of firearms should be exceptional. In developing instructions, clients or private security contractors supplying security personnel to the client should also be guided by international standards, such as relevant international law enforcement principles (e.g. the UN Code of Conduct for Law Enforcement Officials and the UN Basic Principles on the Use of Force and Firearms by Law Enforcement Officials), international humanitarian law and human rights law. The commitment to appropriate conduct should be communicated as terms of employment and, where possible, included in contracts of employment or engagement for security personnel or firms, and reinforced through periodic professional training.

29. Steps taken for the appropriate conduct of security personnel should be based on the principle that providing security and respecting human rights can and should be consistent. For example, any security personnel who interact with workers should not harass or intimidate workers exercising their rights in accordance with Performance Standard 2. Workers and community members should not be subject to discriminatory treatment. If community members decide to associate, assemble and speak out in opposition to the project, the client and any security personnel who interact with them should respect the right of the local communities to do so. The instructions for security personnel should also make clear that arbitrary or abusive use of force is prohibited.

30. Clients should be clear about not only how security is provided for its operations but also who provides security. The client must be diligent in its choice of security personnel and in regularly supervising the manner in which the security function is performed. If employing or engaging any security personnel, the client should make reasonable inquiries to investigate the employment record and other available records, including any criminal record, of individuals or firms and should refuse to employ or use any individuals or companies that have been credibly alleged to have abused or violated human rights in the past. Clients should use only security professionals who are and continue to be adequately trained. Any firearms and ammunition issued should be licensed, recorded, stored securely, marked and disposed of appropriately.

31. In line with the Performance Standards' emphasis on prevention and avoidance of risk to the community, the client should record and investigate security incidents to identify any necessary corrective or preventive actions for continuing security operations. To promote accountability, the client (or other appropriate party such as the security contractor) should take corrective and/or disciplinary action to prevent or avoid a repetition if the incident was not handled according to instructions. Unlawful acts should be reported to the appropriate authorities (bearing in mind that clients may have to use their judgment about reporting infractions if they have legitimate concerns about treatment of persons in custody). Clients should not impede or interfere with efforts by local community members, workers or others to access administrative or other legal remedies to address concerns about security activities or personnel. The grievance mechanism required under Performance Standard 1 provides another avenue to address concerns about security activities or personnel.

32. There may be cases where the government decides to deploy public security forces to protect a client's operations. Governments have the primary responsibility for maintaining law and order and the decision-making authority with respect to deployments. Nonetheless clients whose assets are being protected by public security forces have an interest in encouraging those forces to behave consistently with the requirements and principles set out above in order to promote and maintain good relations with the community (bearing in mind that public security forces may be unwilling to accept restrictions on their ability to use offensive force where they consider necessary). Clients are expected to communicate their principles of conduct to the public security forces, and express their desire that security be provided in a manner consistent with those standards by personnel with adequate and effective training. Where public security forces are deployed, it will be particularly important for the client and the community to understand the purpose and general rules of engagement of those forces. The client should request that the government make as much information available as possible about the arrangements, subject to overriding safety and security needs. If clients are required or requested to provide equipment to public security forces (which can range from transport equipment to lethal equipment), and if the option of declining the request is not available or desirable, clients should try to implement what restrictions or controls are necessary and possible under the circumstances to prevent misappropriation or use of the equipment in a manner that is not consistent with the requirements and principles set out above.

Annex 3: Voluntary Principles on Security and Human Rights

In 2000 the governments of the United States, the United Kingdom, the Netherlands and Norway, companies in the extractive and energy sectors, along with non-governmental organizations began engaging in a dialogue on security and human rights. Consequently, a set of voluntary principles to guide companies in maintaining the safety and security of their operations within an operating framework that ensures respect for human rights and fundamental freedoms was developed leading to the announcement of the Voluntary Principles on Security and Human Rights (VPs).

The VPs provide guidance on risk assessment, along with interactions between companies and private and public security agencies.

In relation to risk assessment, the VPs point out that the ability to assess accurately risks present in a company's operating environment is critical to the security of personnel, local communities and assets; the success of the Company's short and long-term operations; and to the promotion and protection of human rights. The VPs outline a number of factors which effective risk assessments should consider, including:

- *Conflict analysis.* Identification of and understanding the root causes and nature of local conflicts, as well as the level of adherence to human rights and international humanitarian law standards by key actors, can be instructive for the development of strategies for managing relations between the company, local communities, company employees and their unions, and host governments. Risk assessments should also consider the potential for future conflicts.
- *Identification of security risks.* Security risks can result from political, economic, civil or social factors. Moreover, certain personnel and assets may be at greater risk than others. Identification of security risks allows a company to take measures to minimize risk and to assess whether Company actions may heighten risk.
- *Potential for violence.* Depending on the environment, violence can be widespread or limited to particular regions, and it can develop with little or no warning. Civil society, home and host government representatives, and other sources should be consulted to identify risks presented by the potential for violence. Risk assessments should examine patterns of violence in areas of Company operations for educational, predictive, and preventative purposes.
- *Human rights records.* Risk assessments should consider the available human rights records of public security forces, paramilitaries, local and national law enforcement, as well as the reputation of private security. Awareness of past abuses and allegations can help companies to avoid recurrences as well as to promote accountability. Also, identification of the capability of the above entities to respond to situations of violence in a lawful manner (i.e., consistent with applicable international standards) allows companies to develop appropriate measures in operating environments.
- *Rule of law.* Risk assessments should consider the local prosecuting authority and judiciary's capacity to hold accountable those responsible for human rights abuses and for those responsible for violations of international humanitarian law in a manner that respects the rights of the accused.
- *Equipment transfers.* Where companies provide equipment (including lethal and non-lethal equipment) to public or private security, they should consider the risk of such transfers, any relevant export licensing requirements, and the feasibility of measures to mitigate foreseeable negative consequences, including adequate controls to prevent misappropriation or diversion of equipment which may lead to human rights abuses. In making risk assessments, companies should consider any relevant past incidents involving previous equipment transfers.

For further detailed information on security arrangements guidance, see www.voluntaryprinciples.org.