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AQ FEATURE

Reducing the Financial Risk of Social Conflict

BY Daniel M. Schydlowsky and Robert C. Thompson

In Peru, banks are key players in mitigating—even preventing—flareups over resource extraction that could threaten the banking

sector.

Read a sidebar on foiled energy projects.

The Peruvian economy has experienced exceptional growth in the past 10 years, with its GDP expanding at an average yearly rate of 6.5 percent. Much of this growth is due to the mining sector, which in 2012 accounted for 9.6 percent of Peru's GDP, 1.3 percent of its employment and 56.9 percent of its exports.

Unfortunately, this robust growth has been accompanied by an increasing epidemic of sometimes violent socioeconomic conflicts between mining enterprises and surrounding communities.

Conflicts in Bagua (2009) and at the Conga mine (2011-2012) cost 33 and 15 lives, respectively. Overall, the number of conflicts reported in 2013 shot up to 216, from 63 in 2004.

Containing the negative fall-out constitutes a major policy challenge for Peru. To help, the Peruvian banking supervisory agency has developed a regulatory framework to ensure that banks and their customers join efforts to reduce the risk of social conflict by engaging with local communities and performing their own due diligence.

Watch an* AQ *video interview with Daniel M. Schydlowsky and Robert C. Thompson below.

Conflicts in the mining sector have adverse economic effects locally, regionally and nationally: the loss of hours of employment, a fall-off in consumer spending, delayed projects, and defaults on loans. Moreover, the effects usually ripple outward from the mining site itself—affecting nearby towns, suppliers and customers of the company, as well as tourism and transportation enterprises in the area. Resource conflict also affects tax revenues and fiscal expenditures of the local governments.

From a financial perspective, a major part of the problem is the collateral damage inflicted on those not actively participating in the conflict; what economists call "externalities." These secondary effects are widespread, typically a multiple of those directly associated with the conflict itself. All of these losses adversely affect banks' balance sheets, as borrowers become unable to meet their financial commitments, investment projects are postponed or cancelled, contracts of various sorts are cancelled, and interest rates rise in response. There are, of course, also associated human rights risks.

The contagion can also skip across mountain ranges, from one ethnic community to another and from one political context to another. If the conflicts bring international notoriety, then credit ratings and interest costs can be affected, with further repercussions on the financial sector and even the national exchequer.

The Leverage Point: Regulators-Banks-Companies

Hear us roar: Protest against Newmont Mining Corporation's Conga project in the Cajamarca region on June 17, 2013. Photo:Enrique Castro-Mendivil/Reuters.

Regulating socioeconomic credit risk due to potential conflicts is a relatively new field in bank regulation. One cannot predict with certainty whether a given project will experience socioeconomic conflict. Indeed, the understanding of how to prevent, mitigate or resolve such conflicts is at an early state of development.

However, some basic precautions can be taken.

As with other types of risks, banks already make provision for conflict-related losses, as required by regulations for all expected losses. But such provisions as they exist today are not sufficient because they imply only writing off bank losses while ignoring the losses that stay on company balance sheets or are absorbed by third parties.

The first step in a financial regulator's attempt to deal with conflicts is to move from a strictly accounting approach to a more proactive, preventive approach. In other words, rather than simply writing off the losses from conflict, banks need to engage in preventing the conflict from happening in the first place; or, failing that, act to contain the conflict and limit the loss.

Prevention and abatement is much more cost-effective. The operative question is how to do it.

Fortunately, there is leverage. Banks listen to their regulators. Companies listen to their bankers. If the bank regulators spread the word that conflict prevention and abatement on the part of the banks will earn points in bank supervision, and, in turn, banks spread the word that customers with conflict prevention and abatement credentials will get priority attention, we have leverage at work.

It is well established that the role of the banking regulator is to keep bank risk down. Socioeconomic conflict raises that risk. So it is the obligation of the regulators to induce bank behavior that will contain and abate social conflict, following a venerable tradition of using regulation to deal with externalities, i.e. with situations where the effects of concentrated events are widespread.

Risk Reduction in Action

Risk mitigation is a highly technical task and not a political intervention. Political prescriptions and reactions need to be reserved for political authorities. Bank supervisors need to concern themselves with risk, especially risk that might affect the stability of the financial system.

Peru is tackling the problem of socioeconomic conflicts from a variety of angles. In 2011, the government passed the *Ley del derecho a la consulta previa a los pueblos indígenas u originarios* (Law on the Right to Prior Consultation with Indigenous Peoples) with the enabling regulations issued in 2012 (see page 54 for more details on the regulations and their application). The *Defensoría del Pueblo* (ombudsman) is engaged in mediating many existing conflicts, as is the high commissioner of the national office for dialogue and sustainability in the prime minister´s office.

Recently, the Superintendency of Banks, Insurance Companies and Pension Fund Administrators has joined these state institutions in seeking to stem the epidemic of social conflict in Peru. Invoking its mandate to protect the financial sector from exposure to excessive risks, the Superintendency is about to issue its "Bank Regulations on Socioeconomic Credit Risk." These regulations were the product of a two-year consultation with banks, mining companies, Peruvian governmental agencies, and other interested stakeholders within and outside Peru.

The regulations will require banks that lend to large mining developments and other large projects (defined as having an overall investment greater than $10 million) with the potential for socioeconomic conflict to engage in a targeted due diligence process.

The first step in that process is to ensure that each lender adopts appropriate policies and procedures, including clear lines of responsibility, to govern its own role in the due diligence process. Then, for each covered new loan, the bank must require the prospective borrower to provide sufficient information about the proposed project to enable the bank to evaluate the principal risk factors for the potential of socioeconomic conflict.

When mining claims are bought and sold, information on the socioeconomic climate at or around the site of the mine is as important as knowing the quality of the ore, because both will determine the profitability of the venture. This involves an assessment of the potential for labor conflict at the site, and an evaluation of the tolerance of local communities for the work to be conducted there.

Since environmental disruption and damages are often cited as a major reason for conflict, in Peru banks will want to obtain the environmental impact study the government requires of such projects. This ensures that banking regulations act in harmony with other regulatory programs, both for the environment and other areas.

The new regulations will require banks to obtain information about the community's past history of conflict. Also important is an assessment of community leaders´ ability to effectively deliver the benefits that the tax revenues generated by the project are intended to fund. If the community does not perceive that it is actually receiving something tangible in return for the adverse impacts it is suffering, then trouble is likely.

Information involving *consulta previa* is also of critical importance in the evaluation. Banks will be required to obtain information about the consultation process that the borrower has developed with the community in the neighborhood of the project.

This involves learning what specific steps have been taken to inform the community about the project and its impacts, and evaluating the extent to which the community's concerns have been addressed. If there is substantial opposition to the project, this must be disclosed.

Another important factor is the capacity of the borrower to manage community relations throughout the life of the project, including a description of its grievance mechanism and its access to experts in dealing with local communities and conflict resolution. Once a bank has the required information in hand, it must assign a risk level to the proposed project's potential to generate socioeconomic conflict, using a four-level scale.

A project that is assigned a high or medium-high risk level is subject to two additional requirements. The first is that a third-party expert must be brought in to evaluate and report on the degree to which the borrower's *consulta previa* actions have been correctly carried out and what the level of acceptance of the project is among the community. This is to ensure that the *consulta previa* has taken place in an effective and useful way—not just as lip service, but as an integral part of reducing the socioeconomic risk affecting a project.

Second, the bank must require the borrower to develop a risk management plan to measure and address the anticipated impact of the project, including full implementation of any mitigation measures. The plans must outline the approach to be taken in any conflict. This includes: policies and procedures; staff trained and prepared to engage in local conflict resolution; and senior executives' commitment to community relations and to the resolution of any potential problems. A critical part of the plan is the development of a proper grievance procedure and a framework for the kind of sustained and credible dialogue that is likely to build mutual trust. This will substantially lower the temperature in a conflict.

All the commitments made by the borrower that emerge from the due diligence process, including permitting obligations, mitigation measures, action plan commitments and the like, must be incorporated into the loan documents, thus making them enforceable by the lender. The banks must then report annually on how borrowers are meeting their commitments and how the conflict abatement measures are working in practice.

For the Good of Social Peace and Banking

Some banks in Peru, particularly those that subscribe to the Equator Principles (a set of voluntary guidelines agreed to by major banks), have already instituted substantial due diligence programs aimed at reducing socioeconomic conflict. The new regulations will ensure a level playing field within the financial sector by requiring banks of all sizes to comply with the same overall framework.

The new regulations build substantially on the Superintendency's existing policies and procedures for dealing with risk management. But they have also been influenced by other sources that reflect decades of experience throughout the world in dealing with socioeconomic issues. Among these are: the Performance Standards on Environmental and Social Stability of the International Finance Corporation, the Guiding Principles on Business and Human Rights adopted by the UN Human Rights Commission, the Equator Principles, the OECD Guidelines for Multinational Enterprises, and various environmental laws dealing with due diligence.

Ongoing discussions in Peru that involve all participants in the conflict abatement process will produce new approaches that can be shared among the banks, borrowers and others. The Superintendency also recognizes that as more practical experience is gained and lessons are learned, it will likely amend the regulations to reflect these new approaches.

The Superintendency also anticipates—and hopes—that Peru's universities and other educational institutions will train a new generation of conflict management professionals who can help the country address this critical issue. Such professionals would include experts in community relations, conflict resolution, mediation, and public finance, among others.

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  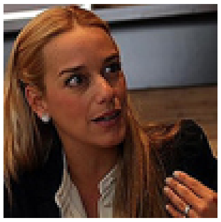

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